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The search for dividend yield in a low growth environment

Investors have faced a low-growth environment with low yield for some time now and this does not appear to be changing anytime soon.

Global economic activity is slowing notably, reflecting a combination of factors affecting the major economies.

Historically investors who look for income in the form of interest payments – also called yield, have looked to fixed income (bonds) and cash (bank deposits) in a normal low growth environment, but with record low interest rates these returns as a measure over inflation have proven harder to find. One of the strategies investors have been forced to look at is to invest into the share market for dividend yield, which is yield paid in the form of a dividend.

This strategy has pushed money into Australia's traditionally high dividend-paying stocks, also driven by the benefit of our franking credit system – which has in-turn been one of the underlying reasons why our share market and many other developed countries share markets have risen strongly since the Global Financial Crisis in 2008.

The share market can be a generator of income, in the form of annual dividends from companies – but not all companies pay a dividend, and it is not compulsory. However, Australian companies pay out a high proportion of earnings as dividends, as measured by the dividend payout ratio. Listed companies have, on average, paid out 65% of their earnings in the form of dividends from 1917 to today.

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Over time, dividends can provide a contribution to the total return earned from shares. In fact, just under half of the long-term return from holding Australian shares comes from the dividend component, looking at the market's "total return" index, the S&P/ASX 200 Accumulation Index.

Over the last 10 years to June 2019, the S&P/ASX 200 Accumulation Index has generated a return of 10.0% a year, versus 5.3% a year for the S&P/ASX 200 price index – meaning that dividends are responsible for 4.7% a year, or just under 50% of the total return.

The importance of dividend yield in stock selection

A benefit for long-term investors who receive the dividend component of the total return, especially for large, mature companies listed on the Australian share market, is that it can be less volatile than the capital growth component, as such companies tend to 'smooth' the payment of dividends through the use of available cash flows, that is independent to the changes in the company's share price from time to time.

However, there are several aspects of the stocks-for-yield strategy that make it one that should be constantly monitored. First, a stock market dividend yield cannot be considered as certain, because the dividend amount is at the discretion of the company, each reporting period. Second, the risk of share-price capital-loss, while holding shares for yield, is always present.

How to find high yield growth stocks

For active stock-pickers with a value orientation – that is, those who like to buy 'unloved' stocks at what they see is good value based on fundamental metrics – opportunities might look like they are thin on the ground, but they are usually present: it might just require a harder look.

The key to this process is to think of the businesses represented by the stocks on the stock exchange. Where short-term market volatility is often driven by macro-economic or geo-political events, the underlying fundamentals of businesses are what essentially drive the returns from the stock market, through the "duration effect" of a company's ability to grow its value over time through the compounding of its cash flow.

From time to time, the stock market will under-value some businesses, and over-value others.

There is little correlation between the performance of individual stock-exchange-listed businesses and economic growth, because each company has specific factors that drive its revenue and profitability.

There are always stocks out-performing the market, and certainly out-performing the economy: whether the investor wants to back these stocks for short-term trading opportunities, or longer-term investment, is up to the investor. But they are always there to be found.

Source: BT