PERENNIAL VALUE MANAGEMENT

Perennial Perspective

The hunt for yield in a low interest rate world

With interest rates on a one year term deposit from the major banks currently ranging between 2.3% to 2.8%, it's no wonder investors and particularly retirees are looking to find higher yielding ways to generate reliable, long term income.

In this environment, I thought it would be helpful to provide a quick refresher on the role of Australian shares as an income source and perhaps more importantly, how we view the current market from a yield perspective as we go about our role of harvesting dividends and franking credits on behalf of our investors.

A quick refresher

The Australian stock market's fantastic historical ability to generate a growing tax-effective income stream for investors through fully-franked dividends is well known. Interestingly, over the last 30 calendar years (to 31 December 2014), the dividend yield (grossed up for franking credits) on the share market is around 6% per annum which is roughly the same as the long-term average 12 month term deposit rate. The key difference, between the two however, is that while the income stream from term deposits varies with interest rates from year to year, the base it is earned off never changes. In contrast, while dividend yields also move around from year to year, the base from which they are earned has grown at around 5% per annum basically in line with the growth in the economy and corporate earnings.

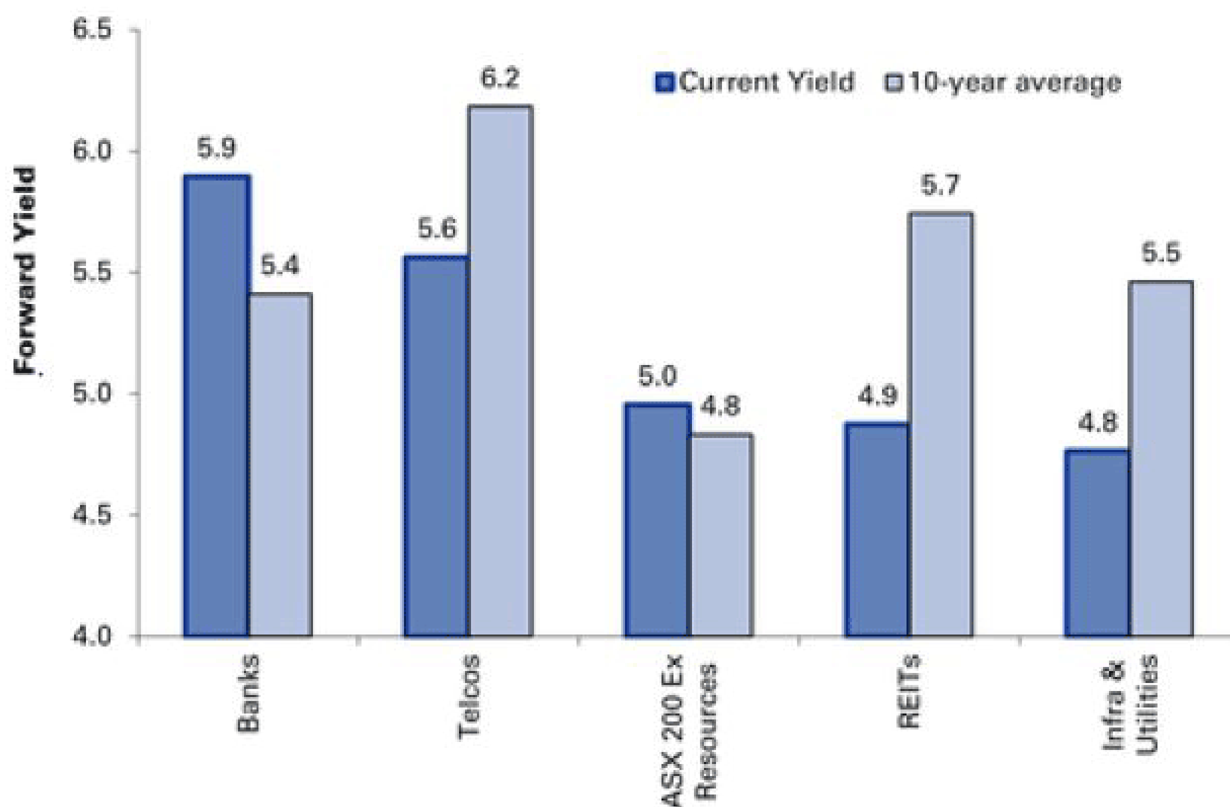
This can make a significant difference over time – If share values continue to grow at say 5% then in 5 years' time the base from which I earn my dividends will have increased by over 25% (around 28% when compounding is allowed for).

