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Understanding Yield In Volatile Times

A Widely Misunderstood Investor Concept

Recent market declines have led many investors to reach for stocks with juicy dividend yields, assuming that they are relatively safe investments. However, with former "dividend aristocrats" like General Electric cutting their dividends to nearly zero, these securities may not be as safe as you think.

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Introduction

From 2016 to 2017, I conducted about 500 formal investment portfolio reviews with various high net-worth clients. Of the many topics that come up in these types of reviews, one of the most consistently misunderstood topics I see pertains to the yield on various investments. Yet, this is one of the items that clients and their financial advisors focus on extensively. I can't tell you how many times I've expressed skepticism about a certain investment and the immediate response is some variation of, "BUT LOOK AT THE YIELD! I NEED THE INCOME." While there are different types of yield calculations, especially in the bond world, the simplest way to think about yield is via the current yield formula:

Current Yield = Annual Income from the Investment / Current Price of the Investment

Therefore, if you own a stock trading for $50 and it pays you $2 of dividends per year, the stock has a 4% yield. This is a simple concept, but are stocks and bonds that have higher than average yields better than those with lower than average yields? There unfortunately isn't a black and white answer here, but there are some critical things to think about when assessing the value of income-producing stocks and bonds for your portfolio:

What Do You Really Need As An Investor?

Frequently, the investors that are yield-focused are those nearing or in retirement. All else being equal, younger investors should have portfolios that are more growth-oriented than the portfolios of older investors. The easy explanation for this is that investors with longer time horizons theoretically have the ability to stomach the market swings that come with being an equity investor. As we age, we tend to be living off of at least some of the money from our portfolios and having a more stable income stream is preferable to risking a market downturn from which we may never fully recover. Hence, many income-oriented investors overweight the importance of the yield of individual positions within their portfolios.

Realistically, as one starts to satisfy more of his or her spending needs from the portfolio, it is important to look past the immediate spending needs. The erosion of purchasing power that comes with inflation must also be combated. A dollar today almost always buys you more than a dollar a year from now. Too often, investors become more conservative than necessary as they draw income and rely too heavily on the income component of portfolio return, hoping that there will be enough to maintain the principal balance of the portfolio. The better solution in many cases is to continue incorporating enough growth-oriented securities to actually grow the base of assets upon which income is drawn. Growth-oriented assets are included within a portfolio to benefit from capital appreciation, which is simply how much a security goes up in value, not inclusive of the security's dividend / income. Over time, growth-oriented stocks provide a better hedge against inflation than income-producing assets do, because the underlying growth companies pass through a higher-than-average percentage of inflationary costs through to their end customers. The concept of balancing the two components of return in a portfolio, income and capital appreciation, is known as investing for "total return."

It's quite a conundrum we have here! How do we balance the need for stability and income with the fact that we need to take on some risk in order to grow (or at least maintain) the portfolio's principal? This is where utilizing an experienced financial advisor to set the appropriate asset allocation for your unique financial situation is critical. My colleagues and I at Matrix Private Capital Group look at the nuances of each client's situation and pair that with our expectations for inflation and the return profile and correlations of individual asset classes to devise the right balance between growth and income.

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Why do some stocks have higher yields than others?

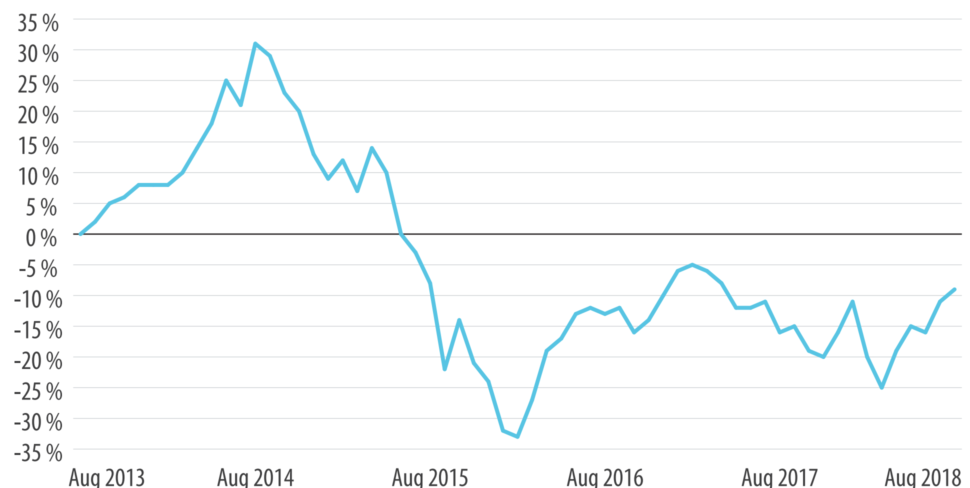
We're going to put aside bond yields for a second to discuss the dividend yields on stocks, since this is typically where I see the most confusion arise. There are different factors impacting dividend yields, but let's boil things down to the company's industry, the business lifecycle, and the legal structure involved.

Industries that are highly regulated tend to have companies with higher dividend yields than those in industries with less regulation. According to Yardeni Research, the dividend yield of the S&P 500 at the end of the first quarter was 1.90%. However, the dividend yield of the utilities sector was 3.60% and for the telecom sector the dividend yield was 5.37%. Given the importance of these services in our lives, regulatory entities like FERC and the FCC tend to limit quick growth of companies in these spaces. Therefore, less of the cash flow produced by these companies is reinvested in growth opportunities and more of it is paid out to shareholders in the form of dividends than what you might see in other industries.

