Quarterly Review

Paying dividends - the chase for equity yield

March 2015

Over the past few years, the strength of investor demand for high yielding shares has been phenomenal, both in Australia and globally. There has clearly been a strong cyclical component to this strong demand for equity yield as short-term interest rates and bond yields have fallen to such low levels. There is also a structural component – the aging population – that could result in investors continuing to favour high dividend yields well into the future.

In this article, Brett McNeill, Portfolio Manager of the Antares Listed Property Fund and Deputy Portfolio Manager of Antares Dividend Builder, discusses the factors that should be considered when investing in equities for yield and compares the current attractiveness of equities relative to other yield bearing investments given the huge rally in yield based stocks in recent years. Investors are now questioning whether the rally in these stocks can continue and, to a large degree, this depends on whether the drivers of yield demand are mainly cyclical (i.e. low interest rates) or structural (i.e. aging population).

The information contained within this article is intended as factual information although we acknowledge that there is a reasonable likelihood of doubt and the information is not intended to imply any recommendation or opinion about a financial product.

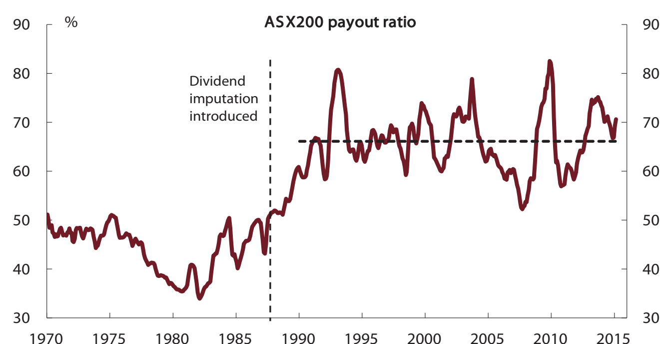
What to consider when investing in equities for yield

The decision to invest in conventional yield investments, such as bonds or term deposits, is usually based on the attractiveness of the yield on offer and the associated risk – i.e. is the yield sufficient to achieve my investment goals and how likely is it that the bond issuer will pay me the promised interest and return my money at the end of the investment period? With equity yield investments, the decision making framework is very similar – i.e. will the company continue to pay (at least) the current level of dividend (dividend sustainability) and how likely is it that I will get my money back when I choose to exit the stock?

So the main factors that need to be considered when investing in equities for yield are those that determine the sustainability of the company's dividend payments and the strength of the business over time. These include:

- **Cash flow generation** – Companies need to achieve solid cash flows in order to pay dividends to investors and it is important to look at the company's future potential for cash flow generation when determining if existing dividend payments are sustainable.
- **Balance sheet** – A company's balance sheet is a window into the true health of the business. Companies with strong balance sheets are more likely to deliver sustainable earnings and income over time.
- **Management quality** – Good quality management with solid experience tend to make good business decisions and this makes it more likely that the company will pay sustainable dividends over time.
- **ESG = Early Signal Generators** – Environmental, social and corporate governance factors can significantly affect corporate cash flow and profitability. Analysing and understanding how ESG factors affect a particular company is necessary to form a realistic view of earnings and dividend sustainability.
- **Dividend payout ratio** – The dividend payout ratio measures the proportion of a company's earnings that are being paid to investors as dividends. Chart 1 (above right) shows the dividend payout ratio for the Australian sharemarket since the 1970s and it clearly illustrates the importance of the dividend payout ratio for yield investors. Australia had a fairly low payout ratio until the introduction of dividend imputation in 1987. Dividend imputation dramatically increased the tax effectiveness of dividends for Australian investors and companies responded to this by increasing the proportion of earnings they paid out as dividends. This dramatic rise in the overall dividend payout ratio of the Australian sharemarket significantly enhanced investors' post-tax returns.

