



Why focus on dividends?

In this edition of the Aviva Investors Quarterly Review, Glenn Hart, Head of Equities, examines the role of dividends in equity returns over time, and how this is relevant for the current environment.

When investing in equities, investors generally have one or two possible mindsets. They either hope to make a quick profit or look to invest for the long term, expecting high returns, or at least higher than most other asset classes, over time. While it is possible to make money quickly, it is generally an unrealistic expectation and a very high risk strategy, as evidenced by the recent climate.

To illustrate, consider the real return from US equities over the past 150 years. During this period, US equities averaged around 6.2% p.a. above the rate of inflation, or a real return of 6.2%. In other words, if inflation is running at 4.0%, the total equity market return is likely to be around 10.2% over the long term.

While this number is vastly superior to bonds and cash, it is lower than what most people might expect. Not only does a real return of 6% sound modest, it comes with very high volatility, where equity investments can spend long periods earning far less than this.

Naturally, as an active manager of equities, Aviva Investors expects to provide better returns for investors than the market average. However, many investors may ask themselves why invest in equities at all, when the market can fall over 50% and long term expectation is only 6% real? To answer this question let's look at some of the drivers of equity returns.

The advantages of compounding

One of the compelling reasons for investing in equities over the long term is the simple benefit of compounding returns, where seemingly modest returns can compound to remarkable numbers,

which then "pays" investors handsomely for the fact that prices are very volatile. In market jargon, the rate of return an equity investor expects to receive over bonds is known as the equity risk premium.

As an example of the beneficial effect of compounding, Figure 1 below shows that \$1,000 invested in US equities from 1900 to 2008 would compound to \$582,000 (real), whereas that same investment in bonds would be valued at \$9,900 (real) and in bills at \$2,900 (real). These numbers are much larger in nominal dollars.

The role of dividends

A little known fact is that of this real return, only 1.7% related to capital gains, with the balance coming from dividends. Dividends therefore produced a very large proportion of the equity returns generated last century. Justifiably, one could conclude from this that dividends will play a significant role in future successful investment strategies. The logic is even more compelling in Australia due to the benefit of franking credits.

Think about it this way; if inflation averages the Reserve Bank of Australia's target range of 2% to 3%, and a stock is yielding 6% (as many are currently), the share price only has to move modestly or at what an equity investor might generally consider to be a glacial pace, for an investor to receive an acceptable total return. The benefits of franking make this proposition even better when measured against bonds and cash for a tax-paying investor. We, as a fund manager specialising in the active management of Australian equities, would also expect through stock selection and risk management to earn above market returns from this strategy.

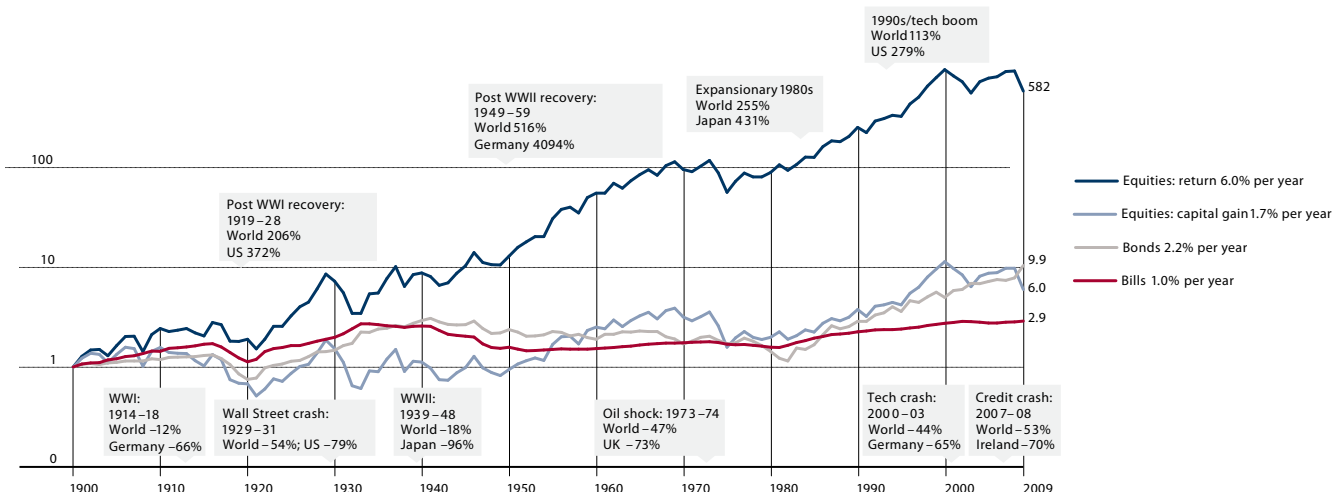


Figure 1 - Cumulative returns on US asset classes (real terms 1900-2008)
 Source: Elroy Dimson, Paul Marsh and Mike Staunton, Credit Suisse Global Investment Returns Sourcebook 2009 and Triumph of the Optimists, Princeton University Press, 2002

