First State Investments

Colonial First State
Global Asset Management

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Investing in a low growth environment.

The Investment Report.

Realindex Investments

The investor's conundrum: Yield in a low growth world

The outlook for investment growth is not particularly favourable in today's market environment: interest rates and investor confidence are near all-time lows, inflation is muted and, GDP growth is anaemic. These conditions are not only prevalent in Australia, but also elsewhere around the world. Unsurprisingly, we find ourselves facing the conundrum of wanting to invest for income and long term capital growth, but not knowing where to do so and achieve a good return for a reasonable level of risk.

This conundrum is particularly troublesome for existing and upcoming retirees who are reliant on their investments to produce a viable income and support a sustainable lifestyle for a number of years. This segment of investors, more than others, need to generate income without depleting their capital base, which they ideally wish to grow as we live increasingly longer lives. Chart 1 demonstrates the declining yield offered by fixed income investments in comparison to the relatively steady yields offered by equity markets. Furthermore, it highlights the additional yield available in Australia through franking credits.

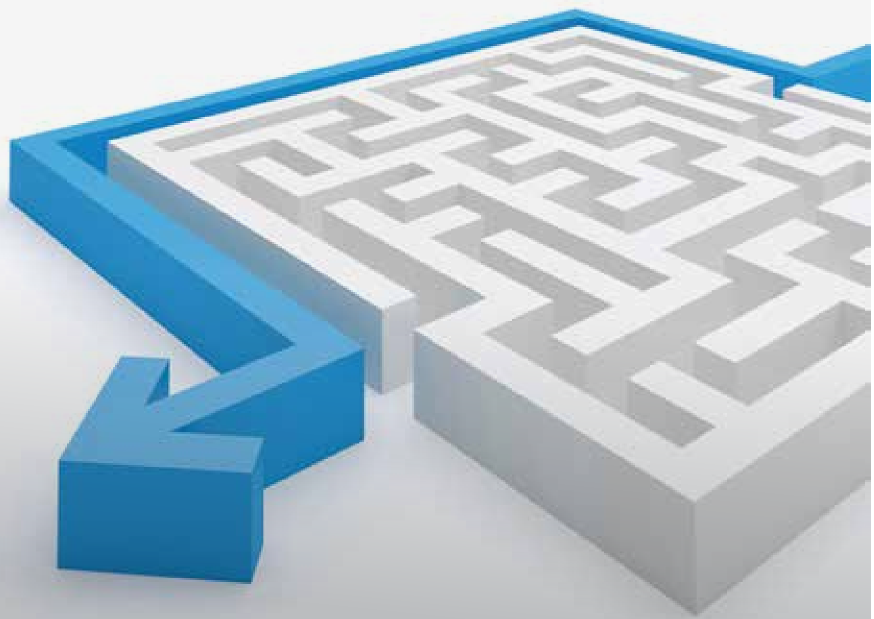
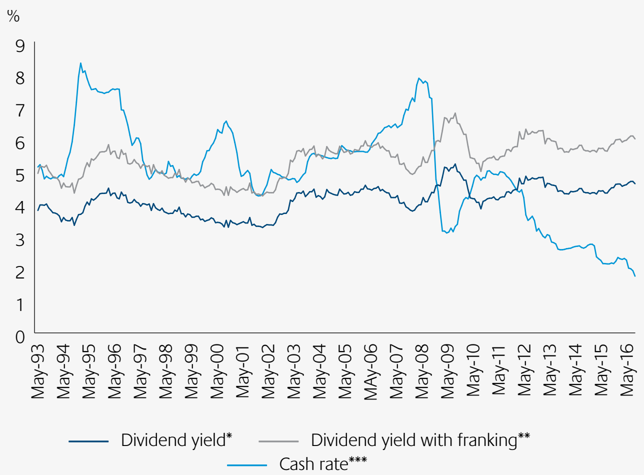


Chart 1: Comparison of cash and equity market yields in Australia



Source: S&P/ASX, RBA, Realindex.

