The secret 7 of yield investing

Growing your income for the long-term

July 2013

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Collapsing global interest rates, along with the lowering of future return expectations across most asset classes in the post-GFC world, has seen investing in higher yielding stocks become a very popular strategy in recent times. However, for more than 7 years, the Perennial Value Shares for Income Trust (the Trust) has been delivering both regular, tax-effective income for investors and capital growth. In addition, the Trust has also delivered an impressive return of 7.0% p.a. (before fees) since inception.

In this article, Stephen Bruce, Portfolio Manager of the Perennial Value Shares for Income Trust, shares his insights and outlines how investing in higher yielding stocks can be a very effective strategy, both for investors seeking to generate a growing, tax-effective income stream over the long-term as well as for investors seeking superior total return outcomes. Stephen also looks at some of the pitfalls that should be avoided when investing in higher-yielding stocks.

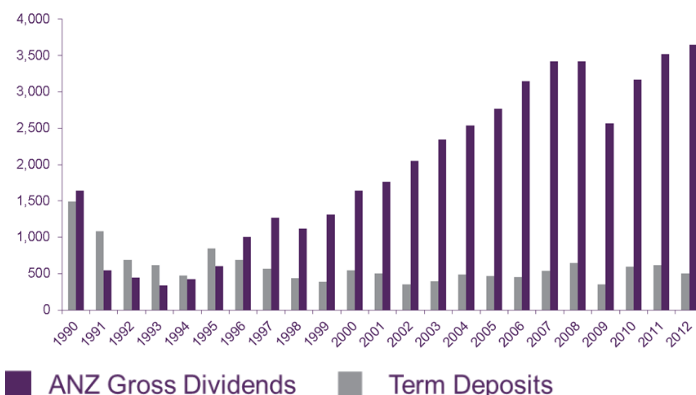
Importance of dividends to total returns

In the equity market, with its focus on capital gains, the role that dividends play in generating total returns is often underappreciated. For example, for the 100 years to December 2012, the All Ordinaries Index returned 11.8% p.a. Of this, 5.6% p.a. was derived from capital gains, while 6.1% p.a. was derived from dividends and their reinvestment. In other words, dividends accounted for 52% of the total return outcome over the period. This is even more significant if you also include the benefit investors receive from franking credits, with the dividends paid by the market being on average franked to around 75% since franking was introduced in 1987.

Using shares to generate income

Dividend-paying shares can also be a very effective source of income for investors. The attraction of using shares for income generation, relative to say term deposits or fixed income investments, is that the dividend stream can be expected to grow over time. This can be shown clearly in the chart below, which compares the dividend income from an investment in ANZ shares to the interest income from an investment in term deposits.

Chart 1: A $10,000 investment in ANZ shares and a 12 month term deposit



Source: Perennial Value. As at 31 December 2012.

While the above example relates to a single stock, the same holds true for the market as a whole. The chart below compares the dividend income from an investment in the All Ordinaries to the interest income from an investment in term deposits.

Chart 2: Overall Market Dividends versus Term Deposits

Income from $1,000 invested in 1982
Dividend income growth: 7.1% p.a. for 30 years

Source: Perennial Value. As at 31 March 2013. For illustrative purposes, Gross Dividend Income assumes 75% franking level for All Ordinaries each year (actual introduction of imputation was in 1987). 2013 yield based on PVM forecasts.

This growth in dividends is due to the fact that dividends are paid out of company profits and, as the economy grows over time, company profits tend to also grow at a similar rate to GDP which has grown at around 7.4% p.a. in nominal terms over the past 30 years. Over this period, dividends from the All Ordinaries have grown at a compound rate of 7.1% p.a.(1). Importantly, this growth in dividends mitigates the impact of inflation which erodes purchasing power of an income stream which does not grow, such as that from a term deposit. The growth rate in dividends compares well to the inflation rate which has run at around 4% p.a. over the same period. By contrast, the annual income derived from an investment in 12 month