To further illustrate, consider the All Ordinaries Index for the five years after the market crash of 1987. Over a four year period from 30 June 1988, the All Ordinaries Index went up only 5%, or a touch over 1% per annum. Occasionally this level of modest index returns over an extended period of time should be expected. If high yielding shares are owned, the overall return is far more compelling once the return from dividends are factored in. A side benefit of this knowledge may also be that investors are less likely to despair and sell out of shares just before one of the vintage market performance eras, which often follow flat periods.

Recent studies of dividends and total equity returns

Conventional market wisdom suggests that companies paying high dividends should have less money left for reinvestment, and therefore have lower growth. Empirical evidence suggests the opposite is in fact true, and that high yielding companies on average, actually experience higher growth and therefore higher rates of return than low yielding companies. This has been supported by a number of recent US studies such as Arnott & Asness (2003) and Zhou & Ruland (2006).

Another research finding undertaken by Rice (2005) suggests that many stocks recover their pre-dividend price shortly after paying a dividend. In other words, it is something akin to receiving the dividend for no give up. Such a finding supports those mentioned above, in that it suggests that the market can, at times, ignore dividends creating a market anomaly and a superior return for investing in higher yielding stocks.

These findings are ignored by many. While it is possible for a share to return many times its initial investment in a short time, these situations are generally outweighed by those stocks that don't work out so well. The key issue here is that high yielding stocks can also earn multiples of their initial investment, although one generally needs to be a bit more patient.

Will current levels of dividends be sustained?

What if dividends are cut, a sceptic might ask? Well, that has already happened. Many large industrial companies have already brought their payout ratios back to reasonable and sustainable levels. For example, companies to have already announced dividend cuts include ANZ, NAB (we expect CBA and WBC will eventually do the same), Wesfarmers, CSR, Boral, Suncorp-Metway, AMP, AXA, IAG, Westfield, virtually all property trusts (REITS), Transurban, ConnectEast, Qantas, Fairfax and Tabcorp. This list is by no means exhaustive, only illustrative. The point is, the market has already substantially cut dividends or factored in reductions due to the changed economic circumstances. The rebasing of dividends should be a substantial way through the process, providing a level of comfort going forward.

A thought for the long term

We are currently experiencing a powerful deflationary market for assets. Fund managers and investors alike, when considering investment strategies, must give thought to the consequences of other market dislocations that may seem improbable now but could potentially occur at some unknown time in the future.

One such possibility is the re-emergence of high inflation. In this instance, seemingly safe but fixed yielding investments could

quickly lose value, where equities with strong balance sheets and pricing power are well placed to preserve the value of your investment and income stream.

Conclusion

From the above research we can conclude that buying high yielding shares provides an actionable investment opportunity for the long term investor. There are also substantial tax advantages to this strategy, and it currently provides a running yield which is all the more attractive given the very low cash rates available through investing in term deposits, cash or government bonds.

Market Review

The domestic equity market ended the quarter positively, with March recording the first monthly rise since August last year. This bounce in March still didn't quite recoup the losses of January and February, as the extremely poor showing in 2008 continued into the new year.

At quarter end, the S&P/ASX 200 Accumulation Index closed down 2.0%, with major global markets suffering a slightly worse fate, with the S&P 500, Nikkei 225 and FTSE 100 all recording losses in excess of 8.5%. Locally, Resources again outperformed the broader market (up 6.0%) as commodity prices recovered, and the banking sector performed well on the back of encouraging profitability statements, gaining 7.7% for the quarter.

The February reporting season was not as dire as the market had expected, implying that a further deterioration in profits has already been factored into prices. Equity issuance was again a common theme during the March quarter, with those to raise capital including IAG, Lend Lease, Qantas, Suncorp-Metway and Tabcorp. There was a significant sector rotation, where a late quarter shift from previously well-performed defensive stocks to cyclical stocks occurred as the market's appetite for risk increased.