* Trailing 12 month dividend yield for S&P/ASX200

** Approximate fully franked S&P/ASX200 dividend yield for a zero tax paying investor, based on current company tax rate and franking levels

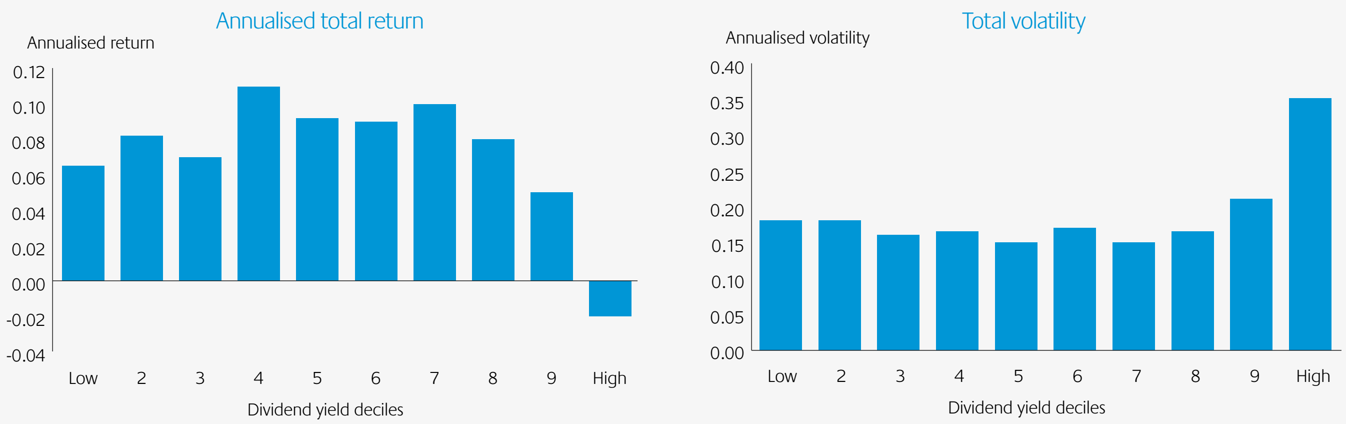
*** Australian 3 month Bank Bill rate

Within the equity market, high yield investments remain an attractive source of income, however there are a number of pitfalls that investors should be aware of when pursuing yield. This paper aims to discuss the nature and characteristics of such pitfalls and offers insights into potential investment techniques to minimise them and assist investors in attaining a sustainable income portfolio throughout many market environments, including low growth.

High yield at the expense of capital growth

The search for yield as a source of income is not a new idea, especially for retirees. However, history has proven that while high yielding stocks might seem attractive from an income perspective, they can come at the expense of total return. Within the Australian equity market, investing in a portfolio of stocks that are selected purely based on the highest historic dividend yield has been an unprofitable strategy over the last 15 years. In particular, Chart 2 demonstrates that the highest yielding stocks have suffered negative total returns, and have significantly higher risk.

Chart 2: Performance characteristics of stocks ranked by yield

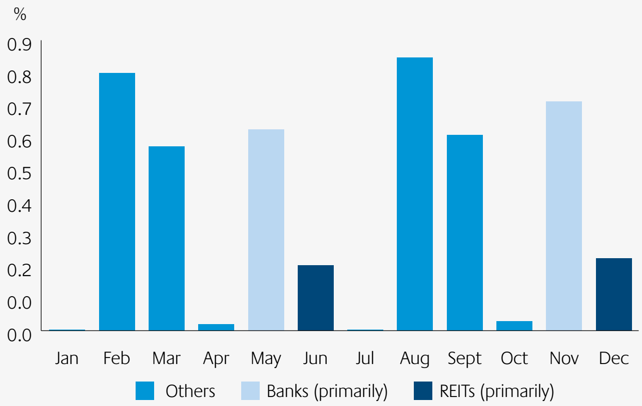


Source: S&P/ASX, FactSet, Realindex.

High yield is cyclical in nature

Investing on the basis of yield alone represents a 'single factor' exposure and there will be times when the yield factor out-performs the broader market and times when it underperforms. History has shown that these periods of underperformance can be prolonged and significant. Sophisticated investors who are incorporating this exposure into a diversified portfolio might be comfortable with this behaviour, however as a stand-alone investment, a single factor strategy will be hostage to this cyclicality. Further to this, dividend yield is highly cyclical in its nature due to concentrated reporting season calendars in the Australian market, as demonstrated in Chart 3. This market dynamic poses two key questions for investors, namely what should I invest in when it is not dividend season; and, which stocks should I choose when it is dividend season? Both decisions are key drivers of the performance profile, from a total return and benchmark relative perspective.

