



ALL THAT YIELDS IS NOT GOLD

EVAN ROBINS | PORTFOLIO MANAGER

ABOUT THE AUTHOR

Evan manages Old Mutual's institutional and unit trust SA quoted property portfolios at MacroSolutions. He has experience in a wide range of roles in the asset management industry, particularly in equity research, portfolio management and strategy.

KEY TAKEOUTS

- PROPERTY INVESTORS SHOULD LOOK BEYOND HIGH HISTORIC OR PROJECTED YIELDS.
- CONSIDER THE MACROECONOMIC ENVIRONMENT, THE TRAJECTORY AND ROBUSTNESS OF EARNINGS, GOVERNANCE AND STRATEGY.
- PROPERTY INVESTORS SHOULD NOT EXPECT IMMEDIATE INCOME RETURNS.



Buying property shares on the basis of an enticingly high historic or projected yield can be an easy way to lose money. This can be the case especially when prevailing conditions are challenging or in a downturn. In addition to yield, investors need to consider a multitude of factors and must understand why the share appears cheap and whether the risk premium is justified.

VALUATION IS JUST ONE OF THE FACTORS

At MacroSolutions, when assessing an investment we do not look at the price (valuation) in isolation. We also look at factors that have the ability to drive capital gains or losses. We call these factors "Theme". Such factors include the macroeconomic environment, the trajectory and robustness of earnings, governance and strategy. Taking a long-term perspective is key in considering

such factors. A used car that seems like an amazing bargain can be a lemon. By taking into account more than the price, such as costs and availability of future maintenance, one can put that price into perspective. Assessing property should be no different.

Property shares that trade at high yields, generally do so because the market expects earnings to fall or believes that the risks around the company are particularly high, necessitating a premium. If those risks come to fruition, the downside can be steep. So observing the forward-looking yields is a reasonable proxy for the market's expectations of risk around earnings. Refer to the chart titled "Forward Dividend Yield...". The blue dots represent all the domestic SA REITs which were sufficiently large and well covered three years ago. On the vertical axis we plotted the consensus forward-looking 1-year dividend

yield three years ago. (These consensus figures were sourced from FactSet, a prominent global data provider.) On the horizontal axis we plotted the actual total return on the shares over the subsequent three years.

By observing a forward-looking and not a historic dividend yield, on the vertical axis, we incorporated existing market expectations of earnings declines for at least one year. By measuring total return and not price, on the horizontal axis, we incorporated the disproportionate income benefits investors in high-yield shares receive. The plot therefore reveals very interesting insights around the risk and return trade-off.

HIGH YIELDS, POOR RETURNS

Shares with the highest forward yields were amongst the worst performers. Those with a yield above 12% in June 2016 recorded

FORWARD DIVIDEND YIELD ON 1 JUNE 2016 AND SUBSEQUENT 3-YEAR TOTAL RETURN



Sources: FactSet

total returns of -15% or worse. This of course goes against finance theory. There should be an upward sloping risk, i.e. forward yield, total return line as investors should be compensated by the higher yield for the greater cash flow risk they accept. Over the cycle and longer term this indeed may be the case. With higher yielding shares, a materially higher total return is a just reward for the downside risk, not a bonus. If investors are not receiving one, they are being short-changed.

LOW YIELDS, NEGATIVE RETURNS

Those shares with the lowest yields, i.e. the most expensive, also gave negative returns as they were overpriced to begin with, and their share prices normalised. It is no surprise to those who follow the sector that two of these three lowest yield shares were Resilient Group companies. We were underweight to these companies because we believed they were excessively overvalued and had under-appreciated risk factors. We are not arguing that entry price is not important; it is critical, but it is not the only factor that needs to be considered. We are prepared to pay a reasonable premium for a company with superior attributes for long-term advantage.

