INTELLIGENT INVESTOR

# What to do when yield becomes expensive

SPECIAL REPORT

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# *Contents*

***John Addis investigates what's today's low-interest rate's means for investors.***

# What to do when yield becomes expensive – Pt 1

For 20 years now, Japanese interest rates haven't risen above 1%. The demand for safes over that period barely budged. Japanese savers weren't getting much in the way of returns but at least they got something.

***Key Points***

- ***Bond market predicts low growth and inflation***
- ***Avoid chasing yield, focus on valuation***
- ***Growth relatively cheaper than yield***

But when rates turned negative earlier this year, demand took off. *The Japan Times* **reports** that Cainz, a home improvement retailer, experienced a 60–70% increase in safe sales since the beginning of the year. Whilst Japanese banks are prepared to live with negative returns, Japanese savers aren't. Weird things happen at the sharp end of '**unconventional monetary policy**'.

In Australia, we have our own version of weird. When we recommended **Sydney Airport** in the ***High yield and safe mini-portfolio*** on 1 Feb 13 (Long Term Buy – $3.18) we did so for the 6.90% yield, expecting (but not banking) on some capital growth. That same argument applied to **ALE Property**, offering a yield of 6.6%, and **BWP Trust**, delivering 5.9%. In hindsight these were salad days – high income stocks with some nice growth prospects at reasonable valuations.

What has occurred in the two years since is astonishing. Sydney Airport's share price has more than doubled, while ALE Property and BWP Trust, both stocks for which the words 'safe and boring' could have been invented, have risen 80% and 46% respectively (see ***Brickbats and bouquets – Part 1***). From Japanese safes to Sydney Airport, the effects of low interest rates on investor behaviour cannot be overstated. Yield is now the sharemarket equivalent of cat nip.

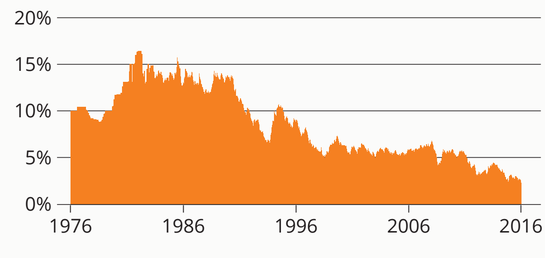
The performance from our high yield mini-portfolio echoes that of our **Equity Income Portfolio**, which returned an average of 15.7% per year in the three years to last December – 6.4% a year ahead of the index. Grabbing an early seat at the front of the yield train paid off. Unfortunately, this is no consolation for investors now scrambling to find an empty carriage.

All this raises a few questions for income investors: What impacts do lower interest rates have on stock valuations? How should that influence my investing mindset? And finally, what income-focused opportunities still exist in a yield-obsessed world? Here and in part two on Friday, we'll attempt to answer these questions.

## Historical lows

When value investors think of rapid price increases in conservative, income-based stocks like BWP Trust and ALE Property, the word 'bubble' is rarely far away. There is, however, a sound basis for these moves. In a world where GDP growth averages, say, 3% a year and inflation hovers around 2%, a 6.6% yield from the like of ALE Property looks okay. But if GDP growth and inflation each fall to 1% a year, 6.6% becomes seriously attractive.

**Chart 1: 10-yr Aust. Govt. Bond yield since 1976 (%)**




Source: Capital IQ

That's essentially what's happened over the past two years. Relatively speaking, dependable yield has been in demand, which, to a large degree, explains why the prices of these stocks and others like them have charged up. 'But in demand relative to what?', you ask.

Here, we can't avoid government bond yields, which define the risk-free rate of return against which other asset classes are measured. In Japan right now, 10-year

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government bonds (ie those set to be repaid in ten years' time) yield −0.08%, 10-year US Treasuries yield +1.85% and 10-year Australian government bonds +2.34%, having fallen from 2.9% earlier in the year.

In these countries and elsewhere, bond yields are at historical lows. That tells us expectations for interest rates are also at historical lows, which in turn tells us that the same is true about expectations of future growth and inflation. This has to be the case, for investors to be happy to get 1.85% a year from 10-year US T-Bills. Against that backdrop, the rapid price increases in the stocks featured in our mini-portfolio makes more sense.

