High-quality stocks can still offer compelling yields

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Much ink and airtime has been spent gnashing over the European sovereign debt crisis. One of the unfortunate side effects of the worlds' almost obsessive macro focus is the fantastic microeconomic situation for many companies that is being simply ignored.

The 24-hour news spin has unfortunately sold viewers on the end of the world scenario, and as a result the retail investor has, once again, likely sold out near the bottom and missed the massive move we are seeing in October.

Instead of shopping for high quality companies at bargain basement prices, I fear many investors simply walked away from equities.

It is a natural instinct to flee from fear; however, by applying some simple math, we may see the irrational error of this behaviour.

In a rush to “safety”' investors have ploughed their money into bonds driving their prices up, and the absolute yield levels down to ranges that are likely to offer negative real returns (real returns are made up of the nominal yield or interest received on the bond less the rate of inflation) for the next ten years.

On the other hand, equities can still offer compelling long-term investment returns especially when one compares them to bonds.

Let's walk through an example by constructing and comparing two portfolios: the first is a three-bond portfolio of AAA-rated corporate bonds, and the second, a portfolio with the shares of the same companies in the first portfolio.

There are currently only 4 “AAA” rated companies in the world: Automatic Data Processing (ADP), Microsoft (MSFT), Exxon Mobil (XOM), and Johnson & Johnson (JNJ).

ADP does not offer a ten-year bond so we will construct our portfolio with the other three companies. The yield to maturity (the rate of return on a bond if held to the maturity date) and average yield for the portfolio (assuming equal weighting) can be found in the Table 1. The average portfolio yield is a paltry 2.65 percent to maturity.

The important thing to note is that if you buy this basket and hold it to maturity and these companies do not default, you will generate a nominal return of only 2.65 percent per year. This probably is not the number you are using in your retirement planning calculations. In addition, one has to take into account the rate of inflation which can eat away at your real returns. Currently the core consumer price index reflects two percent inflation.

Now let's take a look at the stock basket of these three companies and run some very conservative calculations to see what these stocks may generate over the same 10-year period. I have used the following assumptions to estimate possible returns:

1. Earnings. I have used the current Wall Street analyst consensus estimated long-term earnings for each of these companies (JNJ: 6.2 percent, XOM: 4.3 percent, MSFT: 11.6 percent) This is on average significantly less than their current five-year historic earnings growth rate.

2. Dividends will grow at the same rate as earnings over the next ten years (which is less than they have over the last three years). I am also applying a 30 percent withholding tax rate on all dividends which investors in Bermuda are subject to.

3. Multiple. This is probably the most debatable, but I will be conservative. I have chosen to use current multiples for each of the stocks which are significantly lower than their ten- and five-year average multiples for all three companies. This gives no benefit to potential return from any multiple expansions.

The results are displayed in the Table 2.

The portfolio offers an annual return of 7.1 percent with an ending cost basis yield of 4.4 percent. Obviously this is a much more appealing return set and possibly more in line with the expectations you had for your retirement plan. Moreover, the earnings of these companies will reflect the growth in inflation, hopefully eliminating the risk of inflation eating away at your returns. One more interesting item to consider for income investors is that the average ending portfolio yield for this basket after withholding tax is 4.4 percent. As dividends continue to rise, the magic of compounding is clearly working in your favour here.

What's more, the income generated from the stock portfolio almost exactly equals the bond portfolio! The bond portfolio generates income of $7,939 and the stock portfolio generates income of $7,606 virtually identical. In fact, for the equity guy to break even with the bond portfolio we can calculate ending price earnings ratio to apply to ending earnings.

As noted in Table 3 all price earnings ratios would be lower than they have EVER been in some 20 years!

Let's assume you disagree with my assumptions. Assume dividends and earnings only grow at four percent per annum (two percent lower than the long-term average growth rate of earnings in the S&P 500 of about six percent) for ALL of these companies. Let's also assume multiples continue to contract. As a result we will apply the lowest price to earnings multiple these stocks have traded at over the last ten years (in many cases this is the March 2009 low number). In this case the portfolio generates an annualised return of 3.2 percent with an ending cost yield of three percent. This is displayed in Table 4.

Still better than the Triple A bond book. Clearly the market is not over enthusiastic with stocks and even with the draconian bear case scenario you are better off buying these equities over the bonds.

It may also be important to note that none of these three companies NEED to be AAA-rated to run their respective businesses. In fact they could lever up substantially and buy back a large number of shares to juice returns for equity holders. Just for fun let's run a bull case scenario which assumes these companies trade at their average price earnings multiple of the past ten years at the end of the ten-year period and their diluted earnings per share grows in line with their average growth over the last five years. The results in this scenario would be satisfactory to say the least. Table 5 shows the stock portfolio would generate an annual return of 16.4 percent with an ending cost yield of 7.5 percent.

The rally in October has been violent and swift. It serves as a reminder to many that Mr Market is a fickle beast.

Investors would be wise to focus less on the news and more on longer term fundamentals which eventually assert themselves. High quality companies could still offer compelling long-term investment returns, especially when one compares them to bonds.

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