Chart 1: Australian sharemarket dividend payout ratio



Source: Deutsche Bank

The dividend payout ratio is currently around 70% and has been above average for the past three years. This is not surprising as companies are just responding to the record low levels of short-term interest rates and bond yields that are forcing investors to seek out other yield bearing investment opportunities.

When considering equity investments for yield, it is also important to be very careful of "false" yields. For example, the recent trend towards companies increasing their net debt to pay out higher dividends is a worrying development. To be sustainable, dividend payments should be cash flow driven not debt driven. The fact that shareholders are rewarding companies for debt driven dividend payments suggests investors don't want companies to invest for growth. This is similar to what has occurred in the US sharemarket in recent years. Longer-term, this is bound to be problematic. There is a limit to how much any company can borrow to fund dividend payments. Ultimately companies need to grow for them to be able to provide sustainable returns to investors.

Yields compared - how do equities stack up?

Investors globally have been dealing with a "yield problem" for several years now – in short, how do I earn enough yield on my portfolio in an environment of exceptionally low interest rates? Sluggish growth and continued monetary policy easing have pushed developed world interest rates down to such low levels that they are well below dividend yields and barely providing a positive return once tax is taken into account. Table 1 (below) illustrates this low return environment and compares these low interest rates with current equity dividend yields.

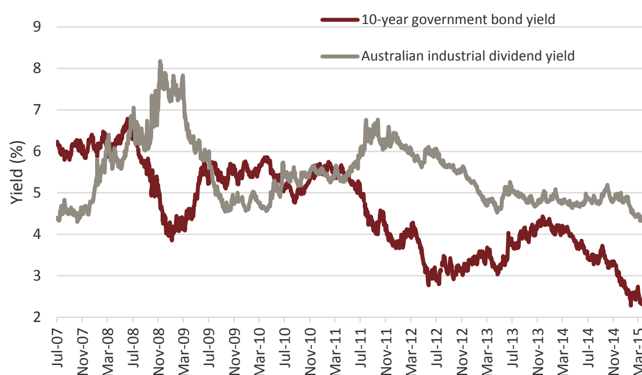
Table 1: Comparing yields on offer

Asset class	Current yield
Australian shares - S&P/ASX 200 Index	4.5%
Australian industrial shares -S&P/ASX 200 Industrials Index	4.5%
Australian REITs- S&P/ASX 200 A-REIT Index	4.8%
Australian 10-year government bond	2.5%
Reserve Bank of Australia cash rate	2.25%
Australian 3-year term deposit	2.8%

Source: Bloomberg, March 2015

Clearly, dividend yields remain very attractive relative to other yield bearing investments. Chart 2 reinforces just how attractive equity yields still are compared to 10-year government bond yields.

Chart 2: Australian industrial equity yield versus 10-year government bond yield



Source: Bloomberg

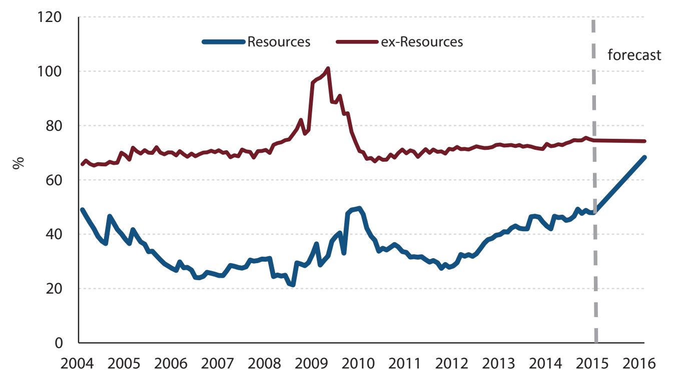
The gap between industrial equity yields and 10-year government bond yields is currently wider than it has been for several years as bond yields have fallen in response to subdued growth, low inflation and renewed monetary policy easing. With the Reserve Bank of Australia having recently cut the official cash rate to an historic low of 2.25% and clearly announced an easing bias following its March policy meeting, equity yields are likely to maintain their relative appeal for some time to come.