Is the bond market right about low growth and inflation expectations? Well, high sovereign and consumer debt, excess capacity, low wages growth, technology and high savings rates certainly support that view.

Moreover, since the 1980s, interest rates have been in long-term decline and bond yields indicate they're likely to stay that way for many years yet. Investors hoping for the quick return of modest inflation, GDP growth of 4% and interest rates above 6% may well be disappointed.

### Changing expectations

Only recently have investors wrapped their heads around this unsettling possibility. After the GFC, the fear was that quantitative easing would produce excessive inflation. The concern now is a future defined by anaemic growth and deflation. If things do play out this way, it's a game changer for investors accustomed to average, annual double-digit returns.

None of this is to predict an outcome, merely to prepare for the possibility. There are five ways we recommend you do so.

1. **Modify your expectations** – If, like me, you lived through the 1980s when mortgage rates hit 17%, accepting the possibility of near-zero rates for the next decade is hard. But rates have been falling for the last 30 years and at no time has inflation broken out. The bond market inherently accepts this argument but, looking at my portfolio returns over the last decade, I still struggle with it.

   That potentially sows the seeds of a future problem. In a low-inflation, low-growth world, demanding the same kind of returns as we've got in the past could take us up the risk curve to a place we shouldn't really be. If 6% was okay a few years ago, 4% isn't so bad now.

2. **Don't overcomplicate it** – In researching this subject, your analytical team produced a voluminous email chain addressing, amongst other things, bond yields, equity risk premiums and the Gordon growth model. Yes, our interior lives are fascinating. None of this should concern you. If in our valuations we reduce our growth expectations by the same amount as our discount rate, everything ends up the same anyway.

   Investors that require certainty over nominal values in the short term use bonds and cash. That's not what we're about. We can salt away our savings for decades, safe in the knowledge that over long periods shares have either trounced bonds or lost by tiny amounts. Understanding that is far more important than anything else, except perhaps that once you've dived in, you need to be brave enough to see it through.

> “A company isn’t worth more because it choses to distribute profits rather than reinvest them.

3. **Focus on valuation** – The bond market could be wrong. Circumstances can change dramatically, especially over long time frames. But if you’re keeping things simple and focusing on valuation it need not matter, a point we hope to make clear in part two.

4. **Don’t get hung up on where your returns come from** – Investors relying on regular dividend cheques to cover living expenses have less flexibility here but for those that don’t, try and be agnostic about whether your returns come from dividends or capital growth.

   When a clear preference emerges - as is the case with dividends now - mispricings follow, which is why high-yield stocks have been bid up by hungry income investors. This is a mistake. As Gaurav Sodhi says: ‘A company isn’t worth more because it chooses to distribute profits rather than reinvest them. In fact, the opposite case can be made. If we want to compound our money over time, we should allow businesses to reinvest their earnings without a valuation penalty and, equally, be careful about rewarding management for their capital decisions.’

5. **Seek dividend ‘truth’** – In the rush to meet the demands of income-hungry shareholders, some companies have committed to unsustainable dividend policies. **BHP Billiton**, **Origin Energy**, and **ANZ** are just three companies to have cut their dividends. With high payout ratios and earnings growing slowly – or going backwards – more will undoubtedly follow. Two years ago there were stocks with dependable yields at reasonable prices. That is no longer the case. Prices have risen and dependability has declined. There’s a greater risk now that the yield you receive will be lower than the one you based your decision on at the time of purchase.

**Staff members may own securities mentioned in this article.**

***John Addis reveals a list of stocks to satisfy those hungry for yield.***

# What to do when yield becomes expensive – Pt 2

In a world of falling bond rates, the prices of reliable, high yield stocks have risen. That has a number of consequences for investors searching for income.

### *Key Points*

- ***Need to lower yield expectations***
- ***Be wary of historical yields***
- ***Look for coverage by free cash flow***

First, we're quietly being invited to climb up the risk curve. **Woolworths**, for example, currently offers a historical yield of 5.3% and **Origin Energy** 6.1%. Those figures may seem attractive but these stocks carry far more dividend risk than traditional income stocks like **Scentre Group** and **Transurban**.

