



# Fisher Funds

## Investor Education Centre

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### **There's yield then there's yield**

**10/10/10**

Generally when we talk about yield, we refer to the income that we receive off an investment, such as the yield on a term deposit, or the rent on a property or dividend from a share market investment.

There is another yield, the earnings yield, which is used to compare shares with bonds to determine whether they are expensive or cheap.

This explanation is a little technical, but bear with me as it is worth it!

The earnings yield is the reverse of the price earnings ratio. It is calculated by dividing the current earnings per share by the current share price per share.

Generally speaking, if the earnings yield of a stock is less than the yield on 10-year government stock, the stock can be considered overvalued. If the earnings yield is higher, stocks might be considered undervalued relative to bonds.

The difference between the earnings yield of a stock and the long-term bond yield is known as the risk premium. The theory is that government bonds are risk-free and the risk premium is the additional return that investors require from an investment for taking additional risk. Over time, the risk premium in the major developed markets has averaged between 4-6%.

Right now, the earnings yield on US stocks is at its highest for two decades, and interest rates are extremely low. This has resulted in a risk premium of close to 7% which is significantly higher than the historical average.

This either means that stocks are very cheap and might make an attractive buy, or that investors have such a pessimistic view about the economic outlook, that they are demanding an enormous premium to compensate for the risk that they believe lies ahead.

It may very well be a combination of the two factors – investors are nervous and stocks are cheap – but it certainly makes stocks look quite interesting.

Of course, the risk premium might stay this way for a long time, and interest rates will undoubtedly rise at some point, thereby closing the gap. But successful investors should be alert to extremes such as these in market valuations.

Back in the dot-com bubble of the early 2000s, the US market had an earnings yield of just 1.67%. At the time, the risk-free rate was around 5.9%. That means that investors could have received a yield of 5.9% without taking any risk, but they chose instead to accept 1.67% for the chance of winning big on unproven, high tech companies. Lots of smart investors saw an accident waiting to happen and sold out before it happened.

The undervaluation of shares relative to bonds is not as extreme in the New Zealand and Australian share markets as it is in the US, but it is clear nevertheless that shares are not particularly expensive.

The earnings yield of the New Zealand share market is currently around 8% which compares favourably with the ten year government bond rate of 5% ... and that's not factoring in an average net dividend yield of 5%!

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