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Is yield and dividend growth the holy grail?

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Research & Insights

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The perennial question for investors when seeking income is whether they can achieve higher yields without sacrificing growth in earnings? There are very few single stock options in the investment world that can deliver both yield and growth. However, it is possible to construct portfolios that can deliver to this dual goal. Michael Price, Portfolio Manager, Equity Income at Ausbil looks at the search for growing dividends and why portfolios might be the answer for income seekers.

5-minute read

Michael Price
Portfolio Manager,
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Key points

- It is difficult to find individual stocks or sectors that can deliver higher yields with earnings growth, however carefully constructed equity income portfolios may be the answer.
- The dividend and yield outlook for companies is ever-changing and to maximise the benefits requires ongoing monitoring of the market.
- The highest yields are not necessarily the best yields for long-term income investment. Neither may the higher earnings growth companies be the best for income investors.
- As in most things, balance and measure are the ideal approach, and this can only come through the construction of optimised income portfolios as they can offer higher yields and growth with the benefits of diversification, optimising for both franking credits and dividend capture across all months of the year, not just August and February.

Q: How have higher interest rates impacted dividends?

The normalisation of interest rates from emergency monetary policy settings was always expected, however the pace of the response by central banks in raising interest rates to current levels was not anticipated by most. That said, the consensus outlook for dividend yield for FY23 is currently around 4.4% (S&P/ASX 200) and for FY24 around 4.4% again. This is similar to the long-term dividend yield for the Australian market.

Q: Are dividends still attractive relative to income alternatives?

The level of dividends paid by the Australian equity market has been relatively stable over many years at an average of around 4.5%pa (excluding the benefit of franking credits). When adjusted for franking credits (remembering that a dollar of franking credit is worth the same as a dollar of cash dividend to all Australian tax payers) the gross dividend yield rises to around 6%pa. The current 3-year bank term deposit paying monthly is also around 4% before tax. The difference here is the benefit franking credits offer over and above the dividend yield, and the potential for long-term portfolio growth in shares to provide some protection for the impact of inflation. Of course, there is always risks in equity income portfolios for a temporary drawdown in the value of capital, but long-term investors should be able to hold their investments for market recoveries.

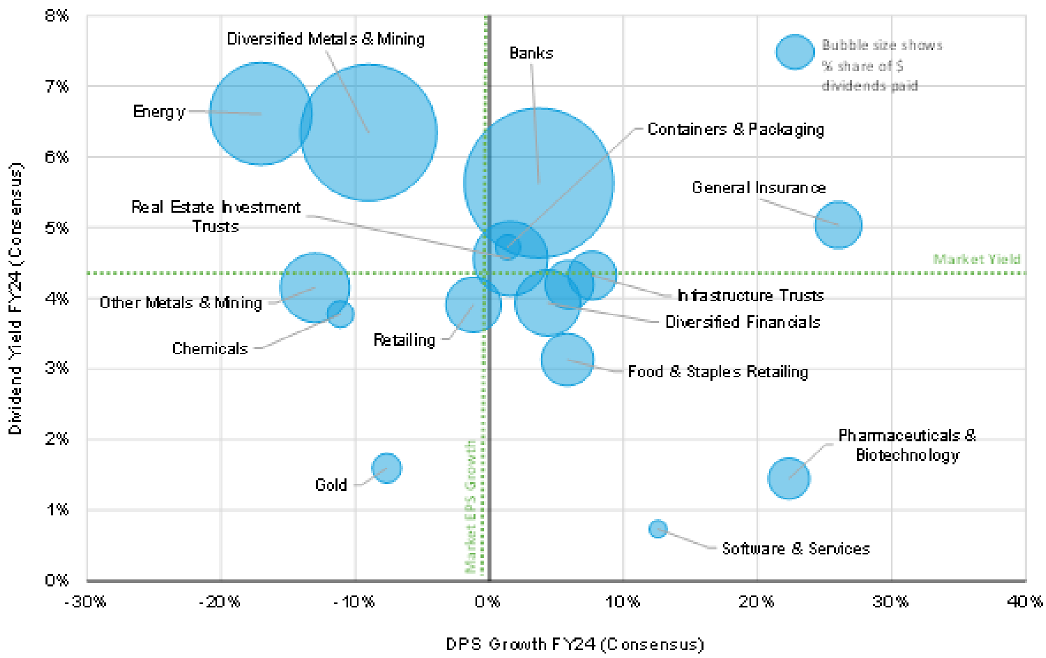
About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly- owned subsidiary of New York Life Insurance Company. As at 31 May 2023, Ausbil manage over $15.8 billion in funds under management.