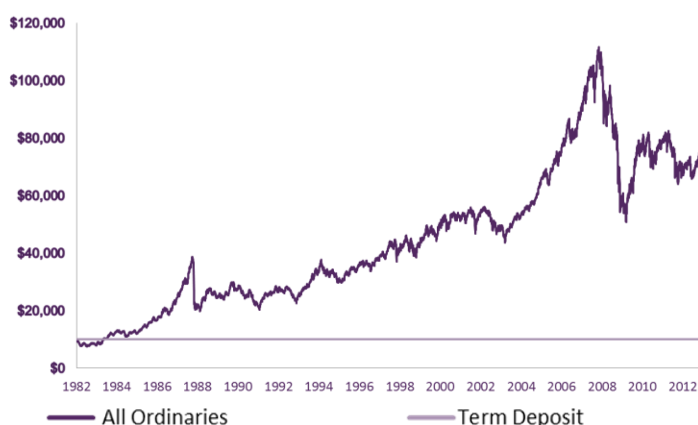
term deposits is currently lower than it was 30 years ago on account of the current low interest rates(2).

This clearly shows that, while at times the nominal dividend yield on the market may be lower than that of say term deposits, over time, the total amount of income generated will likely be significantly higher.

In addition, to a significantly greater income stream, shares offer the potential for capital growth. Over the same 30 year period referred to above, the capital value of an investment in the All Ordinaries has risen by some 660%, or 6.8% p.a., while the value of an investment in term deposits is, of course, unchanged.

Chart 3: Term Deposits versus All Ordinaries

Value of a $10,000 investment



Source: Perennial Value.

Volatility of dividend income

One of the concerns voiced around using dividends as a source of income is the volatility associated with dividend levels from year to year. While dividends on individual stocks and on the market as a whole do go up and down from year to year, there is also significant volatility in the income that can be generated from term deposits. For example, in 2009 during the GFC, dividends were cut across the market by approximately 29% from their 2008 levels. However, the reductions in interest rates by the Reserve Bank of Australia (RBA) has also seen term deposits fall sharply. In fact, an investor rolling a 12 month term deposit rate at the beginning of 2009 would have been offered a rate of only 3.55% - some 45% lower than that 6.45% they would have received in 2008(3). Perennial Value's analysis finds over the last 30 years the volatility of dividend income is very similar to that of term deposit income when measured over rolling 5-year periods(4).

Benefits of investing in high-yielding shares

While the discussion above has dealt with the dividend yield on the overall market, those looking for income may be better served with a portfolio weighted towards higher-yielding stocks. This has the benefit of increasing the level of income generated and also of potentially producing a less volatile portfolio as higher-yielding stocks tend to be larger, more mature businesses and predominantly in the industrials rather than the resources sector.

In addition, various models have shown that strategies which involve investing in shares which have sustainable dividend yields may outperform other strategies, not only on an income basis, but also a total return basis(5). While there are no conclusive reasons as to why this may be the case, some of the possible explanations are as follows. Firstly, stocks with a moderate to high dividend payout ratio may make, on average, better investment decisions. The logic is that if a portion of earnings are paid out to investors, less is available for reinvestment. Given that management will prioritise their investment spend from highest expected return to lowest, this forced capital rationing means that the more marginal investment propositions may not be pursued. An alternative explanation is that by only investing in companies which clearly have a high and sustainable dividend payout, companies with a high level of gearing and therefore risk are avoided. In addition, "blue sky" companies, without a proven business model or a track record or earnings, also screen out. This is particularly important, given that half of investing is avoiding the big bad mistakes.

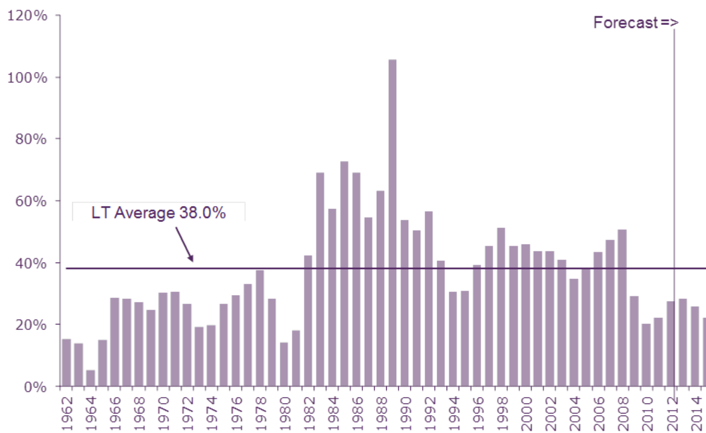
Pitfalls to avoid when investing in high-yielding shares

