

# Yields, Fact or Fiction?

By Nick Raynor, Investment Adviser

A (dividend) yield tells you how much your shares are earning in percentage terms so that you can compare it with other investments.

Published yields are in fact historic yields and represent the dividend income received for each pound invested (see the next page for more information). However, the more important piece of information for an investor is the forecast yield. This is not a calculated figure but is the average broker forecast of the expected future yield. This information is available on our website on a company's summary page. If you are in any doubt about these figures and what they mean then talk to our Advice team.

Currently the companies listed on the FTSE 100 have an average yield of 5.9% which includes the historic yields of the banking sector plus 4 companies that do not even pay any dividend. Strip away the banks and you are left with a yield of 4.1%: still better than you'll be getting in any savings account but without the capital security of a savings account. There is also the potential of getting a bit of growth on your money as well, however it must be remembered that the value of stock market investments and the income from them can go down as well as up and that investors may get back less than their initial investment.

If you search through the Financial Times for a company with a high yield then you'll be spoilt for choice. At the time of writing there are 7 FTSE 100 companies that have an historic yield of over 10% and

two of those are over 50%. Such a high yield should immediately set alarm bells ringing.

A company could have a relatively high yield for several reasons. The company could be performing very well and decide to reward investors with a higher dividend. However, in the current market it is more likely that a higher yield is the consequence of a tumbling share price. In this case, investors need to understand why the share price is falling. If there has been a sharp fall in profits then it is likely that the company will be cutting or ceasing to pay the next dividend. It may prove better for shareholders if a company holds onto its cash to revitalise the business in the hope of a better return over the longer term. Marstons, the brewer and pub operator, recently maintained its final dividend rather than cut its payout. In response, analysts have turned their back on the company. By cutting or not making a payout the company could have saved themselves over £35 million and reinvested this in the business.

Similarly, there may be several reasons why a company has a low yield. It could be a fledgling company, new to the market, not making much profit and therefore unable to pay a dividend. Alternatively, the company may have cut the dividend due to a fall in profits and be looking to make cost savings. Understanding a company's trading history will help you interpret the published yield.

If you study a company's financial details, you can form an educated opinion on whether or not a dividend is sustainable and whether there is likely to be any change in the dividend payout. If a

company is not making a profit then you have to wonder where the money is coming from to pay the dividend. There may be a cash surplus available but that cannot last forever, and if profits are down, then a dividend is usually the first cost saving. Dividend cover is another good indicator of potential increases or decreases to the yield and this and other key figures are covered in more detail on the next page.

Those investors who are looking for a consistent yield without the volatility of equities could consider investing in corporate bonds. Corporate bonds can offer a higher yield compared to some other investments, but that higher yield may come at a cost. Most corporate bonds are debentures, (loans not secured by collateral) and carry a credit risk as there is the potential that the issuer will default on its debt obligations. If such a situation occurs, however, the company would go into administration and its equity shares would be worthless: that's why it's often said that corporate bonds 'stand behind' equity. It is important that investors in corporate bonds understand both the potential gains available and how to assess credit risk—whilst rising interest rates can reduce a bond's value, a default can almost eliminate it.

## Find out more

Corporate bonds and corporate bond funds are covered in more detail in the accompanying edition of The Fundholder. For more information on yields or bonds please contact our Advice team on 01296 41 43 45.

# Six figures that can help you decide whether to buy a share

Now's not the time for investing on a whim. That's why we're publishing these six key ratios that offer an insight into a company's potential.

## 1 Dividend yield

The dividend yield relates the annual dividend income per share paid out by a company to its market share price and reflects how much income an investor receives for each pound invested.

$$\text{Dividend yield} = \frac{\text{Net dividend income per share}}{\text{Market share price}}$$

If a company declares a net dividend of 2.5p per share and its share price is 100p, then the dividend yield will be  $2.5/100 = 2.5\%$ .

**Note:** A dividend yield should not be considered in isolation. A comparatively low dividend yield could indicate a high share price that reflects a company's positive growth prospects or it could mean that the company cannot afford to pay a decent dividend. A comparatively high dividend yield may provide a dividend that lessens the financial impact of any fall in share price but it may also raise concerns about a company's future prospects (see the previous article).

## 2 Dividend cover

Dividend cover relates a company's earnings (net profit after tax) to the net dividend paid to shareholders and reflects the number of times a company's profit covers the ordinary dividend.

$$\text{Dividend cover} = \frac{\text{Net earnings per share}}{\text{Net dividend per share}}$$

If a company has earnings per share of 5p and it pays out a dividend of 2.5p, the dividend cover will be  $5 / 2.5 = 2$ .

**Note:** Generally a ratio of 2 or higher is considered safe; anything below 1.5 is risky. At 1, a company's profits are only just covering the dividend. Under 1, the company is paying the dividend from retained earnings which is not normally a sustainable situation.

## 3 Price/earnings ratio (P/E ratio or PER)

The P/E ratio (also known as the 'multiple') relates the market share price to earnings per share (EPS) and reflects the price investors are prepared to pay for each pound of earnings of a company.

$$\text{P/E ratio} = \frac{\text{Market share price}}{\text{Earnings per share (net profit after tax/ no. of shares)}}$$

For example, for a company with a share price of 100p and EPS of 5p, the P/E ratio is 20.

**Note:** A high P/E indicates that the market expects the company's future earnings to grow higher than a company with a lower P/E. However, the P/E should not be considered in isolation but rather used as a tool to compare a company with others within the same industry or to compare a company's current performance with its historical performance.

## 4 Price/earnings to growth ratio (PEG ratio)

The PEG ratio relates a company's P/E ratio to its estimated future growth rate in earnings per share of the company. It is seen as a better investment tool than the P/E ratio because it considers future growth in addition to historical performance.

$$\text{PEG ratio} = \frac{\text{P/E ratio}}{\text{Estimated future growth (expressed as a percentage)}}$$

If a company with a P/E ratio of 20 is forecast a future growth rate of 15%, then the PEG will be  $20 / 15 = 1.33$ .

**Note:** The lower the PEG, the less you pay for estimated future earnings; shares with a PEG of 1 or lower are considered

good value. However, a PEG ratio is only as reliable as a broker's forecast; it therefore makes sense to consider multiple or consensus forecasts.

## 5 Gearing ratio

Gearing relates the level of a company's debt to its market capitalisation and reflects how encumbered a company is with debt. It is usually expressed as a percentage.

$$\text{Gearing ratio} = \frac{\text{A company's debt}}{\text{Market Capitalisation}}$$

If a company borrows £120 million against a market capitalisation of £200 million it will have a gearing of 60%.

**Note:** 'Prudent' gearing ratios vary between industries. Generally, anything over 100% is considered risky or 'highly geared'.

## 6 Price-to-book ratio (P/B ratio)

The P/B ratio relates the market share price to the net asset book value per share and can be a useful tool for finding undervalued companies.

$$\text{P/B ratio} = \frac{\text{Market share price}}{\text{Net asset book value per share}}$$

If a company has a book value (value of assets – value of liabilities) of £100 million and 200 million shares, then each share represents 50p of book value. If the share price is 100p then the P/B ratio is  $100 / 50 = 2$ .

**Note:** Generally, if a P/B ratio is less than 1 the shares are good value; at over 2 they may be over-priced. However, the usefulness of this ratio is dependent on the valuation of the assets being both accurate and current.

Some of these ratios can be found on a company's summary page at [www.share.com](http://www.share.com).