Seeking yield in non-traditional sectors

"Traditional" yield stocks are generally those that are very interest rate sensitive and they tend to be industrials. Typical yield sectors in the Australian sharemarket include banks, utilities, defensive industrials, REITs and telecoms. In recent years, these sectors have performed incredibly well as interest rates have fallen. For example, the All Industrials Index (excluding dividends) is up over 80% since its low in 2011. Hence shares in these sectors of the market are now looking quite fully valued.

In response to this, investors are being forced to seek out yield investments in "non-traditional" yield sectors. For example, there has been a recent move by resource companies to significantly increase their dividend payout ratios (see Chart 3) and many analysts expect this to continue. Resource companies usually reinvest for growth and are not traditionally sought after for the dividends they pay. However, in the current environment of over supply in some commodities and widespread investment cut-backs, many resource companies are choosing to payout significantly higher dividends instead of implementing expansion plans.

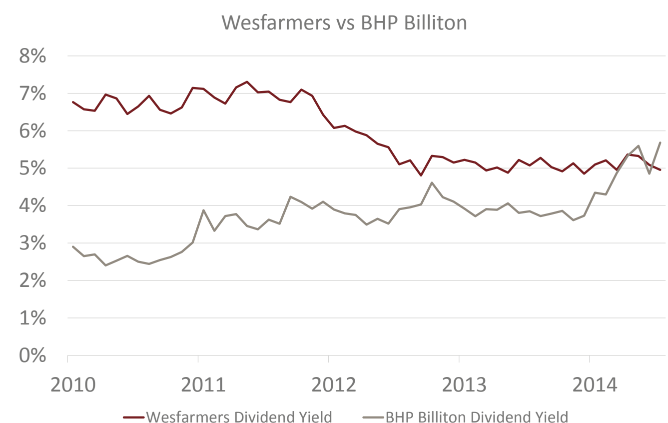
Chart 3: Dividend payout ratios - major market sectors



Source: Factset, UBS

This yield growth in non-traditional sectors can also be seen in Chart 4 which compares the yields on offer from Wesfarmers (WES), a traditional, defensive industrial yield play, and resource stock, BHP Billiton (BHP). BHP's yield is now higher than that offered by WES, an historically unusual occurrence!

Chart 4: Yield comparison – Wesfarmers and BHP Billiton



Source: Bloomberg

In line with this theme, Antares' Dividend Builder portfolio has recently taken a position in BHP Billiton despite resource stocks not being part of the Fund's benchmark. The decision to invest was based on BHP's high, fully franked dividend which is higher than most traditional, large capitalisation industrial yield stocks. We clearly see merit in diversifying away from traditional yield stocks which have performed so strongly that they are quite fully valued. So resource stocks are now providing yield opportunities despite being a "non-traditional" yield sector.

The future of equity yields

A key issue in the debate over whether yield stocks can continue to deliver strong returns in the future is whether the demand for yield stocks is cyclical, and therefore temporary, or whether it represents a structural shift that will continue in the future.

Low interest rates are the main cyclical driver of the current demand for high yield stocks and history suggests this driver of equity yield demand will be temporary. Global growth will eventually improve to the point where interest rates start to normalise. In this environment, bond yields will likely rise again and may well move higher than dividend yields like they did in 2007 and 2009-10. Once this occurs, cyclical demand for high yielding stocks should start to slow.

However, there are also structural forces that are driving higher demand for yield stocks, with the most significant being the aging population. Australian Bureau of Statistics (ABS) data shows that the percentage of the population that is potentially in retirement – i.e. aged 65 years and above - has risen from 8.5% in 1960 to over 14% in 2012. ABS projections suggest this cohort will grow to around 22% of the Australian population by 2061[1.]

