CIO MONTHLY NOTE

SOLID DIVIDENDS HEADING INTO YEAR END

As global markets begin to digest and contemplate the removal of very accommodative monetary policy settings, it is expected that the process will be slow and very prolonged. Yield will therefore remain a focus.

Domestically, the case for higher RBA cash rates is not that clear. The higher AUD, low inflation and the very uneven growth momentum across the different states suggests that remaining on hold is the prudent path. This implies many SMSF investors, particularly retirees, will remain yield hungry and when it comes to domestic equities, remain focused on the dividend yield.

Most large cap equity portfolios should be able to deliver a 4.5% dividend yield over the next year before the franking contribution. A specific yield focus equity portfolio will be able to target a 6% or greater yield, however you will need to trade off lower earnings growth potential.

The key will be investing in companies that have consistent or improving dividend per share (DPS) momentum. Dependable high cash flow businesses are required to accumulate a more reliable and consistent yield. From a portfolio perspective, the aim will be to target lower debt levels. Therefore, exposure to highly geared utilities or infrastructure, for example, imply you will need to include lower geared industrials or diversified financials.

A standard yield focused equity portfolio should include both the major and regional banks, some consumer discretionary/gaming (Tatts Group, Tabcorp), consumer staples (Wesfarmers, Woolworths and even Coca-Cola Amatil), diversified financials (ASX, IOOF, Macquarie Bank, Magellan, Perpetual, Scottish Pacific, Medibank Private), infrastructure/rail (Macquarie Atlas, Transurban, Sydney Airport, Aurizon Holdings) and some A-REITs (Charter Hall, Stockland). These businesses in a portfolio context tend to accumulate and distribute cash flow back to the investor in a more consistent way.

More cyclical businesses imply less reliable dividends but if your timing is right, some of the more volatile sectors can distribute some additional income. These would include Caltex (energy), BHP and Rio (materials). More cyclical sectors are not traditional income exposure stocks and investors need to be aware of this and remember to sell eventually. A purely growth portfolio is of course a different process and cyclical material/resource companies feature.

On the general market outlook, October has produced a good solid month of returns following a very long period of the market moving sideways. The recent recovery was well overdue. As a fund manager, we also have targets to keep an eye on as we are always pricing future earnings. These will always move based on changing expectations, but the target for the broader equity market remains unchanged. The ASX300 30 June 2018 target of 6,250 and the December 2018 target of 6,500 are still on track provided local interest rates remain steady, the AUD remains below USD 0.75 and for global economic activity to continue at trend pace. In this context, a growth equity portfolio should be able to deliver a 4.25% yield and a dividend focused portfolio (ie with a lower growth outlook on their earnings) should be able to deliver closer to 6.5% on a one year view.

On balance equities (both global and local) remain reasonable on a one year view compared to the very low bond and cash yields. Domestically, the compelling dividend will remain a key contributor to your local equity portfolio returns. The December quarter is conveniently a good dividend paying period. Hopefully this helps the retail sector as we head into the holiday period.

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