

## Why yield matters for investors – particularly now

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### Key points

- In a world of constrained and volatile investment returns, the yield – or cash flow – from an investment will be increasingly important.
- This is particularly the case with shares. In recent decades, investor focus has mainly been on capital growth, but dividends have accounted for more than half of the return delivered by Australian shares since 1900.

### Introduction

The renewed turmoil of the last month or so has provided a reminder that we are in an investment environment of constrained capital growth and increased volatility. This is likely to persist for several years as the US and Europe work through the aftermath of the global financial crisis and the public debt problems they have been lumbered with.

This has several implications for investors. A key one is that the yield an investment provides will be a major component of returns going forward. Focusing on investments that offer a decent and sustainable yield provides greater certainty of return and, for those in retirement, a regular cash flow as well. But what do we mean by yield? Why is it so important? And where can it be found?

### What is yield?

The yield an investment provides is basically its annual cash flow divided by the value of the investment.

- For bank deposits, the yield is simply the interest rate, e.g. bank one-year term deposit rates in Australia are now around 5.7% and so this is the cash flow they will yield over the year ahead.
- For ten-year Australian Government bonds, annual cash payments on the bonds (or coupons) relative to the current price of the bonds provides a yield of around 4.4% right now.
- For residential property, the yield is the annual value of rents as a percentage of the value of the property. This varies depending on the property, but on average in Australian capital cities is about 4.7% for apartments and around 3.5% for houses. Of course these are gross yields – after allowing for costs, net rental yields are around 2.2% for apartments and 1% for houses.
- For unlisted commercial property, yields are typically around 7% or higher.
- For corporate debt, investment grade yields are typically around 7% in Australia and lower quality corporate debt yields are higher.
- For a basket of Australian shares represented by the ASX 200 Index, annual dividend payments are currently running around 4.7% of the value of the shares. Once franking credits are allowed for, this increased to around 6.2%. Of course, this masks a wide range – bank shares are currently trading on dividend yields of around 9.5%, whereas mining shares are trading around a 2.2% dividend yield.

### Yield and total return

The yield an investment provides is important because it forms the building block for its total return. The total return an investment provides is essentially determined by the following.

$$\text{Total return} = \text{yield} + \text{capital growth}$$

For some investments like cash or term deposits, the yield is the only driver of return (assuming there is no default). For fixed income investments it is the main driver – and the only driver if bond investments are held to maturity – but if the bond is sold before then there may be a capital gain or loss if the bond's price has changed.

For shares and property, capital growth (or loss) is of course a key component of return, but dividends or rental income form the base of this return. For example, over the year to June, Australian shares returned 11.7% but this was comprised of 7.1% capital growth and 4.6% dividends. Prior to the early 1960s, most investors focused on yield, particularly in the share market where long-term investors bought stocks for their dividend income. This changed in the 1960s as the focus shifted to capital growth. This trend continued through the disinflation of the 1980s and 1990s as the falling rate of inflation saw dividend yields pushed lower. It was taken to an extreme during the bull market from the mid 1990s as investors chased share prices higher in pursuit of growth (which in turn pushed dividend yields lower) and there was a greater focus on companies retaining earnings to generate future capital growth. Similarly at various times – usually when the market has been strong – real estate investors have only worried about price gains and not rents.

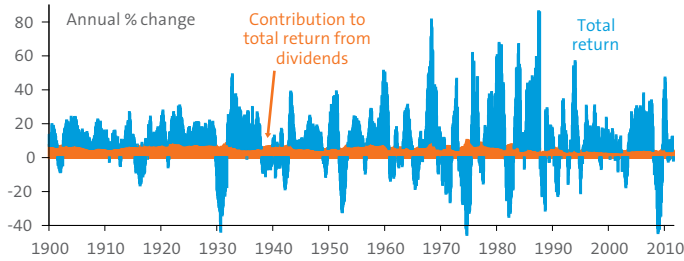
### Why yield matters?

In recent years, yield has started to make a comeback and it is likely this will continue in the years ahead.

Firstly, the constrained and volatile ride from global shares over the last decade, and more recently from Australian shares, has led to increased uncertainty about capital growth from shares. This has also occurred in relation to property markets, particularly Australian residential property, with recent price volatility, high house price to income ratios and the slump in house prices in the US and elsewhere all leading to concerns that house prices might fall sharply going forward. This has seen the investor obsession with speculation and growth fade substantially in relation to both shares and property.

Secondly, a high starting point yield for an investment provides some security during tough and uncertain times. As can be seen in the chart on the following page, dividends provide a relatively stable contribution to the total return from shares over time compared to the year-to-year volatility in capital gains. In fact, while many investors have focused on capital growth, it's worth noting that since 1900 more than half of the 11.7% pa total return from Australian shares has come from dividends (i.e. 6% pa). The importance of dividends is highlighted by the following: \$100 invested in Australian shares in December 1980 would have grown to \$874 by the end of August 2011 based on capital growth alone, but once dividends are allowed for and reinvested along the way this amount rises to \$3,213.