As investors, retirees generally have a higher demand for yield based strategies, given their desire to preserve capital and use it to generate a stable income. People are also living longer, as generally better health and medical breakthroughs are extending life expectancy. So retirees today often need to generate a stable income for a longer period of time. Finally, the "baby boomer" generation (born 1946-64) are now entering retirement, with the first group turning 65 in 2011. These well-off retirees tend to have a relatively high demand for yield focused strategies as they wish to generate sufficient income to maintain the lifestyle to which they are accustomed.

So, although demand for equity yield may slow once the economy starts to strengthen and interest rates normalise, the structural demographic shift towards an older population is likely to keep dividends in demand over the longer term.

Conclusion

In summary, there are many factors that need to be considered when investing in equities for yield. Dividend sustainability is paramount and factors affecting dividend sustainability should be thoroughly analysed. Equities remain an attractive source of yield at present although investors are being forced to consider non-traditional sources of equity yield following the strong performance of traditional yield based stocks.

Whilst the current low interest rate environment has generated a cyclical increase in demand for yield stocks, the aging population and the growing number of baby boomers seeking high yield investments as they enter retirement is not a short term phenomenon. It's a longer term, structural issue for markets and it suggests dividend yields are set to remain a significant component of expected equity market returns in coming years.

[1.] Australian Bureau of Statistics, 3222.0 – Population Projections, Australia, 2012.

Antares market & Fund updates

Below is a brief review of how the Australian sharemarket performed during the quarter as well as short commentaries on each Antares Fund, outlining their net performance and the main contributors to performance.#

Australian sharemarket review

The S&P/ASX 200 Accumulation Index rose 10.3%, supported by continued weakness in the Australian dollar and the Reserve Bank of Australia's decision to ease monetary policy by cutting the official cash rate by 25 basis points to an historic low of 2.25%. The best performing sectors were consumer discretionary (+14.3), banks (+14.3) and utilities (+13.7) that all benefited from lower interest rates. Energy (-3.7%) and resource stocks (+3.1%) were the main laggards, impacted by slowing growth in China and weaker iron ore (-27.9%) and oil prices (-4.4%).

The February reporting season was broadly in line with expectations. Aggregate net profit after tax rose 2% in the six months to end December 2014 but this masks significant divergence amongst the major sectors. For example, industrial net profits rose around 15% during the period whilst resource sector net profits fell around 24%. The main themes evident in the reporting season included:

- a continuation of the subdued revenue growth environment as trading conditions remain challenging;
- further cost cutting to achieve earnings growth, although new initiatives have tended to be smaller in scale;
- strong dividend growth, with companies still choosing to return cash to shareholders rather than reinvest for growth;
- a significant rise in share price volatility in response to earnings reports, with significant de-ratings for stocks that released earnings disappointments.

Australian Equities Fund

The Antares Australian Equities Fund returned 11.4% (net of fees) for the March quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 10.3% by 1.1%. The main contributors to performance for the portfolio over the quarter were overweight positions in Incitec Pivot and AMP. An overweight position in Santos and not holding a position in Macquarie Group detracted from performance.

Dividend Builder

Antares Dividend Builder delivered a return of 13.2% (net of fees) for the quarter, outperforming the benchmark S&P/ASX 200 Industrials Accumulation Index return of 11.7% by 1.5%. The main contributors to performance over the quarter were an overweight position in Toll Holdings and a zero weighting in Woolworths. The main detractors from performance were the decision not to hold a position in Macquarie Group and an overweight position in Suncorp Group.

Elite Opportunities Fund

The Antares Elite Opportunities Fund returned 11.1% (net of fees) for the quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 10.3% by 0.8%. The main contributors to performance for the portfolio were overweight positions in Iluka Resources and Qantas Airways. The main detractors from performance over the quarter were overweight positions in BlueScope Steel and Santos.

