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NEWSLETTER

Stocks, REITs and Bonds

INVESTING FOR YIELD

With a volatile stock market and an extremely low interest rate environment, investments that provide a regular income yield are increasingly popular.

Let's explore some of the important financial measures that will help you in your hunt for yield.

Stocks

Dividend Yield: this is computed using the dividend per share divided by the current share price.

If the dividend yield of a stock is 5%, it would have beaten money put in the bank as fixed deposits earning less than 1%.

However, if inflation is at 4%, your real return might just be 1%, excluding any potential capital gain from price appreciation.

A key to investing for dividend yield successfully is cash flow sustainability.

A useful measure for the latter is to measure the company's Free Cash Flow ("FCF"). This is calculated using its Cash Flow from Operations and deducting Capital Expenditure necessary to maintain its operating capacity.

One way to gauge a company's ability to generate FCF is to calculate its **FCF Margin.**

This is computed using FCF divided by revenue. A company that is able to maintain a regular dividend payment would have a stable FCF margin over the years, as compared to one that is unable to maintain a consistent payout ratio as a percentage of its earnings.

Another measure that can be computed is the company's **FCF Yield.**

This is calculated using FCF divided by Market Capitalisation.

The alternative is to divide by its Enterprise Value, which is calculated as Market Capitalistion plus debt, minority interest and preferred shares, less cash.

REITs

Real Estate Investment Trusts are set up to own a pool of real estate such as mall, offices, hospitals, hotels and industrial space on behalf of unit holders.

They are professionally managed by a manager and the trustee.

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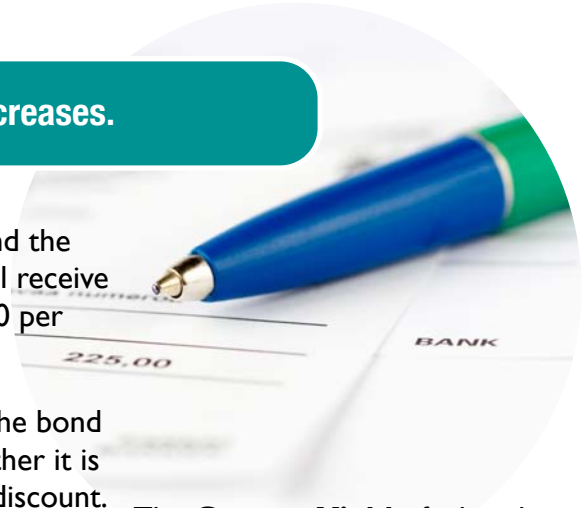
When interest rate increases, bond price decreases.



Distributions are made quarterly or semi-annually.

With REITs, the key measure is its **Distribution Yield**. This is similar to dividend yield for stocks and is calculated using the distribution per unit divided by its current unit price.

The distribution yield could range from 5% to 10% depending on the type of REITs.

Generally, the more likely a REIT is able to increase its rental income in future, the lower the yield. We can see this in the case of retail REITs.

Industrial REITs, on the other hand, tend to have yields approaching the higher end.

Bonds

When you buy a bond, you will receive an interest payment called the coupon. The **Coupon Rate** is computed using the annual payout divided by the par value.

The par value is also known as the face value of the bond.

If the par face is $1,000 and the coupon rate is 4%, you will receive an interest payment of $40 per annum.

The current price which the bond is selling depends on whether it is selling at a premium or a discount.

If it is selling at a premium, you will have to pay more than the face value to buy the bond.

This happens when current interest rates go down, making existing bonds with higher coupon rates more attractive, which increase their current market prices.

On the other hand, if interest rate increases, say, from 4% to 5%, the price of a $1,000 par value bond with coupon of 4% ($40 payout) will drop to $800. This makes the bond yield consistent with current interest rates (40/800 x 100 = 5%).

The above is a simple illustration to show the impact of changes in interest rates on bond prices. The return calculated is called the current yield.

The **Current Yield** of a bond refers to its coupon divided by the current market price.

As bonds typically have multiple coupon payments spread over the term of its maturity, the current yield only measures the first year's immediate return.

To measure the return that considers not just the current yield but the total return from holding the bond till maturity, which comprise all coupon payments plus any capital gain or loss (depending on whether it was purchased at a discount or premium), we need to compute the **Yield-To-Maturity** ("YTM").

This is the bond's internal rate of return which makes the present value of a bond's payments equal to its market price.

About the author

James Leong C. Foo, Chartered Accountant, is CEO of VisionsOne Consulting Pte Ltd. and Adjunct Associate Professor with National University of Singapore. His highly popular workshop, Finance for Non-finance Managers, coaches managers and executives on using financial numbers to drive their business better. James can be reached at jamesleong@visions1.com.sg.

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