The importance of decent investment yield – especially in volatile times

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Key points

> Assets with decent and sustainable yields are attractive in an environment of return volatility as they provide greater return certainty.
> Bank term deposit rates have collapsed, so it makes sense to continue to look elsewhere for income.
> Dividends tend to grow and be more stable than term deposits over time. The key for an investor is to work out what matters most: stability in the value of their investment or a higher/more stable income flow.

Introduction

The renewed turmoil in global financial markets on worries about global growth has provided a reminder that we remain in an investment environment of constrained capital growth and high volatility. This has several implications for investors around interest rates and the yield investments provide. First, interest rates are likely to remain low for longer: the Bank of Japan has cut interest rates on excess bank reserves to -0.1%, the ECB is likely to ease further, the Fed is backing away from rate hikes and the RBA is more likely to cut rates than increase them. Second, it reminds us about the importance of the yield an investment provides as opposed to just relying on capital growth. Third, while a fall in the capital value of an investment is unsettling, the cash flow it provides is generally a lot more stable and becomes relatively more attractive during periods of market declines. But what do we mean by yield? Why is it so important? And where can it be found?

What is investment 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, eg bank 1 year term deposit rates in Australia are around 2.4% and so this is the cash flow they will yield in the year ahead.
- For ten year Australian Government bonds, annual cash payments on the bonds (coupons) relative to the current price of the bonds provides a yield of 2.5% right now.
- For residential property the yield is the annual value of rents as a percentage of the value of the property. On average in Australian capital cities it is about 4.2% for apartments and around 2.8% for houses. After allowing for costs, net rental yields are about 2 percentage points lower.
- For unlisted commercial property, yields are around 6% or higher. For infrastructure investment it averages around 5%.
- For a basket of Australian shares represented by the ASX 200 index, annual dividend payments are running around 5.3% of the value of the shares. Once franking credits are allowed for this pushes up to around 6.9%.

Yield and total return

The yield an investment provides forms the building block for its total return, which is essentially determined by the following.

Total return = yield + capital growth

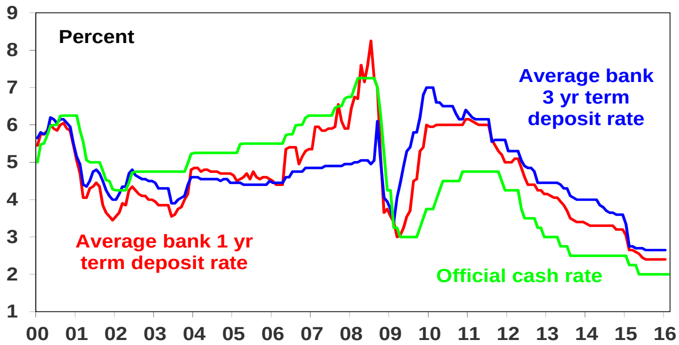
For some investments like term deposits the yield is the only driver of return (assuming there is no default). For fixed interest investments it is the main driver – and the only driver if bond investments are held to maturity – but if the bond is sold before then there may be a capital gain or loss.

For shares, property and infrastructure, capital growth is a key component of return, but dividends or rental income form the base of the total return. Prior to the 1960s most investors focused on yield, particularly in the share market where most were long term investors who bought stocks for dividend income. This changed in the 1960s with the "cult of the equity", as the focus shifted to capital growth. It was pushed further through the bull markets of the 1980s and 1990s. Similarly at various points in the cycle real estate investors have only worried about price gains and not rents.

Why yield matters?

In times like the present a focus on the income an investment provides is important. First, with interest rates set to remain low or fall further, bank deposit rates – already at their lowest in Australia since the 1950s – are likely to remain low or go lower. Our view is that further falls are likely as the RBA is likely to cut official interest rates to 1.75% in the next six months on the back of global uncertainties, sub-par growth and benign inflation. This in turn means an ongoing need to understand and consider alternative sources of yield on offer.

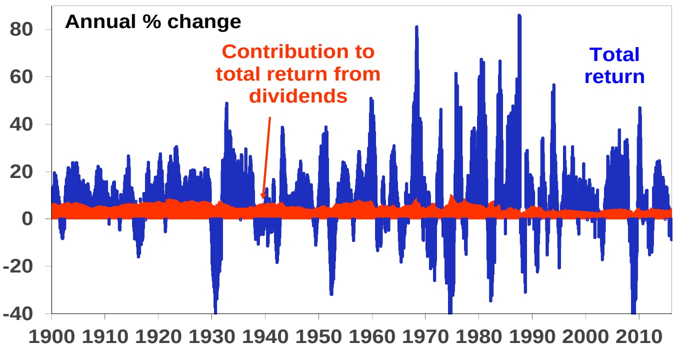
Interest rates to remain low



Source: RBA, AMP Capital

Second, a high and sustainable starting point yield for an investment provides some security during volatile times like the present. For example since 1900 dividends have provided more than half of the 11.6% total return from Australian shares and as can be seen in the next chart their contribution has been stable in contrast to the swings in the capital value of shares.

Aust shares - contribution to return from dividends



Source: Global Financial Data, AMP Capital

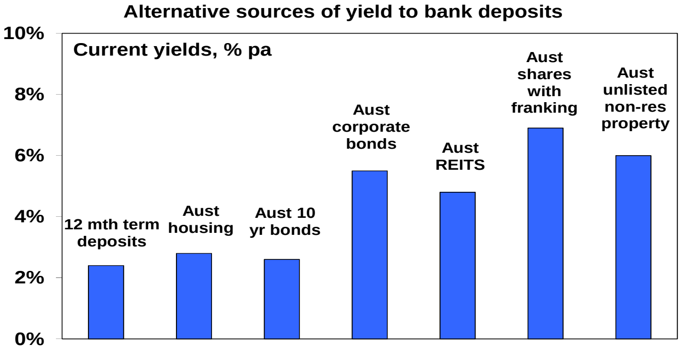
Dividends are relatively smooth over time. Companies hate having to cut them as they know it annoys shareholders so they prefer to keep them sustainable.

