WHAT IS A YIELD ?

One of the reasons why there are people who think that we have come to a peak in equity share prices, is that there is a lot of muddled thinking on the subject of yields. They think it ridiculous that we should buy an equity on a 3% "yield" when you can buy gilt edged on 5½%. The simple answer is that we are not buying equities on a 3% "yield". What do we mean by yield? I think it is the expression of the average annual return an investor receives on his investment by way of interest or dividends throughout the life of the investment. Most people speak of yield as if it is the return on the money invested in the first year, or, more accurately, what the return would be if last year's dividends were repeated. In the case of an undated fixed interest security the yield is quite clear and very easily calculated, one merely divides the nominal rate of interest by the present price and multiplies by 100. Even this, of course, implicitly assumes that the interest will in fact be paid and there will be no default at any time in payment of the interest.

In the case of British Government securities one may assume that there will be no default and that the yield will turn out to be as calculated. One cannot strictly have the same confidence in calculating the yield on a Preference stock, particularly if the Preference is a non-cumulative one. Allowance should be made for the possibility of there being a default in the future. In the case of equities the true yield will obviously depend on what the future dividends are and we are therefore not in a position to calculate at the present time what is the true yield on an equity - we shall not know that for many years to come.

In the meantime, however, when we are endeavouring to compare fixed interest securities and equities it is, in my opinion, absurd

What is a Yield ? (contd.)

to graph the comparative yields arrived at by the methods described above and endeavour to draw firm conclusions from them without realising the implications involved. I think that because this is done is the reason why until two or three years ago it was traditional to buy gilt edged securities on the basis of an immediate return at present less than this calculated yield on equities.

How then are we to get over this difficulty?

As the true yield on any particular equity will not be calculable until the investment has run its course we will require, if we are to make an assumption of what the true yield is likely to be, to endeavour to forecast the trend of future dividends. This I agree is an extremely difficult matter but one thing of which I am quite certain is that the dividends on Ordinary shares will not remain constant at the level of last year's declared dividend, which is assumed in the usual calculations of an Ordinary share yield.

In this problem of trying to make a guess as to what the true average yield is, even if one is brave enough to attempt, as one must do, to forecast the future trend of dividends on a particular company, I find that very few people in the investment world can translate their forecasts into firm figures. With the object of endeavouring to throw some light on this problem, I produced some tables showing what the true yield on an equity really was on certain assumptions as to future dividends. For instance, on a share which was alleged by present methods to be yielding 3%, it would only require an annual improvement in future dividends of 10% simple to produce a true yield
/ of £7-7-5%. You have a copy of this table and also a note of the
/ formula involved in calculating these yields which gives, I hope, a picture of what I think a long term investment is.