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Caution needed on high dividend stocks

Fund managers warn on stretched valuations

Philippa Yelland

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Equity yields are looking very attractive at the moment but an eight to 11 per cent yield does not mean investors should rush in, according to fund managers.

Prime Value Asset Management portfolio analyst Shih Thin Wong said a classic valuation "trap" is emerging among some traditional income generating stocks.

Investors need to be extra cautious and weigh up a stock's distributions versus its cost of entry, Wong said.

"High-yielding stocks have the potential to be overvalued especially if a large number of market participants crowd out value from the dividend thematic," he said.

"A high dividend yield is similar to a stock that is cheap - it promises much but may deliver little. Some of the highest yielding stocks on the market may be some of the worst investments."

Wong said stocks commonly targeted by investors for income - such as telecoms, utilities and selected gaming stocks - were trading at near-historically high valuations.

"It is getting harder to find opportunities in those traditional high yielding areas, and investors may be tempted to overlook price and focus on dividend yield," he said.

Wong also said investors needed to consider several factors when investing in equities for income, such as a company's ability to maintain a robust dividend payout.

"Some companies have a consistent track record of distributions but other elements come into it," he said.

"Notably in the past two years there have been a number of on-going structural changes affecting Australian companies. The resultant impact is a much lower ability to generate profits and cash flows, and consequently dividends."

Real Estate Investment Trusts (REITS) were a good example because before the global financial crisis, they were a strong income play, he said.

But when they started to over-engineer their growth, the REIT sector became higher risk and was punished severely in the ensuing market crash, he added.

Russell Investments ETFs director Amanda Skelly said to maximise income while maintaining exposure to the market, a high dividend equity strategy was a sound approach.

"Russell agrees that for this strategy to be effective investors need to look at more than the headline dividend yield to include factors such as earnings quality but, by and large, Australian equity market valuations are very attractive," Skelly said.

She said while banks offered excellent dividend opportunities right now, investors should not overlook other sectors such as resources where the dividend growth rate had been quite high.

Hyperion head of Australian equities and portfolio manager Joel Gray agreed that some of the highest yielding stocks on the market may be some of the worst investments.

"What is important for shareholder returns is not the next dividend payment per se but the sustainability of the dividend and the ability of the dividend to grow over time," Gray said.