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

Alternatives to term deposits for yield

The chart below shows the yield on a range of Australian investments. Yields on global investments tend to be lower.

Alternative sources of yield to bank deposits

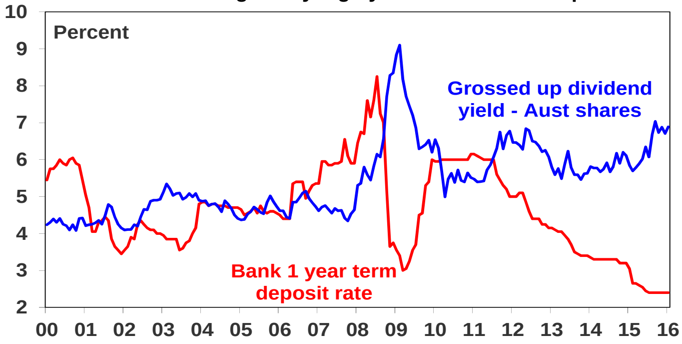


Source: Bloomberg, AMP Capital

All of these yields have fallen over the last few years as interest rates have fallen, but as can be seen several of the alternatives do offer much more attractive yields than term deposits.

- Australian ten year bond yields are now around 2.5%. This will be the return an investor will get if they hold these bonds to maturity. They can generate a higher return if yields continue to fall, but they are already very low. Global bond yields are lower, averaging around 1%.
- After the house price boom of the past twenty years the rental yield on capital city houses is just 2.8% and that on apartments is around 4.2% and even lower after costs.
- Corporate debt is an option for those who want higher yields than term deposits but don't want the volatility of shares. For Australian corporates, investment grade yields are around 6.5% or less and lower quality corporate yields are higher. Sub investment grade corporate bond yields in the US are actually now yielding around 9% as worries partly about loans to energy companies have pushed them higher.
- Following the turmoil of the GFC Australian real estate investment trusts (A-REITs) have refocussed on their core business of managing buildings, collecting rents and passing it on to their investors, with lower gearing. While their distribution yields have declined as rental growth has not kept up with total returns of 15% over the last 5 years, they are still reasonable at 4.8%.
- Unlisted commercial property also offer attractive yields, around 6% for a high quality well diversified mix of buildings, but higher for smaller lower quality property. And it doesn't suffer from the overvaluation of residential property.
- Unlisted infrastructure offers yields of around 5%, underpinned by investments such as toll roads and utilities where demand is relatively stable.
- Australian shares also fare well in the yield stakes. The grossed up dividend yield on Australian shares at around 6.9% is well above term deposit rates meaning shares actually provide a higher income than bank deposits. In fact the gap is now back to levels seen during the GFC.

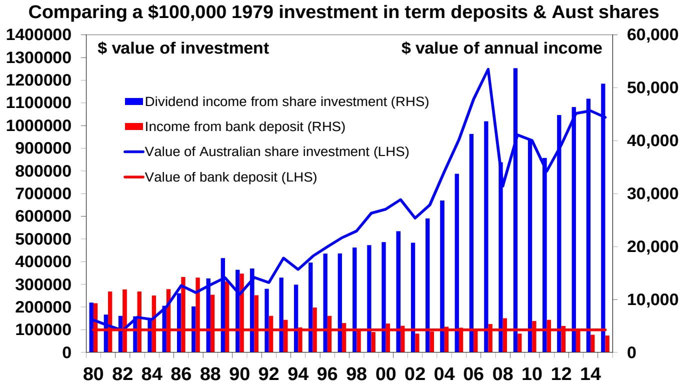
Aust shares offering a very high yield versus bank deposits



Source: Bloomberg, RBA, AMP Capital

Investing in shares of course entails the risk of capital loss. But a way to minimise this risk is to focus on stocks that provide sustainable above average dividend yields as the higher yield provides greater certainty of return. The next chart compares initial $100,000 investments in Australian shares and one year term deposits in December 1979. The term deposit would still be worth $100,000 (red line) and last year would have paid $3200 in interest (red bars). By contrast the $100,000 invested in shares would have grown to $1.04 million (blue line) and would have paid $50,770 in dividends before franking credits (blue bars). The point is that dividends tend to grow over time (because an investment in shares tends to rise in value) and to be relatively stable compared to income from bank deposits which vary with interest rate settings.

Comparing a $100,000 1979 investment in term deposits & Aust shares



Source: RBA, Bloomberg, AMP Capital

Key issues for investors to consider

While there is a strong case for investors to focus on investments offering a decent yield there is no such thing as a free lunch. All of the alternatives come with a risk of volatility in the value of the underlying investment. In the case of shares the key for an investor is to work out whether they want a stable value for their investment in which case bank deposits win hands down or a higher/more stable income flow in which case Australian shares win hands down.

More broadly, in searching for a higher yield investors need to keep their eyes open. It's critical to focus on opportunities that have a track record of delivering reliable earnings and distribution growth and are not based on significant leverage. In other words make sure the yields are sustainable. On this front it might be reasonable to avoid relying on some Australian resources stocks where current dividends look unsustainable unless there is a rapid recovery in commodity prices.

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