Q: Can you invest for higher yield without sacrificing growth?

Investing for higher yield with growth is almost the 'Holy Grail' of investing, that is, something everyone wants but proves very elusive, potentially impossible to achieve. It is generally accepted that in equity investing, high yields are associated with low-growth stocks, while high-growth stocks tend to pay little or no dividend. Even if there were stocks that were both high-growth and high-yield, the market would compete so much for their equity that the prices would be bid to levels where neither growth nor yield would stand out. However, there is an exception to these general rules, investing for yield and growth through a managed portfolio rather than individual stock holdings.

Chart 1: The source of dividends and consensus outlook for their growth



Source: Ausbil, FactSet as at May 2023.

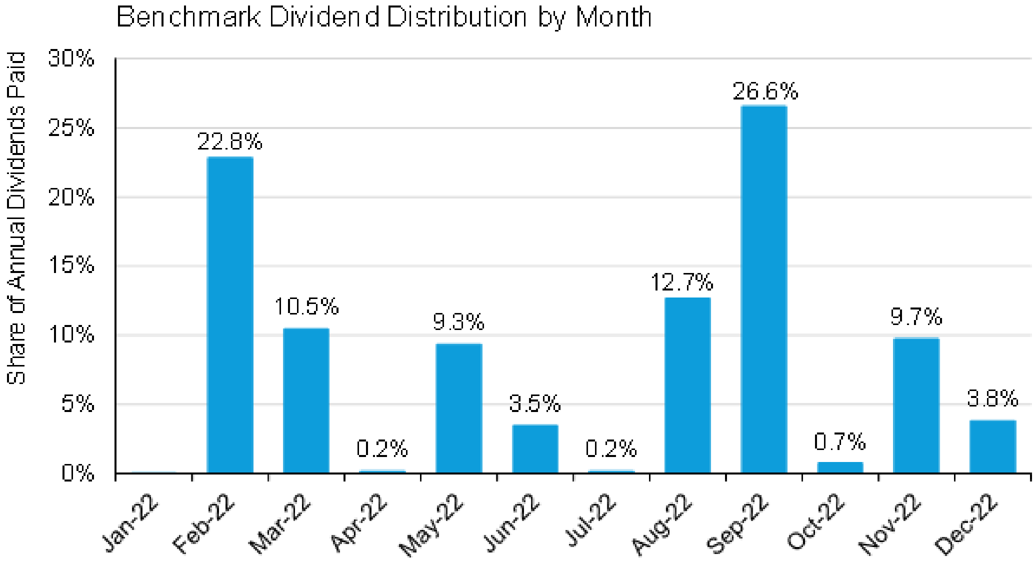
Chart 1 illustrates the current outlook for dividend yield compared to the outlook for dividend growth for select sectors of the market. The size of the ball represents the share of total dividends paid to give a sense of who carries the load in terms of dividend dollars paid. You can see that the largest balls are banks and resources. Software which is dominated by growth companies that typically pay low to no dividends is a very small ball.

Some important observations can be made from this chart. Firstly, some sectors are currently offering high dividends, some are with a growing dividend outlook and some are on a declining dividend outlook. Some sectors like software and pharmaceuticals & biotechnology are offering higher dividend growth but a very low yield. Gold, by contrast, while offering a low yield is also looking at dividend contraction in 2024 based on consensus numbers. Of course, this changes dynamically, and across the cycle. For this reason it is difficult to settle on an individual sector or stock that can deliver both high yield and high growth across time.

