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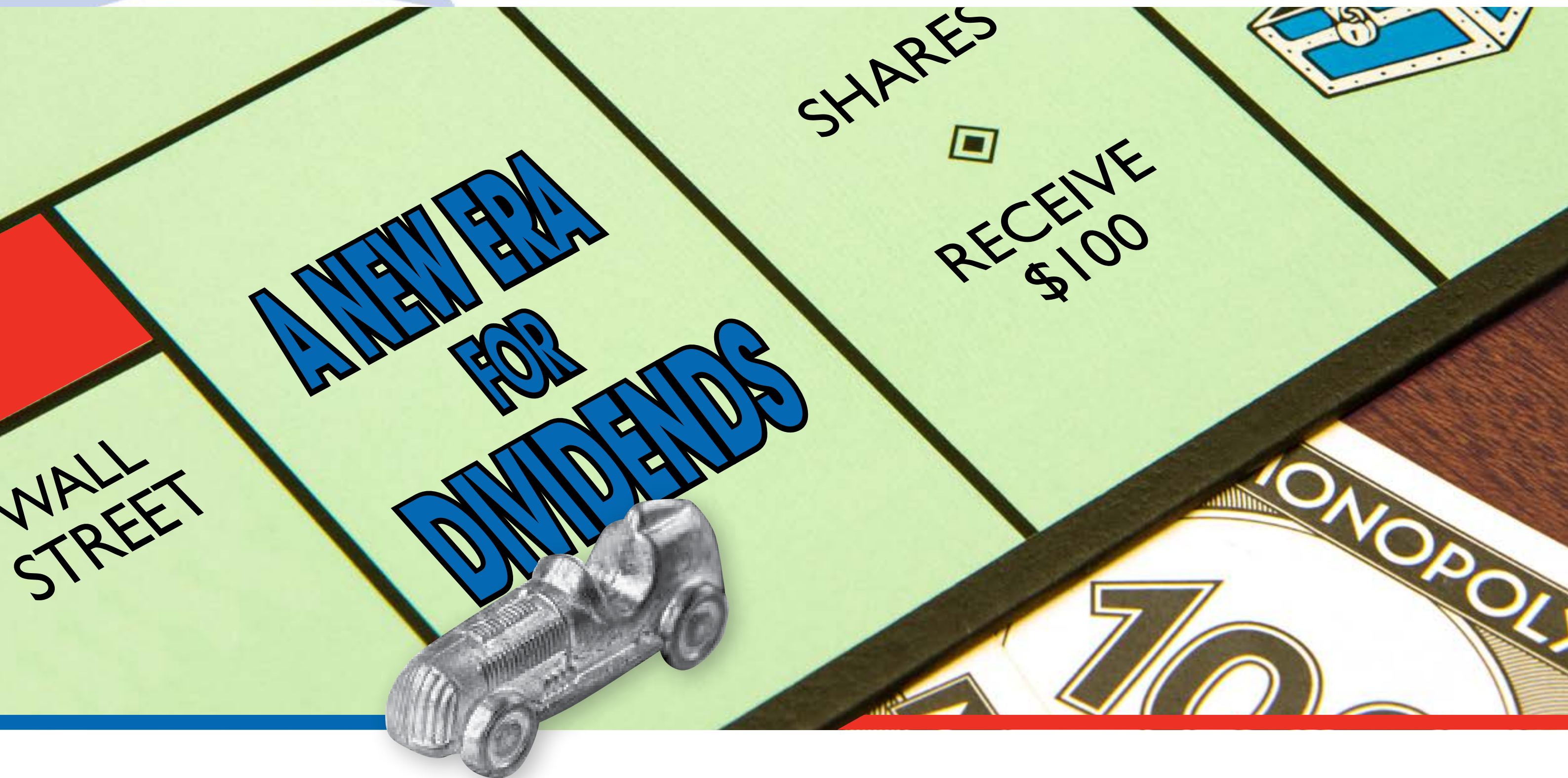
financial planning
SECURING YOUR FUTURE



“We’re in a new era” was how BHP Billiton chief executive, Andrew Mackenzie explained the decision to cut dividends for the December half year by 74 per cent. While the size of the cut grabbed headlines, the Big Australian is not the only company rethinking dividend policy.

BHP, Rio Tinto and Woolworths were among the big name stocks to cut dividends in the latest reporting season. ANZ has indicated it may follow suit when it reports its half-year earnings in May. The Commonwealth Bank held its interim dividend steady and expectations are that bank dividends will remain flat at best.

Outside the banks and resources sectors, the dividend picture is brighter. According to CommSec, 77 per cent lifted or maintained them, while 23 per cent of Australia’s top 200 companies either cut or did not pay dividends for the December half year.

But falling commodity prices, slower economic growth and technological disruption are taking their toll. Companies are responding with cost-cutting programs to shore up their earnings and dividends are one of many costs under the microscope.

