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iShares®

Equity Income: Investment and Strategies with iShares ETFs

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Dividends play a key role in generating the total returns of an investment portfolio. Looking at the cumulative performance of the FTSE 100, as at the end of February 2010 dividends have contributed some two thirds of total returns since 1986. During the past two years of market turmoil, lower earnings saw dividend stocks fall out of favour. However, in recent months, there has been a return of investor appetite to higher-yielding equities. This trend should continue as recovery takes hold and earnings grow.

This paper takes a look at dividend yield and dividend yield indices, to see how dividends impact on the overall performance of equity investment portfolios. It then introduces iShares' range of Yield ETFs and gives some background to the various index methodologies used. Lastly, it sets out the difference between dividend yields and distribution yields and how iShares Yield ETFs can be used across a range of investment strategies.

BlackRock

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Income for stocks and equity indices

The total return of an investment portfolio is made up of price appreciation (or depreciation) + dividend income. When compared to price appreciation, dividend income tends to benefit from lower volatility, which makes it more predictable over time.

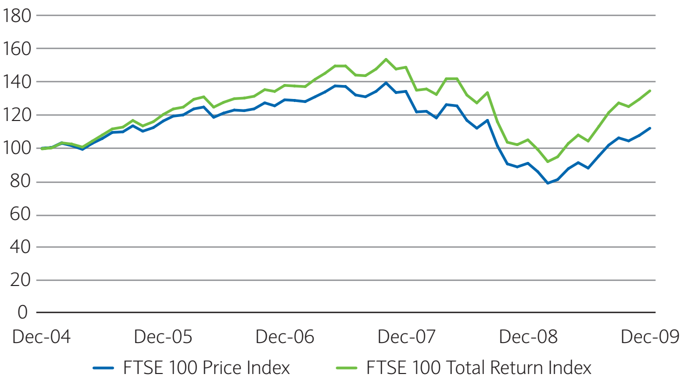
Table 1 shows a comparison between the price index and total return index for the FTSE 100 index. Over the last five years, 65% of the total return index performance was due to dividends paid by the underlying stocks.

Table 1: FTSE 100 Index performance

5 Year Performance	FTSE 100 Price Index	FTSE 100 Total Return Index	Performance difference
Cumulative performance	11.99%	34.87%	22.89%
Annualised performance	2.29%	6.17%	3.88%

Source: Bloomberg. As at 31 December 2009. Performance is calculated in GBP.

Figure 1: FTSE 100 Index performance



Source: Bloomberg. As at 31 December 2009. Performance is calculated in GBP.

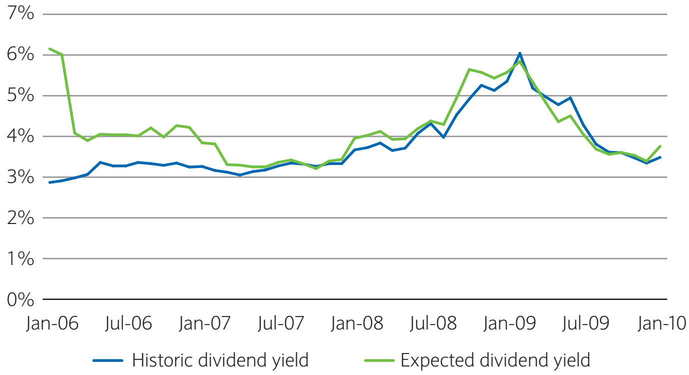
Dividend yield

The dividend yield is used to estimate the dividend payment that will be made on either a single stock or an equity index. Dividend yield is calculated by dividing the sum of dividends paid over the last year by the market value of the stock/index.

There are two types of dividend yield: historical and forecast (or estimated). As the names suggest, historical dividend yield is based on historical dividends, while forecast divided yield is based on the forecast dividend payments over the coming year.

Figure 2 shows the evolution of these two measures for the FTSE 100 Index over the past four years. As can be seen from the graph, dividend yields rose over the course of 2008, due to falling equity prices, but then dropped as equity prices began to rise after March 2009.

Figure 2: Historical and forecast (estimated) dividend yield of the FTSE 100 Index



Source: Bloomberg. As at 29 January 2010.