To make the most of what is on offer, it is possible to blend the benefits of higher yielding companies with those whose dividends may be lower but contain higher levels of growth through the construction of an active dividend income portfolio. There are a number of reasons why taking an active portfolio approach to generating income is possible.

The first is that dividends are not just paid twice yearly, but there are dividend payments in almost all months, as illustrated in Chart 2. Through the activity of dividend rotation, which means pro-actively purchasing into stocks to receive their dividends, an active dividend income strategy can generate dividend income for investors each month.

Chart 2: An active dividend strategy can find more dividends and more franking credits for investors across the year through dividend rotation

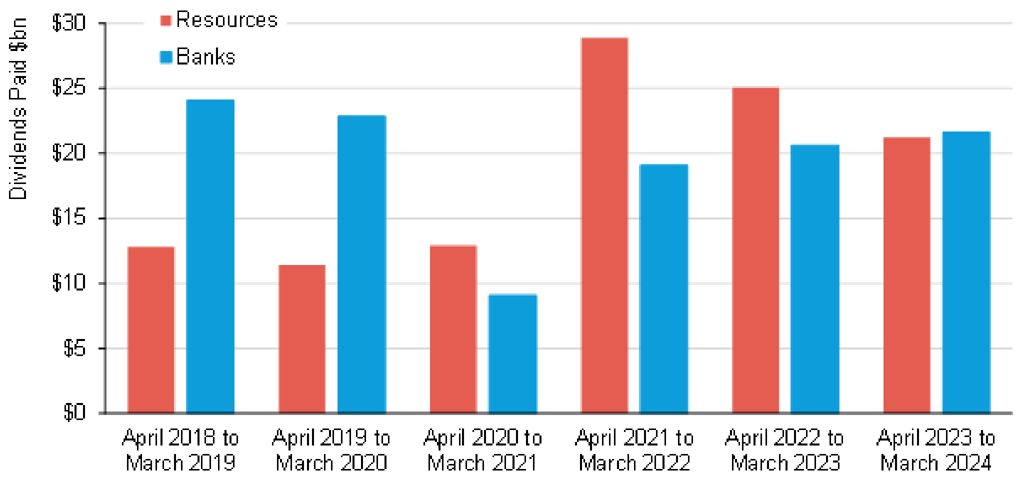


Source: Ausbil, Bloomberg, Dividends paid in 2022, based on ex-dividend date for S&P/ASX 200.

A simple 'buy and hold' strategy cannot maximise the spread of dividends and franking credits on offer across the calendar year. An active dividend strategy can find more dividends and more franking credits for investors across the year through dividend capture.

Secondly, good dividend payers today may not be the good dividend payers in the future. Chart 3, for example, shows the while banks dominated resources in the payment of dividends in 2019 and 2020, this began to swing in favour of resources in 2021, 2022 and 2023. Looking forward, consensus expects banks to resurge again. What matters here is that a flexible and active approach to dividend investing can adjust for swings in which companies are paying the better dividends.

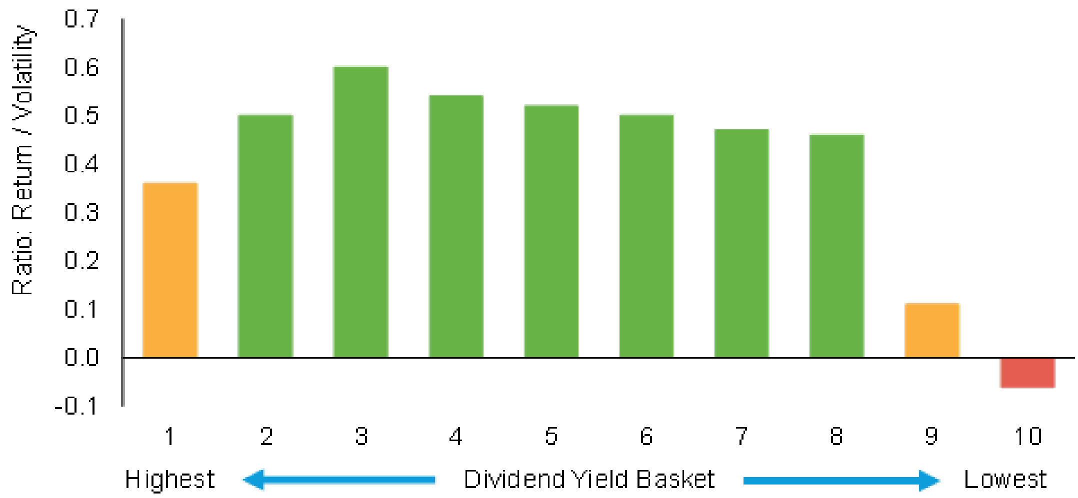
Chart 3: Dividends paid by resources and banks