While there can be clear attractions of investing in higher-yielding stocks, it is critical to avoid the so called "yield traps". These are stocks which look attractive on the basis of very high dividend yield, but where underlying problems in the business exist. In this sense, the name of the game is sustainability. In other words, a stock should only really be considered as possessing a high dividend yield if that dividend yield is sustainable and able to grow. Factors that influence the sustainability of the dividend relate to the earnings outlook for the business. For example, are there adverse structural or cyclical factors on the horizon? Or does the company have an appropriate level of debt? Or could a need for debt reduction result in a reduction in the dividend? It is also very important to ask, "Is the yield a true cash yield or a manufactured yield?" A "true cash yield" is one where the dividend is being paid out of operating cash flow, whereas a "manufactured yield" is one which is paid out of increased debt taken on the back of asset revaluations or similar. This was a strategy employed by many entities in the "easy money" days prior to the GFC where investors were lured into highly-geared and risky vehicles by a supposedly attractive yield. The results were predictable.

Outlook for dividends

In the near term there is, of course, considerable economic uncertainty both domestically with the roll-off of the mining boom, and globally, with concerns around the outlook for most regions. However, Australian companies are generally well placed to continue to grow their dividends going forward. In particular, corporate Australia has been undergoing a period of deleveraging for several years and corporate balance sheets are now in very good shape. This is being augmented by lower interest costs as the cash rate has come down. The chart below shows how low the level of gearing in the market is currently.

Chart 4: Corporate Gearing Levels



Source: Datastream, Goldman Sachs Research estimates.

In addition, corporates have been undertaking significant cost reduction programs in recent times to boost earnings. Finally, in the current lower growth environment, there is less need to invest to expand capacity, thereby increasing the amount of cash available to pay out as dividends. All of these factors above are supportive of moderate dividend growth. This was seen in the most recent reporting season where, 39% of stocks, accounting for 74% of the market capitalisation of the S&P/ASX200 increased their dividend. Companies which maintained or reduced their dividend accounted for only 17% and 9% of the total market capitalisation respectively. This highlights two things, firstly that overall market dividends are growing again post-GFC and, secondly, that it is the larger companies in particular that are in a strong dividend paying position. Consensus forecasts are currently for market dividends to grow approximately 4% in FY13 and 7% in FY14[6]. Longer-term, as the economic issues are worked through, dividend growth should continue as it has historically in-line with growth in the economy.

Footnotes:

(1) Dividend yield on the All Ordinaries, assuming no reinvestment.

(2) RBA data.

(3) RBA data.

(4) Measured as the co-efficient of variation over rolling 5-year periods from 1982 – 2012.

(5) Based on backtesting results of the Goldman Sachs "Sustainable Dividend Model" from 1997 to 2012.

(6) Deutsche Bank.

PERENNIAL VALUE MANAGEMENT

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Stephen has been with Perennial Value for over 13 years. In addition to his Portfolio Management responsibilities, Stephen provides research coverage and analysis of the banking, healthcare, telecommunications, chemical and agricultural sectors for the Perennial Value boutique.

About the Perennial Value Shares for Income Trust (the Trust)

The Trust invests in a portfolio of financially sound companies which demonstrate superior dividend yield characteristics to the overall stock market, with the aim of providing investors with an attractive level of tax effective income.

Since inception, the Trust has not only delivered on its income objectives but also consistently outperformed the S&P/ASX 300 Accumulation Index (the Index).

For the year ended June 2013, the Trust paid a distribution of 4.7 cents per unit. With the addition of the benefit of franking credits, the gross (pre-tax) distribution for the quarter was 6.8 cents per unit. Based on the unit price at the start of the year ($0.84), this equates to a pre-tax income yield of 8.1% for the year.

For the 12 months to 30 June 2013, the Trust delivered a return of 30.1%, outperforming the Index return of 21.9% by 8.2%.

Period to 30 June 2013	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)	Shares for Income Since Inception* (% p.a.)
Perennial Value Shares for Income Trust	30.1%	11.9%	6.3%	6.5%
S&P/ASX 300 Accumulation Index	21.9%	8.2%	2.7%	4.5%
Value Added/Detracted	8.2%	3.7%	3.6%	2.0%

Source: Perennial. *Trust inception date 31 December 2005. Past performance is not reliable indicator of future performance. Gross performance (shown) does not include any applicable management fees.

For a copy of the Product Disclosure Statement for the Perennial Value Share for Income Trust, please contact us on 1300 730 032 or click here.

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