When basing investment decisions on historical dividend yield, investors run the risk of dividends being reduced or omitted in the future. Therefore, dividend indices take into account not only high historical dividend yields of the underlying stocks but also dividend payout ratios which screen for companies with sustainable dividend paying ability. More details on the methodology of different dividend indices can be found in the section below on dividend yield indices.

Compared to bond yields, equity dividend yields can vary substantially over time. Dividend distributions are dependent on a company's earnings and its willingness to distribute these earnings. In addition, dividend yields are also influenced by stock price. This means that even if dividend distributions are expected to remain unchanged, they will be impacted by equity price volatility.

Dividend yield indices

iShares offers a range of dividend yield ETFs based on dividend indices. These ETFs provide all the benefits of dividend investing, combined with the advantages of index investing: diversification, low costs, transparency and market representativeness.

When constructing dividend indices, several factors are normally taken into consideration. As an example, STOXX and Euro STOXX Select Dividend indices screen companies for dividend per share growth and earnings per share ratios as part of their index methodology.

Index screening for the DivDAX® concerns one-year historic dividend yields. All the stocks included stem from the DAX® index universe and are then screened according to liquidity, market capitalisation and turnover parameters.

For the FTSE UK Dividend Plus Index, forecast (estimated) dividend yields are taken into account. In particular, only stocks with positive available forecast dividends are included in the index. The dividend data is based on a one-year dividend per share (DPS) forecast (excluding capital repayments and special dividends) sourced from Markit. The dividend yields are then calculated by dividing the forecast dividend by the underlying stock price at the cut-off date. Table 2 shows in more detail some of the specific index methodologies used.

Different index providers use various screening and weighting methodologies for dividend indices. For example, MSCI High Yield indices screen not only for zero or positive five-year DPS growth, but also require that the dividend yield is at least 30% higher than the relevant parent index yield. In addition, MSCI indices are market capitalisation weighted, which differ from the STOXX and Dow Jones indices that are dividend yield-weighted.

Table 2: Index methodologies

Index Name	Dividend per share growth	Dividend to earnings per share ratio	Historical dividend yield	Forecast (estimated) dividend yield	Liquidity screening	Index weighting method
Euro STOXX® Select Dividend 30 Index	Zero or positive over the last four out of five years	Positive, less or equal to 60%				Based on net dividend yield
STOXX® Select Dividend 30 Index	Zero or positive over the last four out of five years	Positive, less or equal to 60%				Based on net dividend yield
STOXX® Global Select Dividend 100 Index	Zero or positive over the last four out of five years	Positive, less or equal to 60%/80%				Based on net dividend yield
Dow Jones U.S. Select Dividend Index	Zero or positive over the last five years	Positive, less or equal to 60%			Yes, trading volume criteria	Based on dividend yield
Dow Jones Asia Pacific Select Dividend 30 Index	Zero or positive over the last three years	Positive, less or equal to 85%				Based on dividend yield
DivDAX® Index			15 stocks out of 30 DAX® Index stocks with the highest one-year dividend yield		Yes, trading volume, in addition to market capitalisation and turnover data	Based on free float market capitalisation
FTSE UK Dividend Plus Index				Positive one year forecast (estimated) dividend yield	Yes, trading volume criteria	Based on forecast/ (estimated) dividend yield

Source: STOXX, Dow Jones, Deutsche Boerse, FTSE.

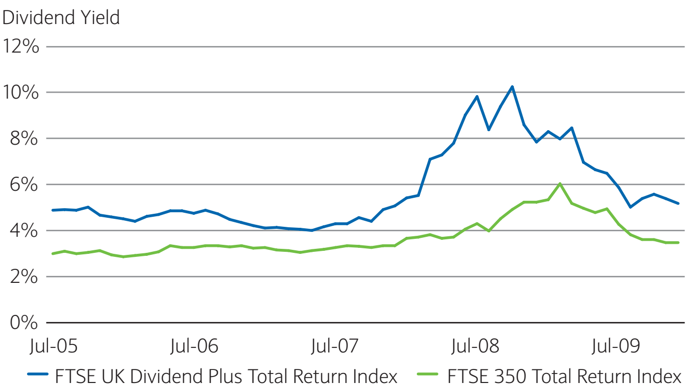
Comparison of dividend index and the respective parent benchmark

Dividend indices have significantly higher dividend yields than their respective parent indices. Figure 3 shows the difference between the yields on the FTSE UK Dividend Plus Index and the FTSE 350 (total return), which has averaged almost 2% over the last five years. The yield difference has proven relatively consistent over time and reached a peak at the time of the economic downturn in late 2008.

