

Too low dividends and too high stock market

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Stock Market Scenario

The real earning for investors in most listed companies comes from dividends that companies pay. Buying and selling of shares involves movement of funds from one investor to another. If investing in shares meant only buying and selling them at different prices it would be another form of gambling (which it is for people involved in day trading). The reason stock market can be viewed different from a casino is that the shares of companies that are listed pay their holders dividends. This money does not come from pocket of another investor. It comes from the company which is the investors partially owns by virtue of being holder of shares of the company.

One of the most important indicators of how high or low the overall stock market is the dividend yield of the overall stock market. The dividend yield is the amount of dividend that you will be paid if you own Rs 100 worth of shares. It is some what comparable to interest rate on fixed deposit. If you do a fixed deposit of Rs 100 for one year in a bank you could get 6% interest rate and the bank would pay you Rs 6 at the end of the year. So the yield of this fixed deposit is 6%. Similarly you could buy Rs 100 worth of shares and if the dividend yield is 2% then you will be earning Rs 2 as dividends. This may not seem significant to begin with but it is real important for two reasons. One it almost always shows that company is generating cash and it is this increase in cash generation that leads to increase in share price. The dividend themselves increase and with passage of time much more can be recovered in terms of dividends than what is paid for buying the shares(if shares are held for sufficiently long period).

The current dividend yield of Indian stock market (as represented by Nifty) is 1.1%. This is low by historical standards and also low by in the present global context. If we look at markets around the world the dividend yield are almost 2 to 3 times higher than in India. Even adjusting for the faster rate of growth this seems at least 30-40% too high. China for example has a dividend yield of 2.3% and its economy is growing faster than India. Brazil which itself is doing quite well has a dividend yield of 3.2%. If we are looking at comparable prices for Sensex we are looking at a level of 9600 to 11200.

Country	Dividend Yield
Australia	4.2
UK	3.4
Germany	3.3
Brazil	3.2
Malaysia	2.9
South Africa	2.8
Taiwan	2.7
Hong Kong	2.6
China	2.3
USA	1.9
India	1.1

Historically India's dividend yield has been more than 2%. Before the start of last Bull Run, in 2003, it had been close to 3%. Again by this standard the market is over priced significantly. The increase in profits if any is being driven by costs cuts rather than increase in revenue. Such an increase is difficult to sustain. So if investors are hoping that that rise in profits is going to be sustained they are probably going to be disappointed.

If we are looking at dividend yield as a parameter than the fair valuation of sensex seems much lower. It is an important parameter because parameters like profits have been abused using change in accounting standards. Investors should sell their mutual funds and wait till market corrects by at least 25% from current level of around 16000.