Driving the market's performance over the quarter was PanAust (up 235.3%) and Macquarie Communications Infrastructure Group (up 171.0%). Detractors were Hastings Diversified Utilities Fund (down 71.8%), Goodman Group (down 56.1%), and APN News and Media (down 53.2%).

The Reserve Bank of Australia (RBA) continued its easing of monetary policy, albeit only once during the quarter, by 1.0% in February. The official cash rate now stands at 3.0%, following a subsequent further rate cut of 0.25% after April's Board meeting; the lowest level since 1960 and representing a 4.25% fall since September 2008.

Fixed income markets had already rallied hard into calendar year end, buoyed by the continued "flight to safety" and the anticipation of official policy easing. As a result, some modest setbacks occurred through the quarter. The global fixed income market returned 0.64% for the quarter as measured by the Barclays Capital Global Aggregate Bond Index (hedged into A\$).

Below are short commentaries on each Aviva Investors fund, outlining their gross performance and the main contributors to performance.

Australian Equities Fund - the fund returned -1.5% for the March quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index return of -2.0% by 0.5%. The main contributors to performance for the portfolio over the quarter were a zero weighting in QBE Insurance Group and an overweight position in Wesfarmers. Stocks detracting from performance were overweight positions in CSR and Fairfax Media.

Dividend Builder - the fund delivered a return of -1.2% for the quarter, outperforming the Benchmark S&P/ASX 200 Industrials Accumulation Index of -5.6% by 4.4%. Overweight positions in Commonwealth Bank and Wesfarmers positively contributed to performance, while stocks detracting from performance included overweight positions in CSR and Fairfax Media.

Elite Opportunities Fund - the fund returned -0.7% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index return of -2.0% by 1.3%. The main contributors to performance for the portfolio were overweight positions in Rio Tinto and WorleyParsons. Being overweight Asciano Group and AXA Asia Pacific Holdings detracted from performance over the quarter.

High Growth Shares Fund - the fund returned 1.9% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -2.0% by 3.9%. The main stocks to contribute to performance during the March quarter were an overweight position in Rio Tinto and an underweight position in Westfield Group. Main detractors from performance were overweight positions in Fairfax Media and QBE Insurance Group.

Small Companies Fund - the fund delivered a return of 5.1% for the quarter, outperforming the Benchmark S&P/ASX Small Ordinaries Accumulation Index of -2.0% by 7.1%. The main contributors to performance for the portfolio were overweight positions in McMillan Shakespeare and PanAust. Stocks detracting from performance were overweight positions in Centennial Coal Company and Apex Minerals.

Sustainable Investment Fund - the fund returned -1.2% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -2.0% by 0.8%. The main contributors to performance for the portfolio during the March quarter were overweight positions in Oil Search and Rio Tinto. Stocks detracting from performance were overweight positions in Sonic Healthcare and AXA Asia Pacific Holdings.

Listed Property Fund - the fund delivered a return of -19.6% for the quarter, outperforming the Benchmark S&P/ASX 200 A-REIT Accumulation Index of -24.4% by 4.8%. Positively contributing to performance during the quarter were underweight positions in Goodman Group and GPT Group. Stocks detracting from performance were an overweight position in Challenger Diversified Property Group and an underweight position in CFS Retail Property Trust.

Premier Fixed Income Fund - the fund delivered a positive return of 1.2% for the March quarter. This return was ahead of its Benchmark¹ return of 0.3%, and above the cash return of 0.9%. The key driver of the excess return versus the Benchmark was our interest rate management, both duration and yield curve, in both the local and overseas bond components of the fund which added significant value. Also adding value was our allocation to short dated inflation linked bonds and a preference to be overweight Australian versus overseas bonds at various times during the quarter.

1 Benchmark is 75% UBS Australian Composite Bond Index & 25% Barclays Capital Global Aggregate Bond Index (hedged in \$A)

High Yield Fund - the fund delivered a return of -2.4% for the quarter, underperforming its Benchmark² by 3.6% over the quarter. It should be remembered that there is no true benchmark for higher yield products available in Australia. The one used by this product contains a mixture of government, semi-government and high quality investment grade bonds, whereas the High Yield Fund invests in domestic hybrid securities, asset backed and higher yielding corporate bonds. The fund's exposure to a Euro denominated Macquarie Bank sub debt holding was the main detractor to performance.