Looking at the historical performance and volatility of the two indices, it can be seen that the dividend index was more volatile (Figure 5) but also delivered outperformance over a ten-year time horizon (Figure 4).

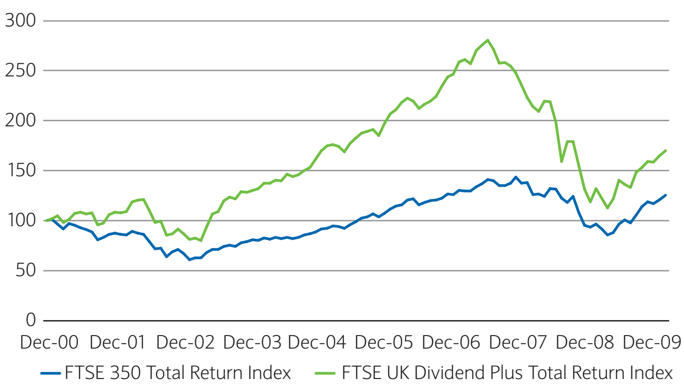
Finally, there was no stable relationship between the parent and the dividend index over time when looking at the historical rolling correlation between the two (Figure 6).

Figure 3: Historic dividend yield



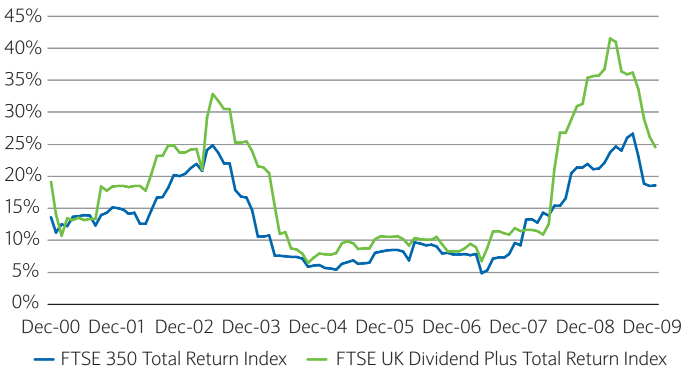
Source: FTSE, Bloomberg. As at 31 December 2009.

Figure 4: Historical performance



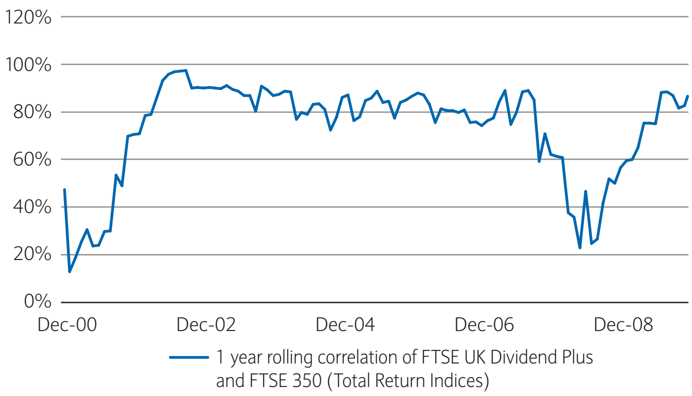
Source: Bloomberg. As at 31 December 2009. Standard deviation is based on monthly total return index values in GBP.

Figure 5: Historical volatility



Source: Bloomberg. As at 31 December 2009. Standard deviation is based on monthly total return index values in GBP.

Figure 6: Historical rolling correlation



Source: Bloomberg. As at 31 December 2009. Correlation is based on monthly total return index values in GBP.

iShares yield ETFs

iShares currently offers a range of dividend yield ETFs to European investors. The funds provide country-specific exposure to high-dividend stocks in Germany, the UK and the US, as well as regional exposure to the Eurozone, Europe, Asia-Pacific and globally. These ETFs aim to track the performance of the benchmarks set out in Table 3.

