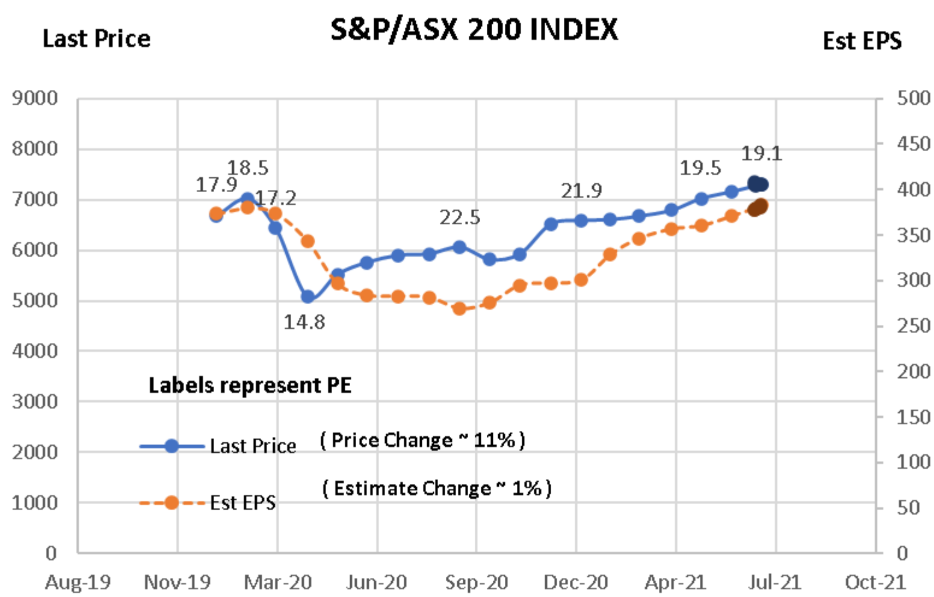
Dividend investors, your turn is coming

By Max Cappetta, chief executive and senior portfolio manager, Redpoint Investment Management

This article first appeared in firstlinks.com.au on 28th July 2018

The upcoming reporting season will affirm how the global COVID-19 pandemic has impacted businesses and sectors in different ways. Aggregate dividend payments over the next 12 months will likely be back in line with that paid in calendar 2019 – pre-COVID. However, the sources of these dividends will be different to previous years.

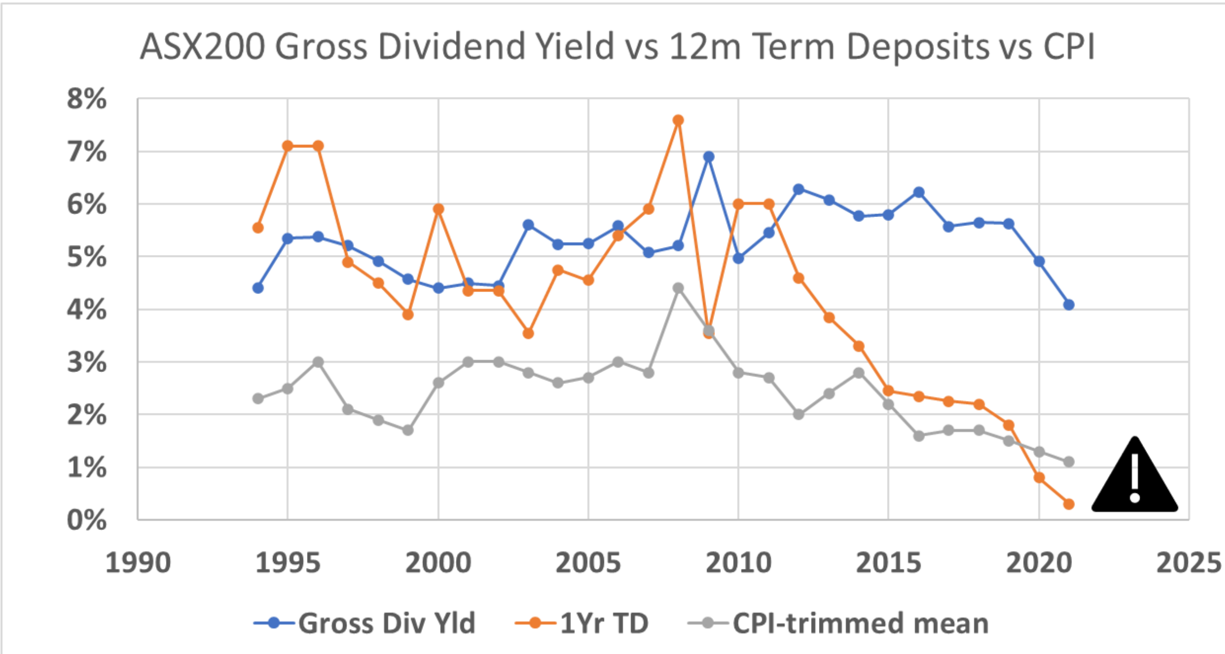
The Australian equity market has now returned to its pre-February 2020 highs: at least in price terms. For the S&P/ASX200 Index, forward earnings estimates have returned to pre-COVID levels while share prices are, on average, 11 per cent above pre-COVID highs.