This leads us to our second factor, which has to do with where a company is in its lifecycle. When a company is newer it demands more capital to exploit growth opportunities. This means that less of its cash flow, if any at all, is paid out to shareholders in the early years. Instead, it gets reinvested into the business alongside outside capital that is raised. As the company grows larger and matures, it becomes more cash flow positive and simultaneously there tends to be fewer and fewer new growth opportunities that surpass the company's cost of capital. With increased profitability, but fewer opportunities for reinvestment, the firm distributes more of its cash flow to shareholders. As Microsoft and Apple matured, they amassed enormous cash balances and eventually submitted to pressure from investors to return some of that cash via dividends.

Stocks that use tax-advantaged structures like real estate investment trusts (REITs) and master limited partnerships (MLPs) typically afford higher yields to investors than those of other stocks. REITs require that 90% of rental income be paid out to unitholders of the trust. MLPs have unique tax deferral properties of which many natural resources pipeline operators take advantage, resulting in high yields. The Alerian MLP Index offers nearly an 8% yield presently. While these high-yielding stocks seem great at first blush, it's important to...

Alerian MLP Total Return Index



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Beware the Value Traps!

The chart above shows the total return of the Alerian MLP Index over the last 5 years, meaning it is inclusive of dividends. Even with the large dividends paid, the return is still negative over this period of time. Based on month end data points, the peak-to-trough decline over this period is 48.5%! Meanwhile, the S&P 500 over the same period had a total return north of 50%. The point here is that by focusing strictly on yield, you may be failing to understand the overall downside risk. At Matrix Private Capital Group, we recently took on a client that brought upward of $10 million in MLPs that has missed out on the significant upside described here because of the previous investment manager's over-emphasis on holding securities with high yields. This person would have been far better off diversifying into other investments.

A stock with a solid dividend yield but a continuously cratering share price is frequently known as a "value trap." Kinder Morgan (KMI), a large pipeline operator, was a great example of this in 2015. During that year, the quarterly dividend had gone from $0.45 to $0.51. Its high in April of that year had the stock price at around $44 per share, which put the dividend yield around 4% at the time. However, the price of oil plunged and KMI's share price also plunged in response over the next several months. Despite the slide in oil prices, KMI continued paying a quarterly dividend in the $0.45-$0.51 share range. With the dividend still elevated, but a share price that had now slid below $20, the dividend yield, which had now more than doubled, might have looked attractive to an unsophisticated investor. The smart money understood that KMI was going to have trouble continuing to pay such a high dividend, hence the cratering share price. In December 2015, KMI announced that it was slashing the dividend by 75%. Income focused investors that tried to take advantage of the elevated dividend yield not only got burned by the slashed dividend, but by the resulting share price as it slid all the way down to $13 by early 2016.

Are Stocks with High Dividends a Bad Thing?

Stocks or any other investments with a high dividend / income payout are fine as long as those payouts are sustainable. If an investment's payout is not sustainable, then at least one of the following things will happen:

1. The dividend will be cut.
2. The price of the security will decline.
3. In the case of fixed income, there could be a default followed by restructuring or asset recovery proceedings.

Analyzing the sustainability of dividends is no easy task and therefore most investors are better off engaging professional help to structure their portfolios, as opposed to just buying some dividend paying stocks that look attractive on the surface. Even GE, which had been known as a "dividend aristocrat" until 2010, cut its dividend to $0.01 per share recently. Sometimes a rising yield can offer great value, but there are many cases, such as the Kinder Morgan example, where a rising yield is a signal of greater problems to come. This concept is no different for bonds, although the risk profile of bonds is usually much safer than is the case for equities.

How Are Securities with High Yields Expected to Perform?

High dividend stocks and high-yield bonds have some similarities in terms of how they are influenced by economic and market conditions. In fact, high-yield bonds have about a 0.6 to 0.8 correlation with the S&P 500, which is fairly high. First of all, if the underlying companies have improving fundamentals, then common sense tells us that the prices of these securities should improve as well. The reverse is also true. Interest rates also have a significant impact. High yield

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bonds and high dividend stocks alike are swayed by the changing risk-reward analysis done by investors. For example, the first half of 2016 produced extremely strong returns for even the most boring dividend stocks, some of which were up as much as 20% over those 6 months. Why did this happen? The answer is that yields on relatively safe investment grade bonds were historically low and income hungry investors responded by chasing the additional yield found in high dividend stocks. As yields on the investment grade bonds started to normalize again at higher levels, for many investors it was no longer worth the incremental risk of being in high yield bonds and high dividend stocks, and they sold off again as a result. Inflation expectations have influence on these types of assets as well. Rising inflation expectations are detrimental to the performance of these securities. If you buy a security for a stable income stream and all of a sudden inflation picks up, the income from the asset will buy you less going forward. Therefore, the security has to reprice lower to factor in rising inflation and the decreased purchasing power of the income that results. This effect is a bigger factor in price changes for bonds that it is for stocks. For bonds with a fixed stream of payments, the bond will not suddenly start paying a higher coupon. Also, bonds generally have a fixed term, whereas stocks do not. For stocks, there is at least the possibility that the dividend will increase in the future and that improving fundamentals will lead to capital appreciation.

Conclusion

Yield is important to understand in the context of one's overall pool of investments, but unfortunately the nuances are poorly understood by most investors. Dividends and income are a key part of achieving the overall returns needed to meet financial goals and sustain one's quality of life. However, over-emphasizing yield at the expense of prudent risk management and growing one's asset base can be very costly over time. High dividend stocks and high-yield bonds exist for various reasons, are influenced disproportionately by certain economic and market factors, and present unique analytical challenges when deciding how to integrate them into a larger portfolio.

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