Table 3: Dividend yield indices tracked by iShares ETFs

	Current Dividend Yield (%)	Number of constituents
Euro STOXX® Select Dividend 30 Index	3.67	30
STOXX® Select Dividend 30 Index	4.09	30
STOXX® Global Select Dividend 100 Index	3.91	100
Dow Jones U.S. Select Dividend Index	4.20	100
Dow Jones Asia Pacific Select Dividend 30 Index	5.39	30
DivDAX® Index	6.55	15
FTSE UK Dividend Plus Index	5.16	50

Source: Dow Jones, STOXX, Deutsche Boerse, FTSE. As at 31 December 2009.

Difference between dividend yield of an index and the distribution yield of an ETF

When estimating future ETF dividend cash flows, investors should remember that there are two key differences between the dividend yield of an index and the distribution yield of the ETF that is tracking that index.

1. The historical fund distribution yield is based on the last 12 months of fund distributions and therefore is NOT EQUAL to the future/expected fund distribution yield

2. The index dividend yield is NOT EQUAL to the fund distribution yield

Both types of yield are calculated using a similar approach and reflect the dividends/distributions of the index/fund over the past 12 months as a percentage of the underlying index's market value/fund's NAV, as at the date shown. However, the following four factors can affect the fund distribution yield and thus contribute to a difference between this and the index dividend yield.

Fees – index dividend yields are not subject to fees, while fund distributions are only paid out after consideration of management fees and other costs, such as the total expense ratio of the fund.

Tax – indices usually assume some standard withholding tax rates, which can be different to the withholding tax rates paid by the ETF.

Reinvestment period – there is a time difference in the reinvestment schedule between the dividend of the index and the distribution by the fund.

Securities Lending – stock lending revenue within the fund will also contribute to the fund distribution value.

The first three factors increase the difference between the fund distribution yield and the index dividend yield. However, revenue from securities lending drives the fund distribution yield up, bringing it closer to the index dividend yield. Indeed, for the iShares MSCI Turkey, a fund that has historically generated significant securities lending revenue, the fund distribution yield is likely to be higher than the dividend yield of the MSCI Turkey Index.

Strategies with yield ETFs

There are different strategies with yield ETFs that can benefit investment portfolios, such as:

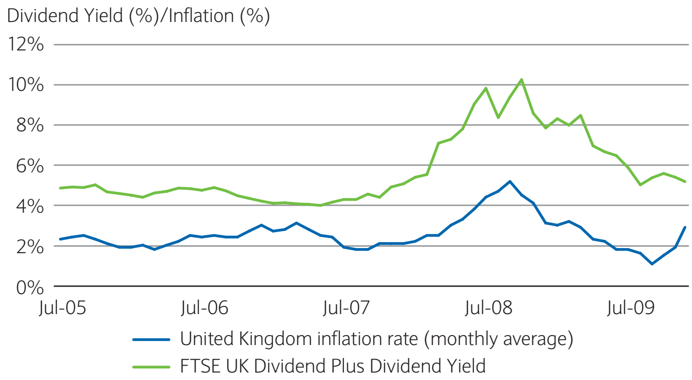
- Offsetting inflation
- Creating regular inflows
- Enhancing portfolio yield
- Reducing portfolio volatility

We look at the first two of these below.

Offsetting inflation

Inflation-linked bonds, property, gold and other commodities are all considered as investments which can offset the negative effect of inflation. High dividend paying stocks can also be used for this purpose. Figure 7 shows the historical relationship between UK inflation as measured by the RPI (Retail Price Index) and the dividend yield of the FTSE UK Dividend Plus Index. Historically, these two parameters have moved in parallel.

Figure 7: Relationship between dividend yield and inflation rate



Source: Bloomberg, FTSE, UK Office for National Statistics. As at 31 December 2009.

Creation of regular inflows

Income strategies can be beneficial for different types of investors. Below is an example of how yield ETFs can benefit an endowment fund.