Source: Redpoint, Bloomberg

But while the unprecedented fiscal and monetary policy settings aimed at effectively hibernating the economy through the past year is well and truly reflected in share prices, corporates have so far been more conservative and held back on dividend payments.

This conservatism in payout ratios has been a double hit for self-funded retirees who have also seen interest payments on cash deposits cut at the same time.



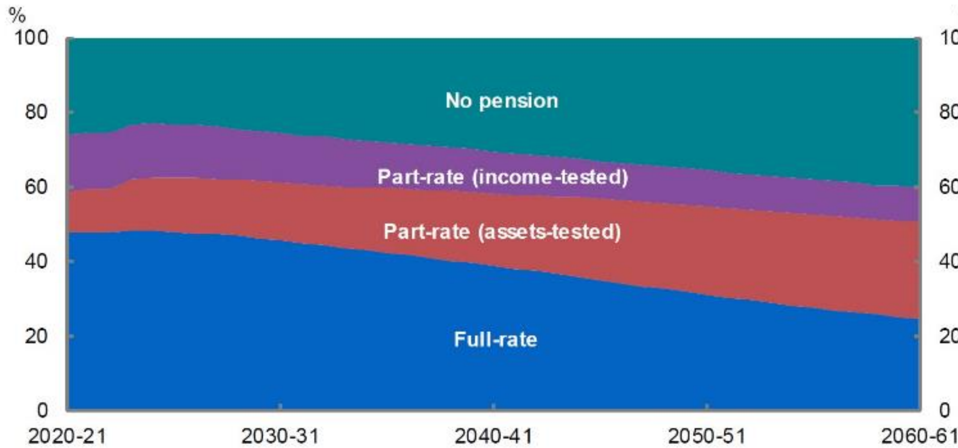
Source: Redpoint, Reserve Bank of Australia

Inclusive of franking credits the ASX200 has delivered an attractive yield relative to term deposits over the long term and especially over the past decade. Driven by underlying economic growth, the resilience and rise in share prices is also a characteristic of dividend payments through time.

Furthermore, Australian corporates continue to favour higher payout ratios due to the Australia's policy against double taxation, through the tax credits associated with company dividends.

This important policy pillar supports the retirement savings system and will enable appropriately constructed equity portfolios to play their part in an effective retirement income strategy. The Australian Government's 2021 Intergenerational Report is forecasting that over 40 per cent of retirees will be self-funded by 2060, and less than 25 per cent will be drawing a full government pension (versus 50 per cent today).

Chart 7.4.1 Persons of Age Pension age or over, by pension category



Source: 2021 Intergenerational Report: Treasury, Australian Government

Dividends returning – but slightly different to before

Australia's mining sector is set to be the star of the upcoming corporate reporting season in Australia. Record profits are expected from companies involved in iron ore mining thanks to record high prices being supported by offshore demand and supply issues in key areas such as Brazil. Companies such as Fortescue, Rio Tinto and Mineral Resources are expected to deliver record dividends in the coming weeks.

The COVID-19 pandemic has also delivered strong trading conditions for other companies and industries while being quite devasting for industries such as tourism and travel. Ongoing COVID breakouts and lockdowns in Australia have again slowed domestic tourism after promising signs through the start of 2021. It is unlikely that operating conditions for these industries will improve soon but investors need to be aware of the potential for mergers and acquisitions as conditions improve.

On the other side of the ledger, there have been a number of companies who have thrived through the pandemic. Government financial support has ensured that retail spending has remined robust. Retailers such as JB Hi-Fi and Kogan have been beneficiaries of this, and have rewarded investors with growing dividends over the past year. Retail supermarket operators have also benefited from the "stay-at-home" thematic, with Coles and Metcash rewarding investors with a growing dividend stream over the past two years.

