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Beware of Yield Traps

Jason Teh, Chief Investment Officer at Vertium Asset Management | 4 October 2021

With interest rates at record lows, investors may be tempted to chase high dividend-yielding stocks to replenish lost income in their portfolios. However, chasing high yielding stocks can be a dangerous strategy that can potentially expose investors to the risk of significant share price corrections and poor total return outcomes.

We have written before about how to identify dividend yield traps. To recap:

1. **Peak earnings**

   Dividends are paid out as a proportion of earnings and when earnings are under pressure dividends typically follow. Hence, investors must be wary when earnings are peaking. For example, from 2017 to 2019 Telstra had to significantly rebase its dividend from 31 cents per share (cps) to 13 cps because of the permanent loss in fixed line earnings to the National Broadband Network.

2. **Weak balance sheet**

   Debt holders get priority to cashflows before equity holders. When it comes to corporate survival, management must pay interest to debt holders first before paying dividends to equity holders. During times of crisis dividends are cut first to preserve the balance sheet, as we recently witnessed during the COVID crash in 2020.

3. **Excessively high dividend payout ratio**

   The higher the payout ratio (dividends as a proportion of earnings), the greater the likelihood of a dividend cut if earnings decline. In 2015, BHP had a 200% payout ratio and had to borrow from its balance sheet to sustain its dividend. Clearly, it was not sustainable which led to the company cutting its dividend and restructuring its progressive dividend policy to a payout ratio policy.

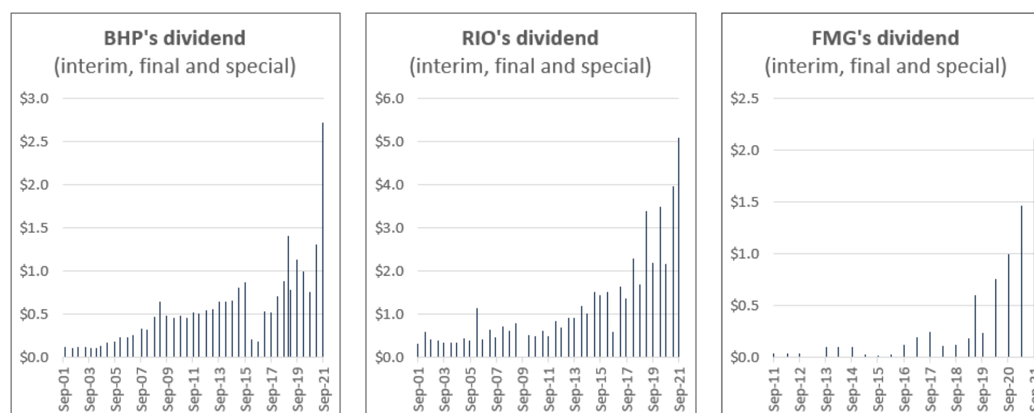
While weakness in any one of these metrics may not lead to a dividend cut, the more a company exhibits these characteristics, the greater the likelihood of a cut. Based on Vertium's fundamental analysis there were a few classic yield traps identified over the last few months.

In searching for yield, the iron ore stocks have been consistently offering high yields over the last couple of years. In fact, recent dividend yields were so high for3 mining stocks, FMG, RIO and BHP, that they accounted for about a third of the ASX100's dividend yield.

	Market Weight	Weighted Average Forecast Dividend Yield	Contribution to ASX100 yield
Iron Ore Miners (BHP, RIO, FMG)	10%	10.8%	28%
ASX100 ex-iron ore miners	90%	3.0%	71%
ASX100	**100%**	**3.8%**	**100%**

Source: FactSet, Vertium

Hence, there was much anticipation from yield hungry investors leading up to the August reporting season as these 3 iron ore miners (BHP, RIO and Fortescue Metals) were about to pay out record dividends. They didn't disappoint. They paid gargantuan dividends never seen before in their corporate history.



