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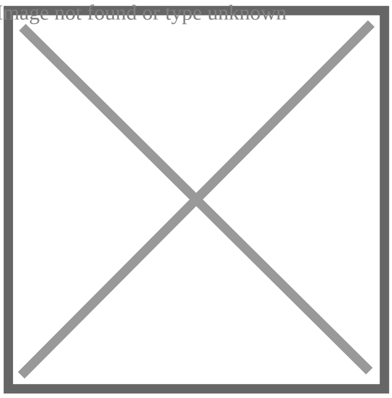

Is 4% the Minimum Yield Income Investors Should Aim for?

Description

A relatively large proportion of income investors have a cut-off point when it comes to buying shares. In other words, if a company's dividend yield is below a specific figure then they will not consider investing. For many income investors, that figure is 4% since it tends to be above inflation in the long run. It is also viewed by some investors as the amount which can be safely withdrawn from a portfolio each year without eating into capital gains.

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Imperfect decision-making

However, setting an arbitrary figure when it comes to income investing can lead to missed opportunities and potential problems. For example, a company may have a yield which is well in excess of 4% and appear to be a relatively attractive income stock. However, its current level of dividend may be unaffordable or become unaffordable in future years. This could be due to changes in its industry, internal problems or an economic slowdown. In any case, its current yield may be high, but its dividend affordability may be low.

Similarly, having a minimum yield requirement may lead to missed opportunities. Investors may unearth a high-quality company which has a yield of 3%, for example. It may have a dividend which is well-covered by profit and due to rise by 10% or more per annum over the medium term. As such, it could have the potential to become a stunning income stock in the long run. However, because it lacks short-term appeal, many income investors may overlook it in favour of a high yield/slow dividend growth company.

Changing environment

A further problem with the 4% rule or other arbitrary figure placed on minimum dividend yields is that the investment environment is continually changing. For example, in the last decade a 4% yield or similar on shares would have been relatively appealing. Across most of the developed world, it would have been ahead of interest rates and inflation. This means it would have offered a real-terms return and a relatively strong income return compared to other asset classes.

However, inflation and interest rates could both rise in future years. Higher spending and lower taxes in the US could be the catalyst for this. In such a scenario, a 4% yield may suddenly appear to be too low and it may mean a negative real-terms return. Of course, an investor could simply change their minimum requirement. But if dividend shares become more popular, obtaining yields above 4% may become increasingly challenging.

Takeaway

Instead of placing a specific figure such as 4% on shares as a minimum required income return, it may be prudent to take a fuller view on a company's merits. While a high yield may be desirable, so too are dividend growth, dividend affordability, stability and diversification. Considering other factors as part of the decision-making process may not only lead an investor to greater success, it may also mean less failure in the long run, too.

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