That brings us to the second point. Over the past two years Scentre and Transurban have risen in price by a third and two-thirds respectively, a consequence of investor appetite rather than business performance. Similar stocks have benefitted from similar price rises. If you want income stability now, you really have to pay for it.

That leaves income investors with a challenging dilemma: should we take on greater share price risk in exchange for reliable dividends? **Part 1** on Monday explained why the answer to that question was a clear 'no'. What follows is an alternative strategy, one based on our **Equity Income Portfolio**, driven by value rather than yield at any price.

Before explaining the nuances, a few points are worth noting. First, if you already own traditional income stocks like **ALE Property**, **Sydney Airport** and **BWP Trust**, purchased at a time when they were on our **Buy List** at far cheaper prices, you have less to worry about. There is no immediate need to sell just because their prices are now much higher. These stocks remain Holds.

Second, if you don't want to do the work of individual stock picking, our **Equity Income Portfolio**, currently yielding 4%, most of which is fully franked, offers a low-effort alternative. It may not sound like much but with bond yields down around the world, 4% is the new 6%. If you want more than that, then additional yield comes booby-trap-wrapped.

A glance down the far right hand column of the income portfolio makes the point. **BHP Billiton** currently yields 5.6%. Woolworths 5.3% and Origin Energy 6.1%. These figures are deceptively attractive, but all three are in

**Table: The 'Okay yield and growth' mini-portfolio**

| COMPANY | PRICE ($) | LATEST RECOMMENDATION | MAX. PORTFOLIO WEIGHTING (%) | FREE CASH FLOW YIELD (%) | DIVIDEND YIELD (%) |
|---|---|---|---|---|---|
| ASX (ASX) | 44.43 | 30 Mar 16 (Buy – $41.14) | 8 | 4.5 | 4.4 |
| COMMONWEALTH BANK (CBA) | 78.77 | 9 May 16 (Hold – $74.67) | 10 | 6.0 | 5.3 |
| GENTRACK GROUP (GTK) | 2.60 | 26 May 16 (Hold – $2.55) | 3 | 6.4 | 4.1 |
| IOOF HOLDINGS (IFL) | 8.24 | 18 May 16 (Buy – $8.48) | 7 | 6.7 | 6.9 |
| MONASH IVF (MVF) | 1.84 | 6 Apr 16 (Hold – $1.74) | 3 | 8.0 | 4.2 |
| PERPETUAL (PPT) | 42.67 | 29 Feb 16 (Buy – $41.52) | 7 | 5.7 | 5.9 |
| PMP LIMITED (PMP) | 0.54 | 7 Mar 16 (Spec Buy – $0.49) | 3 | 17.0 | 5.6 |
| TRADE ME (TME) | 4.37 | 4 May 16 (Hold – $4.30) | 6 | 5.0 | 3.3 |
| VIRTUS HEALTH (VRT) | 7.15 | 6 Apr 16 (Buy – $6.22) | 5 | 5.0 | 3.9 |
| WESTPAC BANK (WBC) | 30.86 | 2 May 16 (Hold – $29.87) | 10 | 6.7 | 6.1 |
| AVERAGE | | | | 7.1 | 5.0 |

> **“ If you want income stability now, you really have to pay for it.**

the process of reducing their annual payouts. Woolies’ assertion that it will continue to target a payout ratio of 70%, for example, is likely to result in a dividend yield of just 4.1%. BHP’s and Origin Energy’s dividends will suffer similar fates.

Although this highlights the perils of relying on historical yields, BHP and Woolies remain good value. Even after their expected dividend reductions, they might still possess a reasonable yield, but uncertainty over their earnings means uncertainty over their dividend. We’ve excluded them from our list for this reason.

## Broadening the lens

To get an adequate return we need to broaden our lens, to our **Growth Portfolio**. There are 24 stocks in our Income Portfolio. Incredibly, the **Growth Portfolio** features 18 of them. The extent of the crossover shows how dependable yield has become expensive relative to growth.