High Growth Shares Fund

The Antares High Growth Shares Fund returned 10.8% (net of fees) for the quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 10.3% by 0.5%. Contributing positively to performance during the March quarter were an underweight position in Woodside Petroleum and an overweight position in Henderson Group. The main detractors from performance were overweight positions in BlueScope Steel and Medibank Private.

Small Companies Fund

The Antares Small Companies Fund delivered a return of 5.9% (net of fees) for the quarter, underperforming the benchmark S&P/ASX Small Ordinaries Accumulation Index return of 7.3% by 1.4%. The main contributors to performance for the portfolio were overweight positions in iSentia Group and NEXTDC. Detracting from performance were overweight positions in Bradken and Ardent Leisure Group.

Australian Shares Fund*

The Antares Australian Shares Fund delivered a return of 11.3% (net of fees) for the quarter, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 10.3% by 1.0%. The main contributors to performance for the portfolio over the quarter were overweight positions in Incitec Pivot and Qantas Airways. An overweight position in Santos and not holding a position in Macquarie Group detracted from performance.

Listed Property Fund

The Antares Listed Property Fund delivered a return of 9.0% (net of fees) for the quarter, underperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index return of 9.4% by 0.4%. Positively contributing to performance during the quarter were an underweight position in GPT Group and an overweight position in Peet. The Fund's performance was negatively impacted by an underweight position in Novion Group and an overweight position in Westfield Corporation.

Premier Fixed Income Fund

The Antares Premier Fixed Income Fund delivered a return of 2.9% (net of fees) for the quarter, outperforming its benchmark return of 2.6% by 0.3%. The main contributors to performance were an overweight position in Australian supranational issuers versus government bonds and curve flattening trades in government bond markets. The main detractors from performance were an overweight duration position in Australian government bonds and positions in peripheral European bond markets.

All returns are net of fees. Please refer to page 7 of the Quarterly Review for a summary of returns which are gross of fees.
* Closed to new investments
[1] Benchmark is 75% UBS Australia Composite Bond Index and 25% Barclays Capital Global Aggregate Bond Index (hedged into A$)

Antares Investment Returns

Performance to 31 March 2015[1]