The hunt for yield

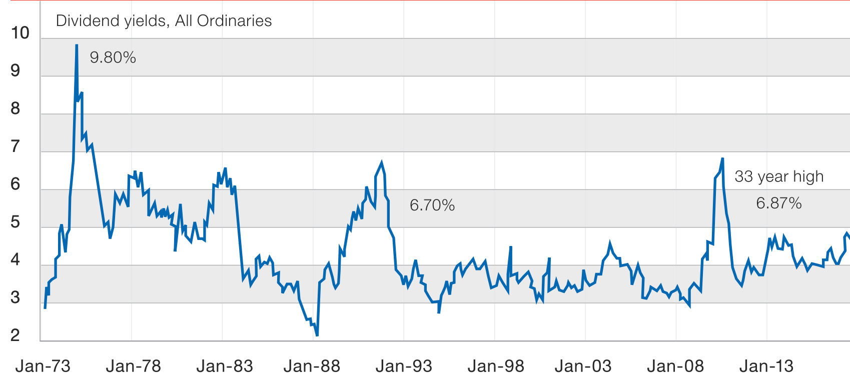
For the past five years, the hunt for yield has been the main game in town. With interest rates at historic lows and returns from cash and term deposits barely keeping pace with inflation, retirees and anyone dependent on income from their investments was on the lookout for alternative sources of income.

Investors who were prepared to move up the risk spectrum flocked to high-dividend paying shares.

The dividend yield on a share is the value of annual dividend payments divided by the current share price. The average dividend yield of the Australian market is currently around 4.8 per cent compared with the cash rate of 2 per cent. As the chart on the following page shows, dividend yields hit a 33-year peak of 6.9 per cent in late 2008, as companies maintained dividends in the face of collapsing share prices.

Popular stocks such as the banks and Telstra have proved even more rewarding. The Commonwealth Bank’s dividend yield is currently 5.3 per cent after reaching a peak of 7.7 per cent in September 2011. Telstra’s dividend yield peaked at 10.7 per cent in 2011 compared with 5.8 per cent now.

Solid returns on shares



Source: Iress, ASX, CommSec

Focus on growth

While the hunt for yield is as strong as ever, there are signs that the pendulum may be shifting from yield to growth.

According to Goldman Sachs, earnings per share of Australia's top 200 companies are growing faster than dividends per share for the first time in five years. Ignoring the resources sector, earnings per share is expected to grow by 3 per cent this financial year compared with 1 per cent growth in dividends per share.

While companies are still keen to pay dividends, they are reducing their payout ratio. That is, the amount a company pays out as dividends as a proportion of earnings.

BHP, for example, has been under pressure from institutional investors for some time to abandon its "progressive" dividend policy which committed the company to maintaining or lifting dividends in future. This has been replaced with a commitment to a minimum dividend equal to 50 per cent of underlying profit or at least US4c a share.

Payout ratios falling

The consensus among market analysts is that the market's overall payout ratio will fall from the 76.5 per cent this financial year to 73.7 per cent in 2017. Cuts are likely to be most pronounced in the resources sector which has continued to pay dividends despite reporting losses, a situation that is not sustainable in the long run.

Generally speaking, when public companies earn a profit they can pay it out as dividends to shareholders or retain funds to grow the company. If opportunities for growth are limited, it makes sense to tip the balance towards dividends.

But companies need to invest in their business to grow. This is particularly so for miners whose future depends on the exploration and development of new projects. In some ways it's a Catch-22; unless companies grow they will not be able to sustain and grow dividends.

Total returns

The total return from shares comes from a combination of capital gains and dividend income. Over the past few years the pendulum has swung towards yield, but there are signs that the pendulum is swinging back to growth.

In the long run, investors need to balance their need for income with an eye for growth. That's the case even if you are a retiree living on the income from your shares. In order to keep ahead of inflation, you want your dividends to grow over time. Companies with strong earnings growth will be well-placed to deliver.

If you would like to discuss your income strategy, give us a call.

Fluid Financial

Suite 4a, Level 1, 5 Ridge St
North Sydney NSW 2060

P 02 9922 4448
F 02 8072 1386
E peter@fluidfinancialplanning.com.au
W www.fluidfinancialplanning.com.au

Disclosure: Peter Small is a Representative of Fluid Financial Planning Pty Ltd ABN 85140515680, holder of Australian Financial Services Licence number: 389518, Suite 4a, Level 1, 5 Ridge Street, North Sydney NSW 2060 General Advice Warning: This advice may not be suitable to you because it contains general advice that has not been tailored to your personal circumstances. Please seek personal financial advice prior to acting on this information. Investment Performance: Past performance is not a reliable guide to future returns as future returns may differ from and be more or less volatile than past returns.