Chart 3: Realised dividend yield throughout the 2015 calendar year

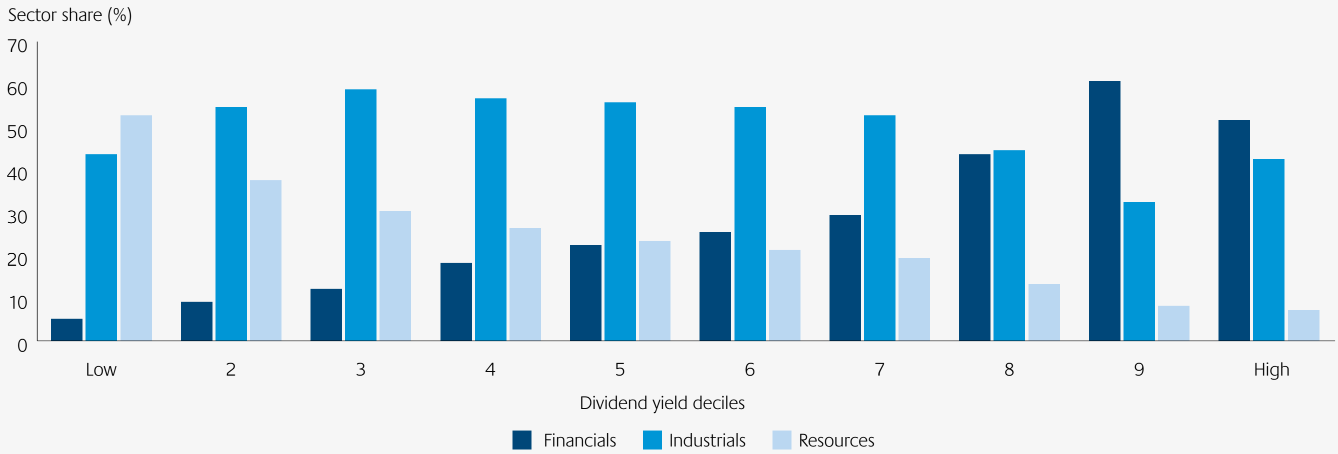


Source: S&P/ASX, Realindex.

High yield is concentrated

Related to this, is the observation that high yielding stocks are concentrated in certain sectors of the market. Chart 4 highlights that the highest yielding stocks tend to be concentrated in the Financials and Industrials sectors, whilst the lowest yielding stocks are more highly concentrated in Resources. This can lead to large sector biases and potential drawdowns due to a lack of diversification in the investment portfolio.