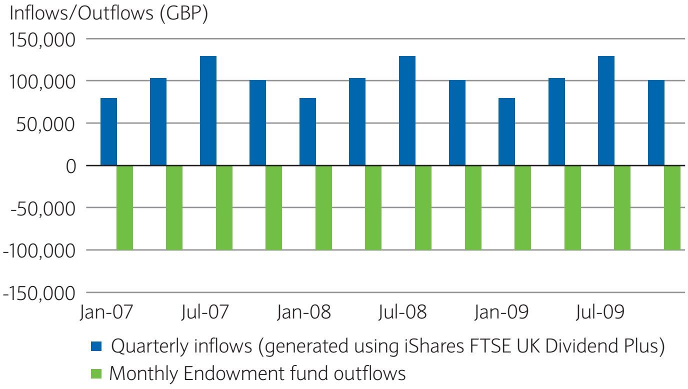
A fund manager expects regular payments to be made out of the fund over the course of the next five years. To generate these regular income streams he is considering yield ETFs.

One major advantage of ETFs compared to single stock exposure is the fact that ETFs replicate underlying indices which in turn follow a comprehensive methodology of stock selection depending on historic, current or forecast dividends. Diversification is another significant advantage compared to single stock exposure. Liquidity and the opportunity to trade ETFs on exchange at tight spreads further benefit investors.

In addition to the regular income that the endowment fund receives from fixed income investments, it would also need monthly income of £100,000. Looking at several yield equity iShares ETFs with regular income distributions the fund manager noticed that the iShares FTSE UK Dividend Plus ETF matches his preferred equity universe. According to the dividend calendar and the ETF distribution table published on www.iShares.com in the fund specific page "Dividend & Yields", this fund has four distributions per year and a 12 month fund distribution yield of 4.23% (as at 26 February 2010).

The fund manager uses fund historical distributions over the last year – published on the iShares website – to estimate the cash flows which can be generated by the ETF, assuming an initial investment of £10,000,000 on 26 February 2010. Figure 8 provides an illustration of the cash flow analysis. Despite the ETF's inflows being more variable due to the seasonal nature of dividend flows, the endowment fund manager is satisfied with matching his cash outflows with the estimated distributions from the ETF and implements the investment.

Figure 8: Cash flow profile

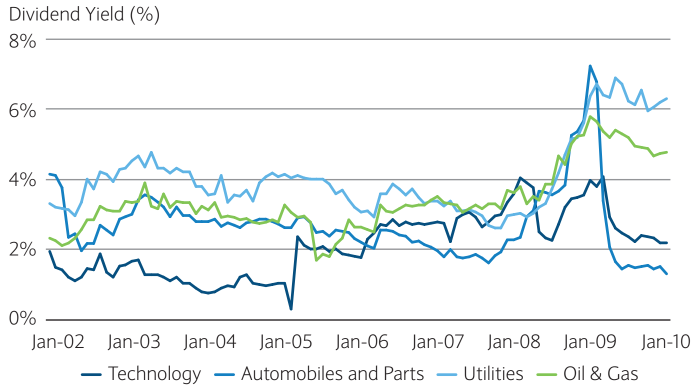


Source: BlackRock. For illustrative purposes only.

Other ways to get exposure to stocks with high dividends

In addition to dividend yield indices, there are other ways to gain exposure to companies with high dividend distributions. These include property indices or defensive stocks (such as utilities). Defensive stocks have traditionally delivered higher dividends than cyclical stocks (such as technology). Figure 9 shows the historical dividend yields of selected defensive and cyclical sector indices.

Figure 9: Dividend yield of selected sector indices



Source: Bloomberg. Historical index dividend yield as at 26 February 2010. Indices used: STOXX Europe 600 Technology, STOXX Europe 600 Automobiles and Parts, STOXX Europe 600 Utilities and STOXX Europe 600 Oil & Gas.

Conclusion

iShares Dividend Yield ETFs can help provide a solution for investors who are seeking regular cash flows from their investment portfolios. In addition, Dividend Yield ETFs can help to offset the negative impact of inflation.

There are various yield measures which can provide investors with an estimate of the cash inflows that can be expected from an ETF investment. iShares provides information on the commonly-used measures of index dividend yields and ETF distribution yields for all European iShares ETFs. However, as dividend payments tend to vary over time, these measures should be used for indicative purposes only. In addition, the dividend yield depends on the price an investor pays when purchasing an ETF.

Investing in high dividend-paying stocks via iShares ETFs makes income investing operationally easy. Investors benefit from the iShares advantages of low cost, transparency and ease of trading.

Contact us

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