In the middle sit a host of companies that deliver acceptable yield and attractive growth prospects. That’s the basis for the ‘Okay yield and growth’ mini-portfolio shown in Table 1, offering an overall yield of 5% plus the potential for some capital growth.

Whilst this mini-portfolio does not include stocks that require a high price for dividend certainty and those that face the likelihood of a cut, it does find a place for six companies currently on our **Buy List** (although **Virtus** has recently risen past our Buy price). That’s evidence of our emphasis on value, with acceptable yield. Whilst the remainder are only Holds, many are close to our Buy price. If you are attracted to the yields on offer you don’t have to stretch too far to reach them.

## Assessing dividend safety

Of course we can’t say for sure that the companies on this list won’t have to cut their dividends. That’s why we’ve included ten of them and this diversity provides protection against possible cuts from individual stocks. We’ve included free cash flow yield in the table alongside more traditional measures to help you assess the safety of the different dividends. If the free cash flow yield is far higher than the dividend yield, there’s protection against a dividend cut. Where it is lower there’s a significant risk of a cut.

Of the 10 stocks in total, two are banks and three more are in the broader financial category: **IOOF**, **Perpetual** and **ASX**. This too is an expression of value, a reflection of a sector that over the past year or so has fallen a little out of favour. The compensation for the risk is in the price and yield. All the usual caveats apply though: no more than 20% of your portfolio should be allocated to the banks, half that for conservative investors.

The two on our list where the dividend yield exceeds the free cash flow yield are IOOF and Perpetual. IOOF’s dividend is not only above its free cash flow, but also its targeted payout range of 60–90% of underlying net profit. So far the company’s strong balance sheet has enabled it to maintain the dividend in spite of this, but any large acquisitions might provide an excuse for a cut. We would most likely welcome such a move, though, as management has a great track record with acquisitions and, ultimately, what’s needed to support dividends is a return to earnings growth after the **expected flat result this year**.

Perpetual, on a yield of 5.9%, is in a similar position. The current dividend represents about 90% of the (slightly reduced) earnings per share expected for this year, and there is some flexibility in the targeted range of 80–100%. However, earnings are dependent on the level of the sharemarket and ultimately, therefore, so is the dividend.

## Surprises

The list offers a few surprises, with billing software supplier **Gentrack** the stand-out. Its yield of 4.1% is well supported by recurring revenue while new customers should lift profits over time. Most of the company’s customers are utilities with few ever having left. An economic downturn is a risk, as is a reduction in IT spending but it’s hard to see an imminent threat to Gentrack’s yield. Liquidity is also

> **“Please read all the recent research on each company to understand the business and financial risks before you act.**

an issue, so we recommend patience in building a position.

Commercial printer **PMP** is in a rather different situation. The generous dividend of around 5.6% (unfranked) initially looks somewhat vulnerable. But free cash flow far exceeds profit because accounting depreciation is greater than economic depreciation. In fact, profits are just 40% of cash flow. The greater worry is the competitive nature of the sector. The loss of a few large contracts could stop the dividend dead, which is why this recommendation carries a ‘speculative’ label.

As for the remaining stocks – **Monash IVF**, ASX, **Trade Me** and Virtus Health – these are examples of reasonable yields topped up by genuine growth potential. All find a place in our Growth Portfolio growth portfolio for this reason.

The eagle-eyed will notice that the maximum recommended portfolio weighting for all the stocks put together is only 62%, which is why this is a ‘mini-portfolio’. It’s not intended to be used as a full portfolio on its own. If you want the fully fledged variety, you will need to look at our Equity Income Portfolio, which offers more diversity (and a little more growth potential) in return for a somewhat lower yield.

Also, please remember that everyone’s needs are different. There may be only a handful of stocks on this list that meet your particular criteria, or perhaps all do. Whatever the number, please read all the recent research on each company to understand the business and financial risks before you act, and then carefully reflect on the flexibility you may have to swap a little extra yield in exchange for a larger potential capital gain.

*Note: The Intelligent Investor **Equity Income** and **Growth** portfolios own many of the stocks mentioned. You can find out about investing directly in Intelligent Investor and InvestSMART portfolios at **our website.***

**Disclosure: The author owns shares in PMP.**