Chart 4: Sector concentration ranked by yield

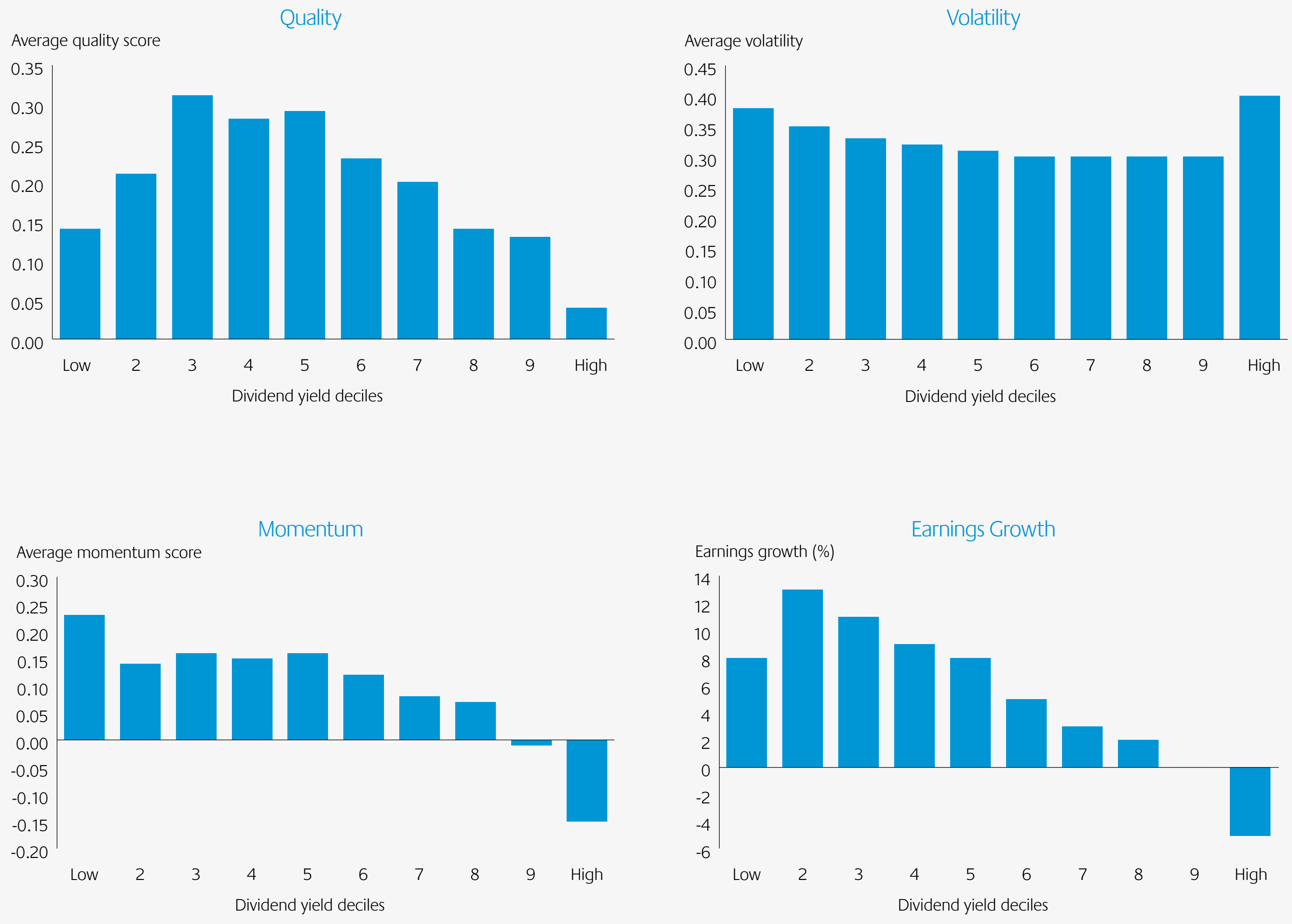


Source: UBS, Aspect.

Understanding the characteristics of high yield

Higher yield at the expense of capital growth, a cyclical return profile and significant sector concentrations and drawdowns relative to the broader market seems far from ideal. Digging a little deeper to understand the potential drivers of underperformance amongst high yielding stocks, we analyse the average characteristics of stocks ranked into deciles by yield, where decile 1 is low yielding stocks and decile 10 high yielding stocks. Chart 5 demonstrates that stocks with the highest yield have the lowest average Quality, Momentum, and Earnings Growth scores, and the highest average Volatilty. This highlights that a naive approach of picking the highest yielding stocks to form a yield oriented portfolio is not sensible or sustainable, leaving investors open to the potential risk in any price-linked valuation measure. Importantly, these results do not indicate that all high yield stocks have these characteristcs, rather that these are the average characteristics. The challenge is to identify the high yielding stocks that have other attractive investment characteristics to replace the poorer quality, price-distressed high yield alternatives.

Chart 5: Factor characteristics of stocks ranked by yield

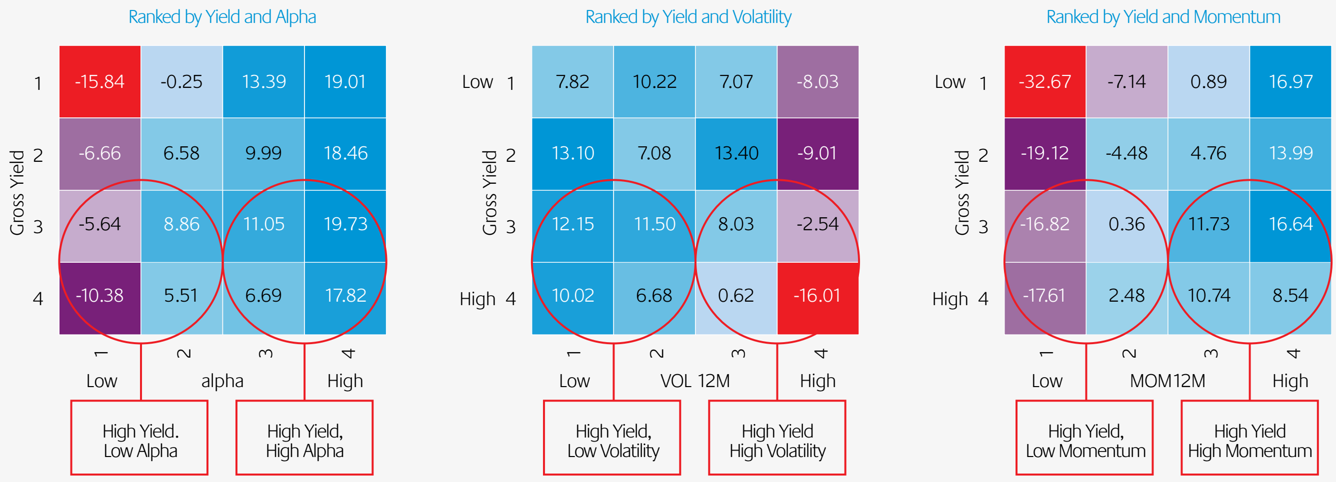


Source: S&P/ASX, FactSet, Realindex.