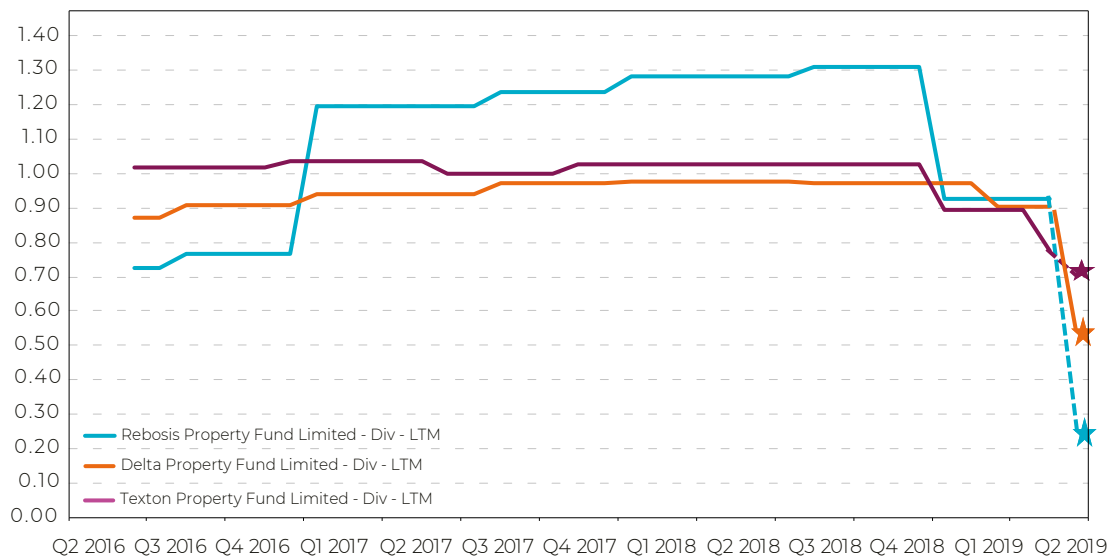
AVERAGE YIELDS, MIXED RETURNS

There were mixed fortunes for those shares with an average yield. A common retrospective feature of the shares which provided a negative total return, is that they disappointed materially in earnings and had or developed governance concerns of various degrees.

Let's focus in on the three high yielding shares in the chart titled "Dividends: Rand per share". These had forward yields greater than 12% when the next highest yielding share provided 10% and the average yield was around 8.5%. This is a substantial dividend yield pick-up. Think of this in fixed deposit terms.

The chart below shows how the actual dividends of these companies have changed since 1 June 2016. The stars are the maximum dividends that are likely for the current financial year, generally based on guidance. The actual dividend could be as much as 25% less. To be fair, some of these dividends may be below sustainable levels if these companies can correct, and we are making no comments on whether these shares are a good buy today. As you can see, with the benefit of hindsight these companies were not "cheap for a reason" but were expensive, considering how much their dividends have fallen

DIVIDENDS: RAND PER SHARE



Sources: FactSet (historical) & MacroSolutions

or are still to fall. It took years for the “reason for the high yields” (or risk) that the market was pricing in to reflect in results – the dividend lines only started turning down in Q4 2018.

COMPREHENSIVE INVESTMENT PROCESS

As mentioned, in investing, we consider both Price and Theme. By including consideration of the characteristics and prospects of a company, in addition to valuation, as a key component of the investment process helps to avoid the value traps discussed. Our funds were, on listing, among the largest shareholders of two of these three high-yield companies. We never held the third. We sold out of these companies as we grew concerned about the strategic, governance and dividend sustainability and/or operational outlook. None of these factors were a secret.

It will take a lot of space to tell the story of why these companies got into trouble. Even though we had concerns, we didn't anticipate this degree of earnings

decline. What pushed some companies over the edge was in most cases an unfavourable external environment. Nonetheless, the potential seeds of what became the undoing of these companies was apparent years ago – and these concerns were reflected in the yields.

INVESTING IS NOT ONE-DIMENSIONAL

Many factors must be considered, of which yield is just one. While our process navigated these landmines very well, our portfolios have occasionally been caught with seemingly cheap shares where we should have taken greater cognisance of the declining outlook or where we under-appreciated gathering clouds. Firmly building this understanding into our investment process should reduce the frequency of this occurring. It also builds more robust portfolios for our clients. Property investing is about assessing risks and being forward looking not the “sugar rush” of immediate income returns.

