

*“More money has been lost reaching for yield than at the point of a gun.”*

Ray DeVoe

*“Do not accept principal risk while investing short-term cash: the greedy effort to earn a few extra basis points of yield inevitably leads to the incurrence of greater risk, which increases the likelihood of losses and severe illiquidity at precisely the moment when cash is needed to cover expenses, to meet commitments, or to make compelling long-term investments.”*

Seth Klarman

The dominant theme in the Australian share market over the past year has been the “search for yield”. So much so that media articles are now referring to “the yield bubble”. Whether it is a “bubble” or not only time will tell. However what is clear is that right now yield is scarce, and therefore expensive. It is for this reason that I believe it should not be a big factor in assessing the suitability of an investment.<sup>1</sup>

A company’s earnings can be split into those that it pays to its shareholders as cash dividends and those that it retains to fund the ongoing growth of its business. The portion that is paid out as dividends should be determined by the company’s ability to reinvest capital to grow the business, not by the appetite of its shareholders for dividends. It is sensible for a company with the opportunity to earn a good return on additional capital (such as a successful and established business expanding into new territories) to retain those earnings and therefore generate much higher future earnings.<sup>2</sup> A company without that opportunity (such as a local quarry) should return the excess capital to shareholders who are better able to deploy it themselves.

However confronted by shrinking returns from cash, where a large part of retail investors’ funds have sat over the past few years, the market is currently favouring earnings paid as dividends ahead of those that are retained. It has therefore placed a higher price on the former earnings relative to the latter.

For the value investor this presents an opportunity. While the rest of the market pushes up the price of stocks paying high dividends such as Telstra, the big four banks and Woolworths, I think we are better served progressively trimming these types of holdings (there’s no need to dump them holus bolus as bubbles often run much longer than we anticipate) and placing the proceeds in cash or in companies with the ability to generate real and sustained earnings growth over time.

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<sup>1</sup> Searching for the most attractive yield right now is a bit like shopping for the cheapest bananas after a cyclone has devastated the domestic banana crop. Far more sensible to eat apples and oranges instead until the market rights itself.

<sup>2</sup> Regional Express, a company owned by most clients, is able to save \$400,000 a year in lease payments by purchasing its aircraft for around \$2 million as they come off lease – generating an easy 20% per annum return that would be unavailable to most of its shareholders.