FINANCIAL REVIEW

Where yield hunters are getting their cash fix

Banks and property stocks have faltered as reliable sources of income, prompting fund managers to look at industrial stocks and the use of options to derive extra income.

Robert Guy
Senior Writer
24 June 2020

The reputation of banks and real estate investment trusts (REITs) as reliable sources of dividend income have taken a battering this year, sharpening the focus on industrial stocks that can translate resilient earnings into steady payouts to investors.

The uncertainty unleashed by the COVID-19 pandemic has triggered a more prudent approach to capital management among banks and REITs, with many deferring or cutting dividends and distributions to protect balance sheets.

Investors Mutual likes Coles as a yield play. **Getty**

But that prudence has come at the expense of yield-hungry investors desperate for income in a low-yield world.

"The traditional sectors of the market that might have paid good and more reliable franked dividends are under threat, particularly traditional sources," Investors Mutual portfolio manager Michael O'Neill said.

"First to come to mind are banks and property stocks."

He notes a third of the S&P/ASX 300 Index has cut or deferred dividends or has withdrawn guidance.

The trailing yield of the index is at around 3.8 per cent but Mr O'Neill said it is "vulnerable" and will be "tested".

The banks have long been a hunting ground for yield seekers but the sector is unlikely to see a return to 5 per cent to 6 per cent yields and 70 per cent payout ratios until the 2022 financial year.

Banks have seen their margins on deposits squeezed by low rates, while profits have been hurt by the removal of excessive fees, remediation costs for past misconduct, and higher regulatory burdens.

"Even in absence of the crisis we're seeing with COVID, banks were suffering structurally lower returns," Mr O'Neill said.

REITs have had their ability to pay distributions hit by the downturn in bricks and mortar retail and the rise on online shopping, while office landlords have endured a dramatic embrace of work-from-home practices that has cast doubt over demand for office space.

However, not all REITs are the same. Mr O'Neill highlights landlords with big-name anchor tenants that offer long-weighted average lease expiries – SCA Property Group, Charter Hall Retail REIT and BWP Trust – as attractive.

"We see those income streams as carrying more secure earnings and cash flows and therefore likely to carry a higher valuation."

Mr O'Neill has turned to industrial stocks with reliable earnings streams, coupled with the use of options, to deliver additional yield.

Rail freight operator Aurizon is an industrial stock that offers attractive yield given its "below rail" business is regulated and its "above rail" business – offering haulage services – is based on long-term take-or-pay contracts with miners.

"Their customers are in very good financial shape being very low on the cost curve," Mr McNeill said.

"Their strong balance sheet and cash flows have seen them through COVID with little disruption and the impact on mining has been minimal."

Investors Mutual added to the stock at around $4 – which equated to a prospective price earnings multiple of 16 times – and a 6 per cent yield at the time of purchase.

"It's done quite well for us since March," he said, adding the stock had rallied to $4.80 and allowed them to write call options against the stock.

The call options are written at a strike price where the fund manager is willing to sell, with the buyer of the call option then paying them a "premium" to be able to potentially acquire those shares at the strike price.

Mr O'Neill said the fund was able to achieve a 5 per cent option income yield on those calls and enhance the yield on Aurizon towards 10 per cent.

Supermarket operator Coles Group is another stock where the fund manager is finding yield. He bought into Coles when it demerged from Wesfarmers and targeted an entry price at around $11 in 2019.

The stock had done "very well" and rallied beyond the target share price, enabling them to sell call options at $17 to reduce exposure and enhance income.

The fund manager rebuilt a position in the sell-off at $14, the stock has since rallied and they have written call options.

Another stock Mr O'Neill likes is packaging giant Amcor.

"It's recently showed the strength of its business in these times through its recent quarterly result, where we saw the strength of its diversified operations."