Source: Ausbil, Bloomberg, Dividends paid, FY23 and FY24 estimates from FactSet.

Thirdly, the benefit of taking an active approach to investing for income from dividends is illustrated by a 25-year sample of dividend yields and volatility in returns, as shown in Chart 4.

Chart 4: The best yields don't always offer the best risk-adjusted return



Source: Source: Ausbil, Macquarie Equities. Data is from a sample between September 1995 to January 2019. Risk adjusted return is return / volatility.

When stocks were split into deciles with the first (1) decile representing the highest dividend yield payers, and the ninth (9) and tenth (10) representing those that pay negligible dividends, the first finding was companies that pay a dividend outperform non-dividend payers on a total return basis. However, companies that paid a growing dividend outperformed the highest dividend payers on a risk-adjusted basis. This can mean many things, but very high yielding stocks may not be investing in future dividend growth, and so while they payout larger amounts, their future income streams may be coming from a declining business. The balance between yield and dividend growth we mentioned before is therefore crucial in generating more sustainable long-term income and total returns (comprising both growth and income).

Q: Can you explain how franking credits work and how an active dividend approach makes the most of what is on offer?

Simply put, franking credits are credits investors receive based on the tax paid by the company in which they are invested. These credits can be deducted from an investor's tax liability, and for retirees who do not pay tax on income, claimed through the tax system. When claimed back by investors, the impact of franking or tax paid by companies, the overall impact is a higher effective dividend yield (post-franking credits).

Q: Are there risks with investing for dividends in equities compared to holding term deposits of bonds?

The key risk in generating dividends from equities is the risk of temporary drawdowns and market events. Of course, those that can hold investments for market recovery can ride out any temporary hits to prices. Earnings growth surprises in stocks can impact dividends and are a risk with holding single income positions. A portfolio approach to active income investing can help reduce the impact of a single stock on the overall outcome, and the diversification across sectors can help cushion the impact of market events. For these reasons, we believe the best results are achieved by taking a long-term view on income investing that allows for ructions in the price of shares, but also offers the advantages that come with adding to quality income holdings during times of weakness at better prices.

Q: What is your outlook for dividends given rates are now higher and economic growth is slowing?

Major COVID stimuli in 2020, a resurging post-pandemic economy from late 2020 and into 2022, and an energy shock with the February 2022 invasion of Ukraine all contributed to the recent record inflation experienced across the world.

Central banks have responded with rapid rate rises to pare back inflation. Recent reads suggest inflation may have peaked, and is on the way down now, though we believe it will take some time. We also think that central banks are near the end of this rate rise cycle and will look to hold for some time subject to data. We do not currently subscribe to any immediate rate pivot, but we can see potential for some rate reversals if economies have slowed a little too much, but this is not especially relevant to current positioning.

Although the Australian economy is slowing on contractionary monetary policy, we believe Australia's resource economy is well-placed to outperform other developed markets with below-trend growth, but no recession.

That said, we believe earnings growth will be hard to come by in 2023, however Ausbil expects key sectors to offer strong EPS growth opportunities above consensus, and some quality leaders across the market to demonstrate earnings growth with resilient demand across the economic cycle, and the capacity to pass on higher costs to end-consumers. In this environment, dividend growth is also expected to be relatively concentrated compared to more exuberant markets. However, we consistently find active dividend growth and yield opportunities across the cycle, and with added capital management events and the potential to capture dividends across the year, we expect the opportunities to remain rich and rewarding for active income investment.

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