2 Benchmark is UBS Australia Composite 0-5 Year Index

Income Plus Growth Fund - the fund returned -1.3% for the quarter, outperforming the Benchmark³ by 0.1%. The fund's outperformance was driven by its overweight position to cash relative to equities. In terms of the fund's Australian equities holdings the main contributors to performance during the March quarter were overweight positions in Wesfarmers and Westpac Banking Corporation. Stocks detracting from performance were overweight positions in CSR and Fairfax Media.

3 Benchmark is 40% S&P/ASX200 Industrials Accumulation Index & 60% UBS Australia Composite 0-5 Year Index

Australian Shares Fund* - the fund delivered a return of -1.5% for the quarter, outperforming the Benchmark S&P/ASX 200 Accumulation Index of -2.0% by 0.5%. The main contributors to performance over the quarter were not owning QBE Insurance Group and an overweight position in Wesfarmers. Stocks detracting from performance were overweight positions in CSR and Fairfax Media.

*Closed to new investments

Aviva Investors Investment Returns

Performance to 31 March 2009

| | | 3 mths % | 1 yr % | 2 yrs % p.a. | 3 yrs % p.a. | 4 yrs % p.a. | 5 yrs % p.a. | Since Inception % p.a. |
|--|------------------|----------|--------|-----------------|-----------------|-----------------|-----------------|------------------------------|
| Australian Equities | | | | | | | | |
| Aviva Investors Australian Equities Fund Inception date: 03/07/1995 | Gross Return | -1.5 | -25.3 | -16.1 | -4.7 | 2.9 | 6.7 | 9.8 |
| | Benchmark Return | -2.0 | -29.5 | -19.1 | -7.2 | 1.0 | 5.5 | 8.5 |
| | Excess Return | 0.5 | 4.2 | 3.0 | 2.5 | 1.9 | 1.2 | 1.3 |
| | Net Return | -1.7 | -25.9 | -16.8 | -5.5 | 2.1 | 5.8 | 8.9 |
| Aviva Investors Dividend Builder Inception date: 06/09/2005 | Gross Return | -1.2 | -27.4 | -20.8 | -7.5 | - | - | -3.7 |
| | Benchmark Return | -5.6 | -31.0 | -23.5 | -10.0 | - | - | -5.1 |
| | Excess Return | 4.4 | 3.6 | 2.7 | 2.5 | - | - | 1.4 |
| | Net Return | -1.3 | -27.8 | -21.3 | -8.1 | - | - | -4.3 |
| Aviva Investors Elite Opportunities Fund Inception date: 18/11/2002 | Gross Return | -0.7 | -21.6 | -14.0 | -3.1 | 3.9 | 8.4 | 11.5 |
| | Benchmark Return | -2.0 | -29.5 | -19.1 | -7.2 | 1.0 | 5.5 | 7.4 |
| | Excess Return | 1.3 | 7.9 | 5.1 | 4.1 | 2.9 | 2.9 | 4.1 |
| | Net Return | -0.8 | -22.2 | -14.6 | -3.8 | 3.2 | 7.6 | 10.6 |
| Aviva Investors High Growth Shares Fund Inception date: 07/12/1999 | Gross Return | 1.9 | -21.8 | -10.2 | -1.8 | 4.7 | 8.9 | 12.6 |
| | Benchmark Return | -2.0 | -29.5 | -19.1 | -7.2 | 1.0 | 5.5 | 5.8 |
| | Excess Return | 3.9 | 7.7 | 8.9 | 5.4 | 3.7 | 3.4 | 6.8 |
| | Net Return | 1.1 | -22.9 | -11.6 | -3.2 | 3.5 | 7.5 | 10.7 |
| Aviva Investors Small Companies Fund Inception date: 19/11/1999 | Gross Return | 5.1 | -36.8 | -19.2 | -6.1 | 2.4 | 7.5 | 9.1 |
| | Benchmark Return | -2.0 | -45.8 | -29.2 | -13.8 | -4.3 | 1.1 | 1.8 |
| | Excess Return | 7.1 | 9.0 | 10.0 | 7.7 | 6.7 | 6.4 | 7.3 |
| | Net Return | 4.9 | -37.4 | -20.0 | -7.0 | 1.5 | 6.5 | 8.0 |
| Aviva Investors Sustainable Investment Fund Inception date: 16/02/2006 | Gross Return | -1.2 | -22.8 | -12.8 | -4.7 | - | - | -2.9 |
| | Benchmark Return | -2.0 | -29.7 | -19.2 | -7.3 | - | - | -4.8 |
| | Excess Return | 0.8 | 6.9 | 6.4 | 2.6 | - | - | 1.9 |
