AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive 16th October 2015

Searching for Yield

Last week my five year old daughter perused the room service menu at a luxury resort in Port Douglas, went past the seafood and steaks on offer and ordered baked beans on toast. This order not only pleased the individual that was paying the bill and the simple tastes of a small child, but it was also within the budget afforded by the paltry 2.3% that she is currently getting from her ANZ Term Deposit.

At current risk free rates even wealthy retirees who have amassed $1 million in a superannuation account face a very meagre retirement (unless they have the same bland tastes in foods as small children), if they are looking to live off income rather than eat into capital. As the market is speculating that the RBA may cut cash rates even further on Melbourne Cup Day, if this occurs the hunt for yield amongst Australian retirees will only intensify. We would expect investors to rotate investments out of cash and into other yield assets such as shares and listed property trusts. In this week's piece we are going analyse what to look for when assessing the sustainability of a distribution.

Financial Repression

Whilst the 2.3% rate on one year term deposits in Australia looks grim (especially in light of inflation running at 2.2%!), spare a thought for investors in other major Western nations. Self-funded retirees in the US are currently being offered 0.05% for the same term from Bank of America, German investors receive 0.05% from Deutsche Bank and English retirees are getting a princely 1% from Lloyds Bank. These historically low rates have been viewed as a form of "financial repression", in that savers globally have born a large part of the costs imposed by governments lowering interest rates post the GFC to stimulate their economies. Near zero rates in Europe, Japan and the US (and historically low rates in Australia) are positive for middle-aged borrowers and companies refinancing debt, they are clearly a negative for savers and retirees.

Many workers in the superannuation accumulation phase have a mental ledger in their minds that if they accumulate $1 million dollars in their superannuation account, this will be enough to provide for a secure retirement. Whilst in 2008 this $1 million nest egg would have delivered an annual risk free income of over $80,000 from investing their portfolio in term deposits, over the past 7 years this amount has been steadily dwindling. Currently that same strategy would deliver just $23,000 for the retiree with $1 million dollars, just above the 2015 "poverty line" of $20,900 (or $403 per week) for a couple that own their own home as calculated by Melbourne Institute of Applied Economic and Social Research. I imagine that most retirees with $1 million in super envisage a diet of duck confit or ribeye on the bone at restaurants, rather than baked beans on toast.

Key factors for a stable and growing distribution

When we look at dividend-paying stocks and high-yielding listed property trusts we are not overly concerned with the trailing or next period payment, but rather in understanding whether a company can maintain their distribution over the longer term and grow it ahead of inflation. Indeed picking a basket of stocks or trusts solely based on their historical dividend yield has been a path to underperformance.

When looking through the list of the highest yielding securities in the ASX200, a common factor is usually a high **payout ratio** (dividend per share divided by earnings per share). Companies with a high payout ratio generally possess fewer options to grow a distribution or maintain it over a variety of market conditions. High payout ratios are often attributed to companies that are either mature or low-growth with few internal investment opportunities to grow their business (such as Telstra or utilities), or management looking to maintain the dividend in an environment where the company's earnings are deteriorating and thus prop up the share price. BHP and Rio Tinto’s historically low payout ratios have allowed both companies to actually increase dividends (BHP +28% and Rio +33%) over the past 12 months even in the face of challenging conditions in the global commodity markets.

In some situations these companies are even borrowing to pay their dividend or may be retaining insufficient cash to maintain their assets. The latter situation occurred in the Listed Property Trust sector prior to the GFC, where a large number of trusts were paying out all of the rental income they collected and were not retaining sufficient funds to cover ‘’stay in business’’ capex. When assessing the quality and sustainability of the distribution of a property trust you have to look at the percentage of the distribution covered by earnings less costs such as replacing lifts, escalators and indeed incentive payments necessary to retain tenants.

In evaluating the quality of a company’s dividend, a factor that we look at closely is the **direction of change** in that company’s dividend. Historically changes in the absolute dividend provides a signal from company insiders (board and management) as to the sustainability of a company’s free cash flow. For example Metcash was a high yielding stock, traditionally favoured by value-style fund managers and investors seeking high income, as the yield being offered was around 7-8%. However from 2012 onwards the company progressively reduced their dividend. This indicated that the company insiders were concerned about the future of IGA in the Australian grocery market, despite glossy investor presentations stating the opposite some sell-side analysts predicting a 14% yield. In June 2015 Metcash suspended their dividend, which caused the stock to fall 18% on the morning of the announcement.

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The analysis of **financial statement quality** also assists in assessing a company’s ability to pay a stable and growing dividend. Piotroski’s[1] work on financial statements analysis seeks to score a company based on a range of measures such as profitability, liquidity, leverage, equity and margins. Here we are not looking at absolute measures such as gross margin or long term debt, but rather the change in these items in the financial statements. This model has proven to be a good forecasting tool for dividend sustainability. In August Myer was trading at 6.4% yield, however when scoring the company’s financial statements it is clear that the quality is deteriorating, which would lead one to question the stability of this dividend. In September Myer announced a large dilutive capital raising to fund changes to the company’s retail strategy.

Another key factor that to look at that may indicate that a company is likely to pay a stable and growing dividend is whether that dividend is **franked**. Franked dividends have a tax credit attached to them which represents the amount of tax the company has already paid on behalf of their shareholders. Whilst companies can make a range of aggressive accounting choices that can boost their earnings per share (and dividend per share), a company is extremely unlikely to maximize the tax that they pay to the government. Firms that pay franked dividends have significantly more persistent earnings than firms that pay unfranked dividends, as it indicates that a company is building up tax credits by generating taxable earnings in Australia. Obviously companies such as CSL and Incitec Pivot who generate large proportions of their profits outside Australia are unable to pay fully franked earnings. However a great example of the role that franking plays in indicating the sustainability of a dividend occurred in 2014 where Arrium paid unfranked dividends in 2013 and 2014. Despite paying dividends and reassuring the market as to the company’s future, Arrium conducted a massive capital raising in late 2014 to shore up a shaky balance sheet. Here the lack of franking could be viewed as an indicator that the quality and sustainability of the company’s dividends was not high.

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1 Piotroski, Joseph D., Value Investing: The Use of Historical Financial Statement Information to Separate Winners from Losers, *Journal of Accounting Research* 38, 1-41

Our View

In seeking to build a portfolio delivering income above the meagre returns being offered by term deposits and thus avoid having to downgrade one's dining choices it is not enough simply to pick high yielding securities. We view that investors should make a detailed assessment of the ability of a company or property trust to continue paying and actually grow distributions ahead of inflation. Further in an environment where more investors are moving from the accumulation to retirement phase and meagre returns are available from traditional 'income' asset classes such as term deposits, there will be an increasing demand for equity fund managers to deliver income to investors. This could be very interesting as in the funds management world, the vast majority of the focus is on growing the capital, rather than thinking about the ongoing income that this capital is often required to deliver.

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