Protecting high yield

Given these characteristics, is it possible for investors to systematically harvest yield without sacrificing returns? By conditioning on a combination of factors referred to as 'Alpha', our research has shown that avoiding high yielding stocks with poor alpha, high volatility and low momentum, whilst favouring high yielding stocks that have strong alpha, positive momentum and low volatility delivers a better return on average. Chart 6 demonstrates that conditioning yield on these factors, on average, effectively avoids the poorer performing stocks and focuses on the better performing stocks.

Chart 6: Identifying yield traps, annualised return June 2000 to December 2015



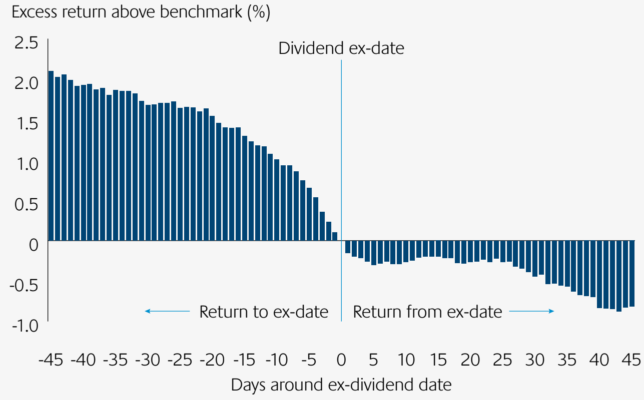
Source: S&P/ASX, FactSet, Realindex.

Boosting yield with franking credits and dividend run-up

Whilst it appears we can avoid yield traps, can we tilt to yield to increase income and return? Dividend run-up is a well-known phenomenon where stocks approaching their ex-dividend date are often observed to outperform the broader market. This behaviour has been noticed in a number of equity markets around the world, including Australia. However, as seen earlier, the Australian market offers additional yield via franking credits which can make a significant difference to the income realised by tax-aware investors due to differences in the taxation rates for companies and some investors. Investors in the retiree-space can benefit substantially by opportunistically investing in franked stocks during dividend season given their low tax rate. In Australia, the requirement to hold stocks for 45 days around their ex-dividend date in order to be eligible for franking credits creates an additional market dynamic that supports the run-up effect. Our research indicates that the run-up pattern extends beyond 45 days before the ex-dividend date for highly franked stocks, while the average run-up window for unfranked stocks is 10 to 20 days.

Amongst all dividends that were paid by stocks in the S&P/ASX 300 over a 15 year time period, the average excess performance of stocks in the 45 days to ex-date (inclusive of the net dividend) is 2% above the S&P/ASX 200 benchmark, as illustrated in Chart 7. The tendency for stocks to underperform the market (on average) after their ex-dividend date is also observed. However, as with any quantitative signal, these trends represent a statistical likelihood and not a guarantee. To achieve the average return a diversified approach is required.

Chart 7: Average excess return around all ASX300 dividend ex-dates 2000 to 2015



Source: S&P/ASX, FactSet, Realindex.

Conquering the conundrum

Investors wanting both income and long-term capital growth need to be careful what they wish for. Poorly constructed portfolios targeting historic trailing yield can be a mirage for investors. They give the illusion of a high income, but this comes at the cost of total return and this illusion is only compounded further in a low growth environment. However, this investment objective is not unobtainable if we are cognisant of the potential pitfalls embedded in high yielding stocks and open to a systematic and diversified investment approach.

By employing systematic strategies which:

1. Target a range of investment factors (not just yield alone);
2. Minimise exposure to stocks that are potential yield traps;
3. Selectively maximise exposure to stocks with attractive yield;
4. Maximise the after-tax benefits of franking and share buybacks; and
5. Control risk through disciplined portfolio construction.

We believe investors can achieve a yield that is significantly higher than the S&P/ASX 200 across the cycle, whilst outperforming the market-cap index over the medium-to-longer term. Now that is something attractive in a low growth environment.