| | Net Return | -1.5 | -23.4 | -13.5 | -5.5 | - | - | -3.7 |
| Aviva Investors Australian Shares Fund Inception date: 25/01/2000 | Gross Return | -1.5 | -25.5 | -15.5 | -4.8 | 2.9 | 6.7 | 7.3 |
| | Benchmark Return | -2.0 | -29.5 | -19.1 | -7.2 | 1.0 | 5.5 | 6.0 |
| | Excess Return | 0.5 | 4.0 | 3.6 | 2.4 | 1.9 | 1.2 | 1.3 |
| | Net Return | -1.7 | -26.1 | -16.2 | -5.6 | 2.1 | 5.8 | 6.3 |
| Listed Property | | | | | | | | |
| Aviva Investors Listed Property Fund Inception date: 28/02/1994 | Gross Return | -19.6 | -49.3 | -35.1 | -18.3 | -10.1 | -4.4 | 5.8 |
| | Benchmark Return | -24.4 | -57.6 | -42.8 | -25.1 | -16.1 | -9.9 | 3.7 |
| | Excess Return | 4.8 | 8.3 | 7.7 | 6.8 | 6.0 | 5.5 | 2.1 |
| | Net Return | -19.7 | -49.7 | -35.6 | -18.8 | -10.7 | -5.1 | 5.0 |
| Fixed Income | | | | | | | | |
| Aviva Investors Premier Fixed Income Fund Inception date: 31/05/2000 | Gross Return | 1.2 | 10.0 | 7.3 | 6.5 | 6.5 | 6.5 | 7.0 |
| | Benchmark Return | 0.3 | 11.4 | 8.5 | 7.1 | 6.9 | 6.6 | 6.9 |
| | Excess Return | 0.9 | -1.4 | -1.2 | -0.6 | -0.4 | -0.1 | 0.1 |
| | Net Return | 1.1 | 9.6 | 6.9 | 6.1 | 6.1 | 6.2 | 6.6 |
| Aviva Investors High Yield Fund Inception date: 21/01/2004 | Gross Return | -2.4 | -7.2 | -6.0 | -2.0 | 0.3 | 1.7 | 1.9 |
| | Benchmark Return | 1.2 | 11.7 | 8.3 | 6.9 | 6.8 | 6.4 | 6.5 |
| | Excess Return | -3.6 | -18.9 | -14.3 | -8.9 | -6.5 | -4.7 | -4.6 |
| | Net Return | -2.5 | -7.8 | -6.6 | -2.6 | -0.4 | 1.0 | 1.3 |
| Aviva Investors Income Plus Growth Fund Inception date: 31/03/1998 | Gross Return | -1.3 | -10.7 | -7.9 | -1.5 | 1.6 | 3.4 | 5.9 |
| | Benchmark Return | -1.4 | -7.2 | -5.3 | 0.2 | 3.3 | 4.9 | 6.0 |
| | Excess Return | 0.1 | -3.5 | -2.6 | -1.7 | -1.7 | -1.5 | -0.1 |
| | Net Return | -1.4 | -11.4 | -8.5 | -2.2 | 0.9 | 2.7 | 5.1 |

Disclaimer: All net returns are based on exit to exit unit prices for Professional Selection units, are net of fees and assume the reinvestment of income. Past performance is not a guide to or indication of future performance. At Aviva Investors' discretion, the management and/or performance fee may be partly rebated to professional, sophisticated or wholesale investors. The above information is of a general nature and has been prepared without taking account of your individual investment objectives, financial situation or particular investment needs. It is not intended as financial advice to retail clients. Before making an investment decision, you should consider the appropriateness of the information, having regard to your objectives, financial situation and needs. We recommend you consult with your financial adviser, who can help you determine how best to achieve your financial goals and whether investing in a fund is appropriate for you. Investment in the Aviva Investors Investment Funds will only be made upon receipt of a completed application form from the current PDS, a copy of which can be obtained from Aviva Investors. Aviva Investors Australia Limited ABN 85 066 081 114. AFS Licence No 234483. Level 28 Freshwater Place, 2 Southbank Boulevard, Southbank VIC 3006 GPO Box 2007s, Melbourne 3001 Telephone: (03) 9220 0300 Facsimile: (03) 9220 0333 Email: investorservices.au@avivainvestors.com Website: www.avivainvestors.com.au Part of the international Aviva plc group.