		3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	10 yrs % p.a.	Since Inception % p.a.
Australian Equities							
Australian Equities Fund Inception date: 03/07/1995	Net return[2]	11.4	17.2	15.8	8.7	8.9	10.3
	Gross Return[3]	11.6	18.2	16.8	9.7	9.8	11.3
	Benchmark Return	10.3	14.1	15.8	8.6	8.3	10.0
	Net Excess Return	**1.1**	**3.1**	**0.0**	**0.1**	**0.6**	**0.3**
	Gross Excess Return	1.3	4.1	1.0	1.1	1.5	1.3
Dividend Builder Inception date: 06/09/2005	Net return[2]	13.2	24.0	23.2	14.5	-	9.5
	Gross Return[3]	13.4	24.8	23.9	15.2	-	10.2
	Benchmark Return	11.7	21.0	22.9	13.4	-	8.8
	Net Excess Return	**1.5**	**3.0**	**0.3**	**1.1**	**-**	**0.7**
	Gross Excess Return	1.7	3.8	1.0	1.8	-	1.4
Elite Opportunities Fund Inception date: 18/11/2002	Net return[2]	11.1	16.3	15.2	8.3	9.5	12.2
	Gross Return[3]	11.3	17.2	16.0	9.0	10.3	13.1
	Benchmark Return	10.3	14.1	15.8	8.6	8.3	10.3
	Net Excess Return	**0.8**	**2.2**	**-0.6**	**-0.3**	**1.2**	**1.9**
	Gross Excess Return	1.0	3.1	0.2	0.4	2.0	2.8
High Growth Shares Fund Inception date: 07/12/1999	Net return[2]	10.8	19.0	16.7	8.9	9.6	11.9
	Gross Return[3]	11.1	20.3	18.0	10.1	10.8	13.5
	Benchmark Return	10.3	14.1	15.8	8.6	8.3	8.7
	Net Excess Return	**0.5**	**4.9**	**0.9**	**0.3**	**1.3**	**3.2**
	Gross Excess Return	0.8	6.2	2.2	1.5	2.5	4.8
Small Companies Fund Inception date: 19/11/1999	Net return[2]	5.9	-4.9	1.8	4.9	8.2	9.9
	Gross Return[3]	6.2	-4.0	2.9	5.9	9.3	11.0
	Benchmark Return	7.3	2.3	-1.7	-0.3	2.7	4.0
	Net Excess Return	**-1.4**	**-7.2**	**3.5**	**5.2**	**5.5**	**5.9**
	Gross Excess Return	-1.1	-6.3	4.6	6.2	6.6	7.0
Listed Property							
Listed Property Fund Inception date: 28/02/1994	Net return[2]	9.0	33.7	21.7	14.3	5.1	8.4
	Gross Return[3]	9.2	34.6	22.5	15.2	5.9	9.1
	Benchmark Return	9.4	34.7	22.7	14.5	3.2	7.7
	Net Excess Return	**-0.4**	**-1.0**	**-1.0**	**-0.2**	**1.9**	**0.7**
	Gross Excess Return	-0.2	-0.1	-0.2	0.7	2.7	1.4
Fixed Income							
Premier Fixed Income Fund Inception date: 31/05/2000	Net return[2]	2.9	10.7	7.0	7.5	6.8	6.8
	Gross Return[3]	3.0	11.2	7.5	8.1	7.2	7.3
	Benchmark Return	2.6	10.9	7.2	7.8	7.1	7.1
	Net Excess Return	**0.3**	**-0.2**	**-0.2**	**-0.3**	**-0.3**	**-0.3**
	Gross Excess Return	0.4	0.3	0.3	0.3	0.1	0.2

Disclaimer:

[1] Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document.
[2] Investment returns are based on exit prices, and are net of management fees and assume reinvestment of all distributions.
[3] Gross returns are provided to show performance against the investment objective.

NOTES

NOTES

Get in contact

Toll free: 1800 671 849
Email: investorservices@antaresequities.com.au
Mail: GPO Box 2007 Melbourne VIC 3001

antarescapital.com.au

Important information: Antares Capital Partners Ltd ABN 85 066 081 114, AFSL 234483 ('ACP'), is the Responsible Entity of, and the issuer of units in, the Antares Professional Selection Funds. An investor should consider the current Product Disclosure Statement and Product Guide for the Funds ('PDS') in deciding whether to acquire, or continue to hold, units in the Funds and consider whether units in the Funds are an appropriate investment for the investor and the risks of any investment. This report has been prepared in good faith, where applicable, using information from sources believed to be reliable and accurate as at the time of preparation. However, no representation or warranty (express or implied) is given as to its accuracy, reliability or completeness (which may change without notice). This communication contains general information and may constitute general advice. This report does not take account of an investor's particular objectives, financial situation or needs. Investors should therefore, before acting on information in this report, consider its appropriateness, having regard to the investor's particular own objectives, financial situation or needs. We recommend investors obtain financial advice specific to their situation. Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document. Any projection or other forward looking statement ('Projection') in this report is provided for information purposes only. No representation is made as to the accuracy or reasonableness of any such Projection or that it will be met. Actual events may vary materially. Any opinions expressed by ACP constitute ACP's judgement at the time of writing and may change without notice. An investment in the Fund is not a deposit with or liability of National Australia Bank Limited ('NAB') or any other member of the NAB group of companies ('NAB Group') and is subject to investment risk, including possible delays in repayment and loss of income and capital invested. Neither ACP nor any other member of the NAB Group guarantees the repayment of your capital, payment of income or the performance of your investment. NAB does not provide a guarantee or assurance in respect of the obligations of ACP.