When investing for income, don't get caught looking backwards

This material is not for circulation to retail investors

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According to Market Index, 19 companies on the ASX currently have a trailing dividend yield above 10%. Very attractive income, in anyone's book.

But income investors need to read between the lines. Trailing dividends are based on earnings over the past year, so you don't want to go long on an income stock on the sole basis that it has a good history of paying dividends.

This is where total return investing comes in. You target the best of both worlds – income and capital growth. And you don't want to fall into a dividend trap where one is traded off for the other.

So I reached out to Andrew Hamilton, Portfolio Manager for the Antares Dividend Builder Fund. Dividend Builder is an actively managed portfolio of high-yielding equities listed (or expected to be listed) on the Australian share market, which aims to deliver regular dividend income and moderate capital growth.

From a dividend builder perspective, whatever happens from a capital perspective, investors will be supported by that yield," says Hamilton.

"And at the moment, on a grossed up basis for franking, we expect the dividend yield to be north of 7% as we look 12 months into the future."

In this wire, Hamilton gives us his take on the health of the two big dividend-paying sectors: financials and commodities. Crucially, we cover the outlook in terms of dividends but also capital return - the two key components of total return.

Banks

With inflation soaring and the property market crashing, one would think that the banks are in serious trouble and, by extension, the sustainability of their dividends.

But Antares are still overweight the banks.

"As far as dividends go, we think the banks will be ok," says Hamilton.

"Balance sheets are still strong; they'll still be very profitable."

The property crash is still yet to flow through to the banks.

"Bad and doubtful debts are still really low, so low by historical standards that you'd say they have to go up, which will eat into profits.

"With interest rates rising, we would expect delinquencies to rise, and that eats into bank profits. Despite that we think profits will still be strong enough to pay solid fully franked dividends"

Hamilton qualifies his bullishness on the banks with one caveat:

"What do banks look like in 10 year time? There's the risk of disruption, which is one of many things our proprietary sustainability ratings take into account. But for the moment they look ok."

Commodities

Investing in commodities stocks can be a catch-22.

"When commodity prices are high, the cashflows resource companies get can be enormous and therefore the dividends can be too," says Hamilton.

"But history tells us that when commodity prices get too high new capital gets attracted to the industry, new mines, and commodity prices fall drastically."

Things can get especially dicey when investing for income.

"If a dividend fund is in a commodity stock at the wrong time looking for yield, they can end up getting into a lot of trouble on the capital side of things."

"Because the dividend is based on last year's earnings over the prior period, whereas the sharemarket is forward-looking and assesses prospects for profits over the next year or two."

The market might say 'we know you've earned enormous cashflow over the last twelve months, and you're going to pay a big dividend, but commodity prices have now fallen 20-40% and therefore your share price is falling 30-40%.'

So while the dividend may be great, the capital value gets smashed.

Antares still have commodities exposure in Dividend Builder through diversified names with tier one assets, such as BHP Group (ASX: BHP).

Beyond that, Antares analyse long-run supply and demand to estimate reasonable long-run pricing.

"So that means we can see at all times what commodity prices are implied in share prices versus current spot prices," says Hamilton.

"We also require any company to have a strong balance sheet, margin for error, in terms of what's implied in the share price vs long run commodity price, and then we have ESG ratings on all our stocks."

The energy sector has the same challenges, and one important other.

"We do know two things: 1) oil is a sunset industry with climate change and technological progress, oil will be a thing of the past, and 2) oil and gas companies are reluctant to invest capital into exploration, discovery and appraisal."

These days, oil and gas are dividend stocks.

"That concept ten years ago would've been laughed at, because they were high return companies that had to reinvest."

The problem is, while oil and gas may be sunset industries, there's still going to be a lot of money made in the interim.

"Every forecast I've seen for Asian oil demand has it growing over the next decade, so you've got a situation where the final cycle is going to generate very big returns."

The long-run oil price now is higher than what it was a few years ago, and this is supportive of stocks like Santos (ASX: STO) and Woodside (ASX: WDS).

However, high prices aside, what will these companies do the day after tomorrow?

Santos have recently made a final investment decision on a carbon capture and sequestration project in the Cooper Basin, and have their eyes set on doing the same in Darwin.

"They're talking about part of the transition being rather than just producing LNG and shipping it overseas, to also sequestering carbon. And where there's a carbon price, you can get paid for that. Woodside are similarly persuing strategies involving hydrogen and other new energy technologies."

"It's an acknowledgement that if they're going to have a business in ten years time, it's not just going to be producing oil and gas."

Access to regular income and capital growth

The Antares Dividend Builder fund is an actively managed portfolio of high yielding equities listed (or expected to be listed) on the Australian share market which aims to deliver regular dividend income and moderate capital growth. For more information, visit their website.