

Why dividends are crucial today

Paul Taylor, Portfolio Manager of the Fidelity Australian Equities Fund, talks about why investing in the Australian share market just for its dividend yield makes sense today.



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How important are dividends today?

Dividends are important all the time for they are how equity investors get paid. It's dividends that drive the performance of stock markets. If we look over the long term, the best correlation in the performance of stock markets is the dividend yield of a market plus the real growth in those dividends. When you think about it, that makes perfect sense. In such a volatile market as today's, dividends take on extra significance.

How do dividend yields compare with term deposit rates?

The interesting thing right now is that equity investors are being paid well in terms of dividends. The dividend yield of the Australian market today, when looking at the S&P/ASX 200 Index, is about 5.9% – almost 6%. Now it's not quite 100% fully franked, but it's not far off. That's a great return, even if the market stagnates.

Now the dividend yield the market offers is even starker when you look at high-dividend stocks such as the Australian banks. They are offering, on average, 7.5% fully franked dividend yields. At the moment, you're much better off investing in bank stocks than putting your money in their term deposits. A 12-month term deposit offered by the big four at the moment is probably about 5.5% whereas on a comparable gross basis their dividend yields are closer to 10%.

Are these dividend yields sustainable?

There are two factors that tell whether dividends are sustainable or not. The first is the strength of Australian balance sheets. When we judge balance sheets, we look at gearing ratios, especially the ratio of net debt over net debt plus equity. Over the long term, that ratio has been about 32% for Australian companies. At the moment, it's closer to 20%, which tells us that Australian balance sheets are in healthy shape. In fact, balance sheets are probably too strong in that debt is too low. We are not only likely to see good dividends, we may even see more share buy-backs as well because of these robust balance sheets.

The second factor is whether cash flows are strong enough to cover dividends. One of the measures we look at to judge cash flows is what's called the free-to-invest cash flow – it's free-cash flow after everything; capital expenditure, changes in working capital and dividends. Even after all of those costs, cash flows for Australian companies are more than adequate. Strong balance sheets and strong cash flows to my mind equal sustainable dividends and even more share buy-backs.

Where are you finding value?

In a low-growth world what we're trying to do is find stocks that offer yield and growth because companies that can deliver growth in a low-growth world will be rare assets bid up by the markets.

Companies that we like at the moment include MAp, which after selling its European assets is basically Sydney Airport, Rio Tinto, mineral-sands producer Iluka Resources, Oil Search, Suncorp and Telstra – all companies that have promising profiles in

coming years while offering strong cash flows.

What is your outlook for the Australian market?

Clearly, there are big economic concerns around such as the sovereign debt issues in Europe, sluggish global growth, a stagnant US economy and slower growth in Asia. We will probably stay in a low-growth environment from a global perspective for a prolonged period. But the Australian share market is attractively valued and I think that's the bottom line. Investors who have a longer-time horizon can invest in the Australian market and in some good companies at great prices.

We like to look at long-term valuations and one measure that does that is the Graham Dodd price-earnings ratio, which is a through-the-cycle valuation tool. The Graham Dodd price-earnings ratio looks at the last 10 years of earnings, averages them and then puts them on a price-earnings ratio. This ratio is showing that Australian stocks are valued at close to recessionary valuations, which means that over the long term the market's attractively priced.

Even on more common measures – the Australian stock market is on about a 10-times price-earnings ratio while offering close to a 6% fully franked dividend yield – the Australian stock market is at attractive levels. That doesn't mean that the stock market will rise in next three, six, nine or even 12 months because short-term uncertainty or fads can take over. But if investors look out for three to five years, they can pick up great companies at great prices.

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