

## Dividend Yields

### What is a Dividend?

Dividends are the portion of a company's earnings that are paid out to its shareholders. For example, suppose a company has 1 million shares outstanding, and it decides to distribute 2 million dollars to its shareholders. In this case, the dividend per share is \$2 (2 million dollars divided by one million shares). Dividends represent the primary cash income received from holding shares.

### What is a Dividend Yield?

A dividend yield is the percentage of a company's share price that it pays out in dividends over the course of one year. More specifically, the dividend yield is given by:

$$\text{Dividend Yield} = \frac{\text{Annual Dividend per Share}}{\text{Share Price}}$$

### What determines Dividend Yields?

Dividend yields are affected by the amount of dividends paid out by the company, as well as the company's share price.

The amount of dividends paid out to shareholders is determined at the company's discretion according to its dividend payout ratio. The dividend payout ratio is the percentage of a company's earnings that are paid out as dividends. Companies have several choices when it comes to deploying corporate profits. They can reinvest the profits back into the business, they can engage in share buy-back programs or other capital management programs, or they can distribute them as dividends. Hence, younger companies with lots of growth opportunities are far more likely to pay a small or no dividend, so that they can fund further expansion. In contrast, companies operating in more mature industries are likely to pay higher dividends, because they do not have the opportunity to invest in expansion.

Most companies try to steadily increase their dividends each year, usually in line with any profit increase. Generally, firms increase dividends only when they are confident that they can sustain them. Thus investors view increased dividends as a good signal that earnings for a company have improved permanently. In contrast, investors view decreased dividends as a bad signal that earnings for a company have worsened permanently. Due to this signalling effect of dividends, managers tend to prefer a stable to a volatile dividend policy. Companies are generally reluctant to cut dividends if profits fall. Similarly, companies are generally reluctant to raise dividends when increases in earnings are only temporary, because the dividend would need to be reduced when earnings fall back to prior levels.

The share price of the company also influences their dividend yield. The price of one share in a company is determined by a multitude of factors and hence is not directly set at the company's discretion. As we will outline below, both the amount of dividends paid out by the company and the company share price should be taken into consideration when using the dividend yield for making decisions.

## **What are they used for?**

### **Investors**

Typically, investors have liked dividends, as they're an excellent way of generating income regardless of how the stock is performing.

Investors that are seeking a relatively regular income stream as opposed to capital growth will be looking for companies with high dividend yields. Additionally, in a market where shares are showing little if any capital growth, dividend yields become a key factor in investors' decisions. If shares are showing little capital growth potential, investors will be more attracted to shares that have higher dividend yields in order to enhance returns, notwithstanding risk to capital. Additionally, if the interest rate earned on bank deposits is low, then investors seeking a relatively regular income stream will be more attracted to shares with higher dividend yields.

However, investors should be wary of simply chasing companies that are offering high dividend yields. A high dividend yield may be due to a higher dividend payout or a lower share price. If it is due to a lower share price, it is necessary to look at the strength of the company to determine whether the low share price is justified. That is, there may be good fundamental reasons why the company's share price is low and may even decrease further in the future. Investors should be careful to ensure that chasing high dividend income is not done at the expense of future share price performance.

### **Analysts**

Typically, analysts and the more sophisticated investors have used ratios such as dividend yields and Price-to-Earnings (P/E) as valuation tools.

A high dividend yield often arises due to a low share price and may indicate that the share is cheap. Generally, a share may be considered to have a high dividend yield if it is more than 50% higher than the share market average. However, as with any valuation ratio, the dividend yield should be treated with caution. If a share price falls and the dividend yield increases to a very high level, this generally means that the market as a whole believes that the company is struggling and will not be able to maintain the current level of dividends. That is, there may be valid reasons why the company is trading at a low share price and hence is not necessarily a cheap buy.

On the other hand, a low dividend yield is often associated with a high share price. This could be an indication that the share is expensive and the market is over optimistic. If a low dividend yield is due to an over optimistic market, then it is likely that the market will correct itself and the share price will decrease. However, there may be viable reasons for the high share price and low dividend yields. As mentioned previously, small growth companies will tend to use profits to expand their business instead of paying the profits out as dividends. These growth companies often have a higher share price as their future growth potential is incorporated into the share price by the market. In this case, a higher price relative to dividends may be justified.

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