## Aust shares – contribution to return from dividends



Source: Global Financial Data, AMP Capital Investors

In a world of constrained returns from mainstream shares and residential property, the yield or cash flow that investments generate will likely represent a higher proportion of total returns going forward.

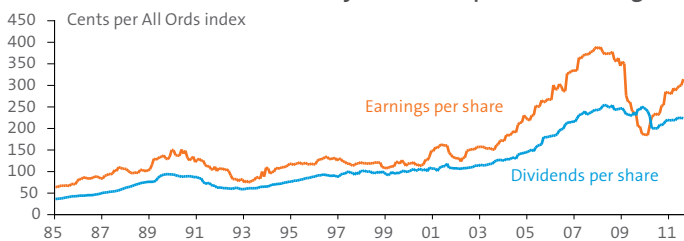
Finally, as baby boomers retire, investor demand for income, and hence yield, will likely be high as the focus shifts to capital preservation and income generation.

## Dividends and shares

Obviously an increased focus on yield will be positive for stocks paying decent dividends. But what about the argument that dividends are irrelevant – that investors should be indifferent as to whether a company pays a dividend or retains the earnings to drive future growth? Although buying stocks for their dividends may seem boring, the evidence suggests higher dividend payouts and higher dividend yields are associated with higher returns over time. This is likely because retained earnings can be wasted, high dividends reflect confidence about future earnings growth and high dividends are a sign that reported earnings are real.

The following chart shows that dividends per share in the Australian share market are relatively smooth compared to earnings per share. Only when earnings fell sharply in the early 1990s and around 2008-09 did dividend payments fall, but by much less than earnings

## Australian dividends are relatively stable compared to earnings



Source: Thomson Financial; AMP Capital Investors

## So where can attractive yields be found?

The following table compares a range of investments, breaking down their medium-term return potential between that derived from current yields (i.e. interest payments, rents, distributions or dividends) and capital growth (based on potential nominal gross domestic product [GDP] growth for shares). Obviously, given the constrained post global financial crisis environment we are now in, there is a greater than normal degree of uncertainty

surrounding the capital growth assumptions. By contrast, the assets providing a higher yield generally come with a higher degree of certainty regarding return.

Assets that currently compare well in terms of yield include: Australian corporate debt, commercial property, Australian equities (once franking credits are accounted for), infrastructure and bank deposits (although term deposit rates have been falling recently).

## Medium-term return projections

	Current yield#	+ Growth	= Return
Unlisted commercial property	7.0	2.5	9.5
Aust. corporate debt	7.0	0.0	7.0
Aust. REITS	6.3	2.5	8.8
Aust. equities	4.7 (6.2*)	5.2	9.9 (11.4*)
Unlisted infrastructure	6.0	4.0	10.0
Global REITS	5.9^	3.3	9.2
Aust. bank five-year deposit rates	5.8	0.0	5.8
Aust. cash	4.7	0.0	4.7
Aust. government bonds	3.9	0.0	3.9
Aust. residential real estate (gross)	3.5	2.0	5.5
Emerging market equities	2.9	7.0	9.9
World equities, local currencies	2.7	4.3	7.0
Asia ex Japan, equities	2.6	8.0	10.6

#Current dividend yield for shares, distribution/rental yields for property and five-year bond yield for bonds. ^Includes forward points from hedging \*With franking credits added in. Source: Bloomberg, REIA, AMP Capital Investors

## But are yields sustainable – what are the pitfalls?

While there is a strong case for investors to focus on investments offering a decent yield, it needs to be acknowledged there is no such thing as a free lunch. When the secular bear market in global shares first commenced last decade, there was an intense investor rush for yield. However, this resulted in investments that provided very high yields when conditions were strong but were in fact high risk – e.g. highly geared sub-prime mortgage debt or heavily leveraged property and infrastructure stocks. So it's critical when investing in yield-based investments that investors focus on opportunities that have a track record of delivering reliable earnings and distribution growth and are not based on significant leverage.

Investors should also realise that just as the higher the return the higher the risk, so too the higher the investment yield the higher the risk.

## Concluding comments

There is no such thing as a sure thing in the investment world, but investments that offer high yet sustainable yields that don't rely on high leverage provide a degree of confidence they will provide a decent return. This is particularly the case while the ongoing hangover from the global financial crisis is resulting in constrained and volatile investment markets.

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1. See R.D. Arnott and C.S. Asnes, "Surprise! Higher Dividends = Higher Earnings Growth", Financial Analysts Journal, Jan/Feb 2003.

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