

Investing in stock market: How important is dividend yield?

Generally speaking, income from stock investments comes from two sources: Increase in the market price of the stock or capital gains and dividend payouts.

Looking at the yield of the stock can be important for you if you are interested in making money off of your stock. The dividend yield of a stock is also a good indicator of the value of the company and whether or not it is performing well. The dividend yield should not be exclusively used as a criterion when evaluating cash producing investment opportunities. When evaluating dividend-paying stocks, investors often turn to the dividend yield as one of their criteria.

The dividend yield is calculated by dividing the current annualized dividend payout per share by the current stock price. The result is a percentage that suggests how much cash return the investor will receive on his investment at today's stock price and provided the dividend payout remains the same. Dividend yields are a measure of an investment's productivity and some even view it like an 'interest rate' earned on an investment. However, there are more aspects to consider when choosing a dividend-paying stock that fits your investment needs.

Function of dividends

At its most basic level, dividends are profit sharing. A share of common stock represents an ownership share in a company. Just as the owner of a small business enjoys the profits of the business' operations, so too does a shareholder in a larger company. The dividend is compensation for the investment made by the shareholder in the business.

Dividend yield - calculation

Find the annual dividend per share. This figure represents the sum of money paid to shareholders of a corporation from earnings.

Find the price per share of your stock.

Use a calculator to determine the annual yield calculation by taking the annual dividend per share and dividing it by the stock's price per share. For example, a stock that costs Rs.10 per share and pays a dividend of 50 cents per quarter would have a dividend yield of 20 percent. To get that figure you would divide the annual dividend amount of Rs.2 (.50 x 4) by Rs.10.

Remember, the effective yield of any stock you buy is based on your initial investment, not the current market price of the stock. In the example above, if you bought the stock for Rs.10, and the market price rose to Rs.12.50, the yield would drop to 16 percent for persons who bought the stock at that price. However, the yield on your initial investment would remain 20 percent--plus you would have a capital gain of 25 percent on your investment.

Dividend yield will always use the last 12 months' dividends divided by share price. It does not involve gross earnings per share. It only uses the part of the profits paid out to shareholders.



A security's dividend yield can also be a sign of the stability of a company and often supports a firm's share price. Normally, only profitable companies pay out dividends. Therefore, investors often view companies that have paid out significant dividends for an extended period of time as 'safer' investments. Thus, should events occur which are detrimental to the share price, the allure of the dividend combined with the stability of the company can support the price somewhat. Newer companies are less likely to pay dividends because they don't have a long record of quarterly profits and they are more likely to use their profits to pay for further growth of the company.

Low dividend yield

Low dividend yield indicates high demand from investors. High demand drives up the stock's price relative to the dividend.

High dividend yield

High dividend yield indicates a stock with low demand from investors, which depresses the share price.

Benchmark

Investors use the dividend yield to compare a stock to the overall stock market or to its industry peers. Significant differences can indicate buying or selling opportunities.

Dividend yield is a historical figure

Since the yield is calculated using the most recent dividend payout, it is not always reflective of the company's future dividend policies. Certainly, some companies have a history of maintaining and raising dividends year after year, but that is not always the case. If you find a stock yielding 5 percent in today's market but then the company cuts the dividend by 50 percent, the new yield would be 2.5 percent provided the stock price did not move. It is a common caveat to consider that past performance is not always an indicator of future results.

High yields may suggest high risk

Investments that offer higher levels of returns usually come with higher degrees of risk. Many companies sporting very high dividend yields may be linked to the value of a commodity. If the underlying value of the commodity were to experience a steep decline, even if only for a short period during a quarter, the dividend amount for that quarter may be reduced significantly or entirely. If a company is sporting an abnormally high yield, consider the source of the dividend and the overall stability of the company as it relates to its ability to pay dividends to shareholders.

Dividend Yield – Colombo Stock Exchange

Year	DY (%)
2005	2.7
2006	2.2
2007	2.5
2008	5.6
2009	3.0
2010	1.2
2011	1.8
2012 (Sep)	2.2

Yield is based on the stock price

The stock price is critical when calculating the dividend yield. Dividend-paying companies that have seen their stock price decline dramatically may see their yields increase significantly provided the dividend payout is kept intact. However, if a stock price is depressed, it may be a reflection of the company's overall performance and it may face some struggles ahead in terms of growth prospects. While it would be nice to earn an 8 percent yield on your investment, it would also hurt if 50 percent of your capital investment was wiped out in exchange for that yield. Additionally, if a company is performing well and the stock appreciates, the current dividend yield will decrease. This may make the percentage look less attractive, but not considering these as investment vehicles may preclude you from participating in capital appreciation related to the company's success and a steady source of dividend payments the company can easily service.

Why yield is important

Simply comparing the dividend per share of one stock to another is a misleading way to determine the stock's investment value. That ignores the number of shares that you can buy with a fixed amount of initial investment. By using the yield of each stock, you have a better comparative term for judging the value of the dividends in your investment.

Risks of high yield stocks

Sometimes a stock with a high yield has had a significant decline in stock price without a change in the company's dividend. For a stock to have a significant decline in market price, there usually is an accompanying steep decline in the company's business and resulting profits. These fundamental problems often make it impossible for the company to maintain its dividend payouts and the yield on your investment will drop. If you spot a stock with a large dividend yield, first check its market price over the previous six months. If the price has dropped precipitously, proceed cautiously.

Summary

The dividend yield indicates the ability to generate dividend income as a percent of the investment. It is calculated as the common dividend per share divided by the market price per share.

This is a particularly an important valuation measure for investors seeking regular income. Investors who depend on income from their investments include retired persons as well as pension and mutual funds, which invest with the primary objective of maximizing the income return. These investors like to see a higher dividend yield. Typically higher dividend yields are associated with more stable and mature companies. In the absence of any capital gains, the dividend yield is the return on investment for a stock.

"An investment in knowledge pays the best interest"

- Benjamin Franklin

When it comes to investing, nothing will pay off more than educating yourself. Do the necessary research, study and analysis before making any investment decisions.