Healthcare has also delivered on dividends with plasma giant CSL, protective-wear specialists, Ansell, and equipment manufacturer Fisher and Paykel Health all growing their dividends (albeit this growth has not translated to share price growth for CSL, which currently trades at 20 per cent below its pre-COVID highs).

The IT sector has been a standout winner for investors over the past year. The price performance both here in Australia and globally has been driven by the fall in interest rates and the perceived stability in their revenues regardless of whether workers are in the office or at home. Global logistics software specialists Wisetech are on track in 2021 to almost double their 2020 dividend. Similarly, global security specialists Codan have also grown their dividends by 50 per cent in 2021 versus 2019 levels. Both companies pay fully franked dividends, albeit they are a low yield.

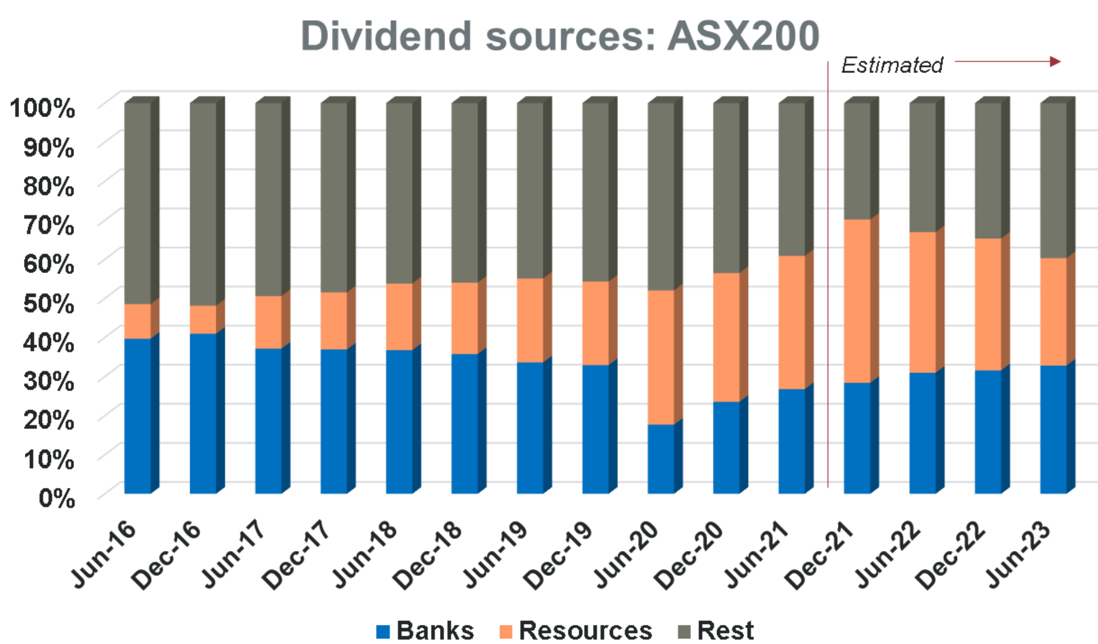
This highlights that income-focused investors need to ensure their income generation also provides some exposure to earnings and dividend growth and not simply focus on high yield alone. Wisetech remains slightly below its pre-COVID highs while Codan trades at $17, more than double its pre-COVID high of $8.

For the banking sector, Australia's banking regulator, the Australian Prudential Regulation Authority, dropped restrictions that banks limit dividends to 50 per cent of profits in mid-December. This enabled an increased dividend from all four of Australia's largest banks in the first half of this year. CBA is likely to further increase its dividend in August after being more cautious in February, with the remaining three - Westpac, ANZ and NAB – having had the benefit of seeing economic conditions improve in early 2021 before paying increased dividends in May.

The rollout of product innovations and divestments in the sector could be a catalyst for earnings growth moving forward. These developments are bringing new dynamics to investing for income in the financial sector. For example, there is a distinct calendar cycle with CBA, wealth managers and insurers reporting in June and December, plus the remaining three majors reporting in March and September. Bendigo Bank and Bank of Queensland respectively split themselves across the June/December and March/September groups.

Just like driving: look forward, not back

Being distracted by a high historic yield can be detrimental to investment outcomes. High yields can often hide low growth, business stress or a failure to properly reinvest to support future growth.



