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Don’t fall for the ‘yield on cost’ myth

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Our portfolio manager has discretionary trading authority over our retirement accounts. In a recent rebalancing, he sold a portion of our BCE shares. These shares were bought years ago at $30 and – based on BCE’s current dividend of $2.73 – yield about 9 per cent. He used the proceeds to buy Shaw Communications, which yields just 4.5 per cent. Trading for a stock that yields half as much seems foolish. What do you think?

Let me assure you that your portfolio manager didn’t trade a stock that yields 9 per cent for one that yields half as much. It only looks that way because you are making an apples-to-oranges comparison between the two yields.

I call this the “yield on cost fallacy” and I’ve seen it many times. Investors who have held a stock for years – and have watched the dividend rise substantially – are often reluctant to sell because they believe the yield on their shares is now so high that everything else pales by comparison. It’s as if they believe selling the stock would erase years of dividend growth and put them back at square one.

Let me show you why this notion is false.

First, let’s look at BCE. Assuming you bought the shares in early 2010 (when they last traded at $30), you would have collected an annualized dividend of $1.74 at the time. BCE’s dividend has since grown to $2.73, so your “yield on cost” is 9.1 per cent (the current dividend of $2.73 divided by your original purchase price of $30).

Clearly, BCE has been a great investment for you. Your dividend income has grown by 57 per cent. If focusing on that 9.1-per-cent yield on cost makes you feel good about your investment’s past performance, that’s fine. But yield on cost is a backward-looking measure, and juxtaposing it with the current yields available on other investments is a spurious comparison.

To understand why, consider the $30 you invested originally in each BCE share. Now, answer the following question: How much of your capital is tied up in each BCE share that you still own? If you answered $30, you’re way off. The amount of capital you have tied up in BCE is equivalent to BCE’s current share price, which is about $63, because that is what you would get if you sold the shares today. The $30 purchase price is history – it’s irrelevant.

It follows then that, if BCE is worth $63 a share to you and it pays a dividend of $2.73, its actual yield is about 4.3 per cent ($2.73 divided by $63). That is less than half of your 9.1-per-cent yield on cost.

Now, let’s turn to Shaw Communications. Shaw pays a dividend of $1.185 annually and the stock recently traded at about $26.50. The yield is therefore about 4.5 per cent ($1.185 divided by $26.50).

So, by replacing some of your BCE shares (yielding 4.3 per cent) with Shaw (yielding 4.5 per cent), your portfolio manager actually increased your yield. This is the proper way to compare yields because both of these numbers reflect current share prices.

I’m not saying that selling BCE was necessarily a good – or bad – idea. Generally, I like to buy and hold stocks unless there is a very good reason to sell. I can only assume that the value of your BCE investment had grown to the point where its weighting in your retirement accounts was such that your portfolio manager thought it prudent to trim the position. Or perhaps he believed Shaw was a good value and wanted to diversify your telecommunications exposure.

The key point I want to make is that yield on cost, while valuable for demonstrating the wonderful benefits of dividend growth, should never be considered as a reason to hold a stock or used for comparisons with yields on other investments. What matters from a yield standpoint is how much income the stock is generating based on its market value today – not on a market value that is many years out of date.