Part of our process at Perennial Value has always been an emphasis on stocks with high fully-franked dividend yields. In addition, for nearly a decade we have been running the Perennial Value Shares for Income Trust, which is specifically focussed on generating a high income yield for investors. Since inception in December 2005, this Trust has delivered a pre-tax distribution yield of 7.6% p.a.

Looking at the current share market with a focus on income or dividend yield

From its highs in April the market has fallen some 10.7% to the end of November this year. From a yield perspective however this fall in the capital value has not, in general terms across the market been accompanied with any material fall in earnings or dividend expectations. Consequently the forecasted dividend yields have risen and are looking more attractive, with the expected Financial Year 2016 gross yield of the market forecast to be 6.8% (higher than the long-term average of 6%). This is comprised of banks expected to yield an average of 8.9%, resources an average of 7.8%, and non-bank industrials an average of 4.9%.

In terms of current yields, the differences between the sectors and how each sector compares to it's 10 year average is illustrated below :-



Source: Goldman Sachs Global Investment Research, RPData

So, where in this mix do we see the most "attractive" sources of yield? For us, to buy a stock on the basis of yield, it has to be a yield which is sustainable as well as growing.

Starting with the Banks, there has been significant discussion on the outlook for bank dividends given higher capital requirements etc. In our view, while the rate of earnings and therefore dividend growth for the banks will continue to be subdued compared to the past. However, based on our assessment that there won't be a material deterioration in credit quality, we would be surprised to see the banks cut their dividends. Combined with the improved valuations following recent share price falls, the banks look reasonably attractive to us from this point in time.

Resources, on the other hand, are offering a high yield but it is important to note that, should the current commodity price weakness continue, it is unlikely that the current level of dividends would be sustainable

over the medium-term. We would therefore be cautious about buying resources stocks on the basis of their dividend yields. It is also worth remembering that resources has not traditionally been a “yield” sector in the past.

This leads us to the industrials, which in our view offer the best trade-off between attractive dividend yields which are both sustainable and have the best prospects for growth. Within the industrials, however, given the current high level of risk-aversion, there seems to have been a general “flight to safety” which has manifested itself in the bidding up of the prices for perceived “defensive yield” stocks such as Real Estate Investment Trust’s (REIT’s) and Infrastructure. These groups of stocks are trading at yields which are low relative to both their long-term average and the overall market.

In our view, investors should be wary of being over-exposed to REIT’s and Infrastructure as they have relatively low growth and, in many cases, high levels of gearing and financial engineering, poor cash coverage of dividends and are highly sensitive to increases in interest rates – which will happen at some point. One should also remember what happened to these “defensive yield” stocks in the Global Financial Crisis?

In short these types of stocks have proven not to be very defensive after all.

As a result, we believe there are much better opportunities for yield-seeking investors in other areas of the industrial market, in stocks which have strong balance sheets and better earnings growth prospects in a recovering economy. Examples of stocks held in our portfolios which meet these criteria include AGL Energy (FY16 gross yield 6.3%), AMP (7.1%) and Wesfarmers (7.9%). While the Top-20 has traditionally been a happy yield-hunting ground there are many opportunities further down the market cap scale, such as Harvey Norman (7.7%).

History has shown us that with good stock selection and a long term approach (say a minimum of 5-7 years) a portfolio of consistently higher yielding shares can provide a growing income off a higher capital base with the added attraction of capital growth as the portfolio growths over time.

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This article is an extract from Perennial Perspective.
To read this newsletter in full please click here.

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