

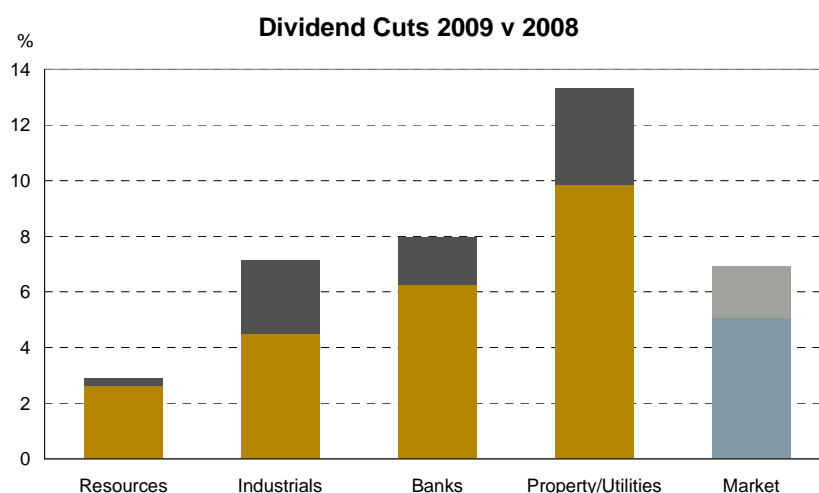
A return to dividend investing

*A cow for her milk
A hen for her eggs
And a stock, by heck,
For her dividends*
(John Burr Williams, 1938)

The forecast dividend yield on the Australian market soared to around 7% last year as the market tumbled. With cuts in dividends over recent months, and some market recovery, this has fallen back to around 5%. Over the long term dividends are the major component of stock returns, despite the occasional distractions of bull market capital gains.¹ Until the late 1950's it was common for dividend yields to exceed bond yields, as has occurred in this bear market. This note looks at whether the market in aggregate is attractive on a yield basis, and the increasing relevance of dividend yield to equity investment.

What has happened to dividends?

The chart below shows the scale of dividend cuts over the past year, in terms of current nominal yield, excluding franking credits. A basic observation is that the Australian market consists of segments with widely varying dividend yields, although franking equalizes the comparison somewhat between property/utilities and the rest of the market. Asset based sectors have been aggressively hit, and bank cuts have been well publicized. However the impact on the market average is dominated by the industrial segment of the market where on average dividends have been cut by a third, as corporate credit has become extremely tight, and the earnings outlook has softened. The market average dividend cut is around a quarter, diluted by the resilient resource sector. In the recession of the early 1990's market dividends fell by around a third which is in line with what has happened this time outside of resources. They took around seven years to recover.



Source: Ankura Capital, IRESS

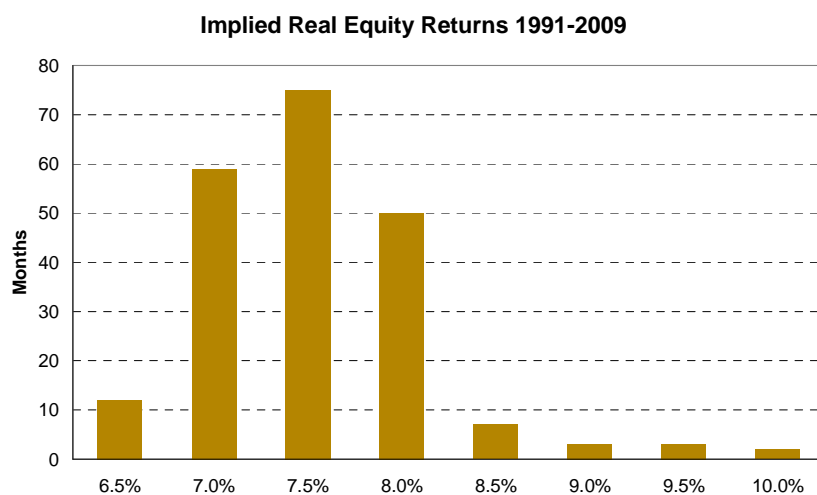
Payout ratios have become more conservative due to tight credit conditions, but may not expand again any time soon. For asset based sectors of property and infrastructure financial engineering of yields has been abandoned in favour of simple cash flow distribution. Banks payout ratios have reverted to more conventional levels of circa 70% of earnings, while industrial stocks have also pulled back towards a more conservative 60%. The resource sector has largely maintained dividends while earnings have retreated so that payout has lifted towards 40%, from closer to 30% over recent years. But over a longer period resource companies have often paid out more than 40% of earnings so current payout levels could be considered conservative for that sector as well. After the adjustments of the past year these payout ratios look sustainable, but dividends still need to withstand any further weakening in corporate profits.

¹ Robert D. Arnott, *Dividends and the Three Dwarfs*, Financial Analysts Journal March/April 2003

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Dividend yield and equity returns

In the seminal work *The Theory of Investment Value* (1938), John Burr Williams derived a simple valuation formula for equities which describes equity returns as the addition of dividend yield and expected dividend growth. The insight is that volatile short-term capital gains simply average out to dividend growth over the long term. The chart below looks at the distribution of expected real equity returns on this basis over the past two decades.



Source: Ankura Capital, ASX, Consensus Economics Inc

Dividend growth expectations are drawn from Consensus Economic Inc regular surveys of long-term GDP forecasts. Over the long-term a common assumption is that corporate profits, and consequently dividends, should grow broadly in line with GDP, but this assumption might now be a little optimistic. The corporate profit share of GDP at 23% is currently high relative to history where the long term average is closer to 15%. Any reversion to earlier levels would imply slower corporate profit growth than GDP. As well we should dilute aggregate corporate profit growth for the effects of new equity investment over time, and there is certainly much of that recently.

Currently the ten year GDP forecast for Australia is 2.6% having declined from 3.6% ten years ago. Of the four market segments referred to above, it is clear that banks and property/infrastructure, which together account for over a third of the market, will struggle to achieve dividend growth in the near-term environment. That is consistent with this moderate aggregate growth outlook for dividends. Other things being equal, dividend yields should move higher to compensate for lower growth. So if we were comfortable historically with a 3.5-4% dividend yield, that neutral range is now arguably 4.5-5%. The current market yield of 5% plus the current long-term real growth forecast of 2.6% sits right on the mode of the above distribution of expected real equity returns. So valuation in terms of dividend yield is neutral.

A fresh investment focus

The market's current yield is not especially attractive because of the perceived change in growth prospects. Gross dividend yields, including franking credits, can reasonably remain above bond yields if the equity risk premium demanded by the market is high relative to expected dividend growth. Without the tailwinds of increasing PE multiples and credit driven economic expansion, equity returns can ultimately rely heavily on dividends. At the stock level the old idea that low dividend payouts correspond to strong earnings growth has been effectively debunked over the last decade². However the ability of companies to distribute is adversely affected by the enduring tight credit conditions, reflected in the avalanche of capital raisings. Attractive companies are those with cashflows that can comfortably meet dividend, interest and capital expenditure requirements. In the current environment we are witnessing strong returns by companies with this characteristic.

² Robert D. Arnott and Asness, Clifford S., *Surprise! Higher Dividends = Higher Earnings Growth*, Financial Analysts Journal Jan/Feb 2003.

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