Source: Redpoint, ASX, IHSMarkIt

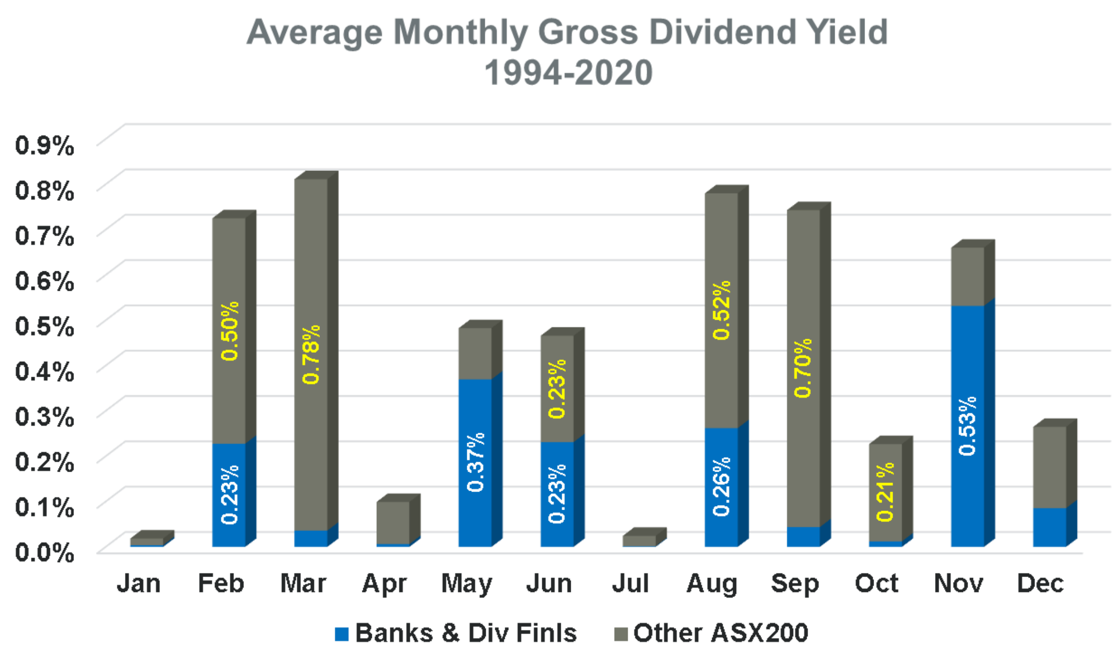
Research indicates that a focus on historical yield has consistently underperformed the ASX200, and by taking a forward-looking approach to dividend yields, opportunities can be found. By capturing the income available today while keeping an eye on share price downside improve overall investment outcomes.

However, dividends are not the only characteristic sought by investors. In fact, the market goes through phases where dividends and company's that pay dividends are very much in demand and other periods when they are not. The past 15 months are a brutal reminder of investor appetite for growth and risk versus cashflow and dividends.

Some income-focused strategies commence with defining an investible universe based on higher dividend yielding stocks. Some strategies start with a specific income style and then seek to identify the highest yielding stocks within that sub-group. This can be rewarding at times when dividend-paying companies are in greater demand, but can be harmful to overall returns at other times.

Being constrained to invest in just a subset of the market can also lead to less consistent dividend capture if particular sectors of the market are impacted by a change in business conditions while others are not. This is where risk management and a diversity of stock selection views can deliver an investment edge versus a singular focus on high yield alone.

Sometimes investors will find companies with below-average dividend yields. However, with the knowledge that different companies pay dividends at different times during the year, there is an opportunity for a more dynamic approach to trade across different opportunities at different times to capture an overall above-average income yield while retaining an exposure to higher growth stocks or those reinvesting to improve future earnings. Of course, investors also need to abide by holding period rules to ensure they not only capture the cash dividend but also any valuable tax credits attached.



Source: Redpoint, ASX

Income-focused investors will naturally be aware of the risk for dividends to be cut. At the same time, investors need to be aware that share prices generally lead earnings, and earnings generally lead dividends.

So, with dividends returning for Australian equity investors after the largest contraction in payments in recent times, investors will serve themselves well by re-evaluating their equity income strategy.

Capturing a consistent dividend yield from equities cannot be a set and forget endeavour. Building a portfolio from last year's best yielding stocks has delivered above average dividend income but has consistently underperformed the index overall.

The goal for most income seeking equity investors is to earn a consistent and above average yield on their capital, including an appreciation of the calendar and industry profit cycles can assist with this goal. Taking advantage of these opportunities also opens the door for a range of other stock selection insights to be utilised.

While that last year has been one of the most challenging in history it has also highlighted the need and opportunities for being more dynamic and having a broader perspective in how investors should seek to capture income from equities.