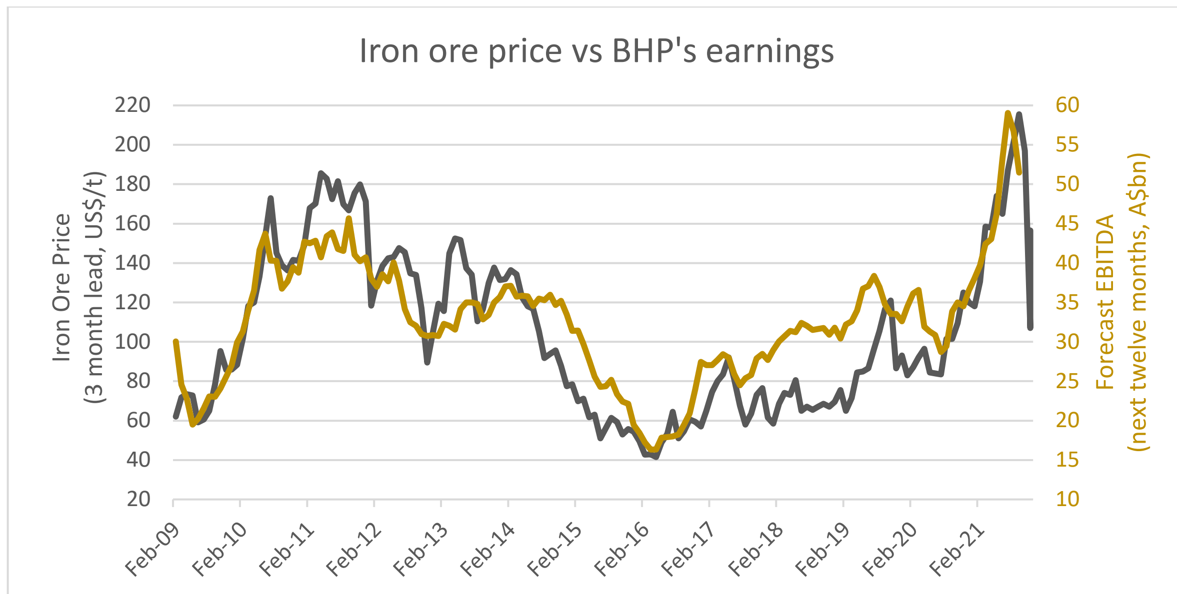
Source: Iress

However, the euphoria on these enormous dividend was short-lived. While the dividend payments were certainly large they have paled in significance when compared to the collapse of their recent share prices. It was like picking up pennies and getting hit by the proverbial steamroller.

	Share Price 30 July 21	Recent DPS (dividend yield)	Change in share price to 30 Sep 21 (price return)
FMG	$24.9	$2.1 **(+8.5%)**	-$10.0 **(-40.0%)**
RIO	$133.4	$7.6 **(+5.7%)**	-$33.2 **(-28.6%)**
BHP	$53.5	$2.7 **(+5.1%)**	-$15.9 **(-29.8%)**

Source: Iress

While the iron ore miners have excellent balance sheets and sustainable payout ratios they were also yield traps because of their peak earnings, driven by the extremely high iron ore price. As seen in the chart below, BHP's earnings closely track the boom-bust cycle of the iron ore price. In recent months its earnings followed the iron ore price and has just crested over its peak.



Source: FactSet, Vertium

In fact, it takes about 3 months for consensus to mark to market earnings based on the prevailing iron ore price. Given this lag, consensus forecasts have further to go in revising down BHP's earnings and dividends will certainly follow. It's highly likely investors will not see the same level of dividends paid by the iron ore miners for at least another decade.

In conclusion, dividends are an essential component of investment returns but chasing yield can be a very dangerous investment strategy. At Vertium we are constantly on the look-out for yield traps with our lens sharply focused on peak earnings, weak balance sheets and high dividend payout ratios. Avoiding yield traps helps mitigate risk while generating a reasonable return from our investments.

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About the author

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Jason founded Vertium Asset Management in 2017 and has around 20 years' Australian equity investment management experience. He leads Vertium's investment team and is responsible for the firm's investment philosophy, process and portfolio management.

Before establishing Vertium, Jason was a Senior Portfolio Manager at Investors Mutual. He was the architect of the Investors Mutual Equity Income Fund, which he successfully managed for almost six years. As the second-longest serving employee at Investors Mutual spanning over 16 years, he had a variety of roles including managing a share of the Investors Mutual Australian Share Fund and as an Equity Analyst and Senior Quantitative Analyst.

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