

# MATH 101

## “THE MAGIC OF YIELD ON COST”

BY PROFESSOR TOM A. LEWIS

Welcome Class. I'm pleased that you're here and interested in learning about something that, I believe, is the “holy grail” of income investing. You've already learned the rules and psychology of income investing, but now we need to get to the “Magic” of how to manage your investments so that you can obtain investment income that lasts as long as you need it to last.

The secret is in how we analyze our income investments. Conventional financial advice has historically been to put together a portfolio that involves some income combined with a gradual drawing down of one's principal. All of this is predicated on an estimate as to how long one plans to live and how much the cost of living will increase.

Building a retirement portfolio in this way can be fraught with complications. Attempting to predict how long we'll be retired or what the cost of maintaining our style of living will be is difficult at best, particularly since people are living much longer than ever before. There is also the constant monitoring of the portfolio, making adjustments as needed, worrying over such moves and paying the costs associated with them. Add to this the tax ramifications of trading and it is not surprising that a number of investors are challenged to

meet their income and financial goals once their earning years are over.

“OK then, Investing for Income is for me” you might say. But, how exactly can we measure the ongoing success of our income investments. The answer is, of course, we measure success differently than how growth and total return investors measure success in their portfolios. For income investors, measuring success involves the use of a great income investing metric. When this “Magic” metric is used in combination with a long-term outlook and a conservative orientation, we have a better chance of accurately measuring our results and obtaining the increasing income we need over time. Many Realty Income investors have achieved investment success by applying this “holy grail” of income investing—**Yield on Cost**—in measuring their investment results.

The formula for calculating Yield on Cost is relatively simple. Divide your current annual dividend by the original cost you paid for your shares of stock and the result is your Yield on Cost. For those of you who took basic algebra in high school the formula would be:

$$\frac{\text{Current Annualized Dividend}}{\text{Original Cost Per Share}} = \text{Yield on Cost}$$

Pretty simple, huh? What this metric tells us, on any given day, is what our dividend yield is today on our original investment. As owners of Realty Income, for example, the dividend has been regularly increased over the past eleven years, so our income (and Yield on Cost) has continued to increase over time. This means that \$10,000 invested in Realty Income shares in 1994, at \$8.56 per share, today has a Yield on Cost of 16.3%, based on a current annualized dividend per share amount of \$1.395. So, if we use our formula for Yield on Cost, our calculation would be:

$$\frac{\$1.395 \text{ (Our current annualized dividend)}}{\$8.56 \text{ share price at 12/31/94}} = 16.3\% \text{ (current yield on cost for shares purchased in 1994)}$$

**“I suspect that many more investors will become shareholders of Realty Income once the Baby Boomers begin to look for more secure avenues of depositing their capital. Annuities are sound, but they yield too little for someone trying to fight inflation. Realty Income offers something wonderful by means of dividends. Take the \$1.11 dividend back in 2000 yielding about 11%. Now that old money is yielding 13.95% today, something no annuity or money market fund could come close to touching.”**

Michael Whitten

2nd Lieutenant, U.S. Army, (stationed in Germany),  
Shareholder and Yield on Cost Expert

**EXAMPLE:**



<b>SHAREHOLDER YIELD ON COST</b>						
Name of Company	Ticker Symbol	1,000 Shares Purchase Date	INFORMATION BASED ON ORIGINAL COST		INFORMATION BASED ON CURRENT VALUE 12/31/05	
			Yield at Purchase Date	Total Annual Dividend at Purchase	Current Yield on Original Cost	Total Annual Dividend
REALTY INCOME	O	10/18/94	11.3%	\$ 900	17.4%	\$ 1,395
REALTY INCOME	O	12/31/94	10.5%	\$ 900	16.3%	\$ 1,395
REALTY INCOME	O	12/31/95	8.3%	\$ 930	12.4%	\$ 1,395
REALTY INCOME	O	12/31/96	7.9%	\$ 945	11.7%	\$ 1,395
REALTY INCOME	O	12/31/97	7.5%	\$ 960	11.0%	\$ 1,395
REALTY INCOME	O	12/31/98	8.2%	\$ 1,020	11.2%	\$ 1,395
REALTY INCOME	O	12/31/99	10.5%	\$ 1,080	13.5%	\$ 1,395
REALTY INCOME	O	12/31/00	8.9%	\$ 1,110	11.2%	\$ 1,395
REALTY INCOME	O	12/31/01	7.8%	\$ 1,140	9.5%	\$ 1,395
REALTY INCOME	O	12/31/02	6.7%	\$ 1,170	8.0%	\$ 1,395
REALTY INCOME	O	12/31/03	6.0%	\$ 1,200	7.0%	\$ 1,395
REALTY INCOME	O	12/31/04	5.2%	\$ 1,320	5.5%	\$ 1,395
REALTY INCOME	O	12/31/05	6.5%	\$ 1,395	6.5%	\$ 1,395

The chart above demonstrates the Yield on Cost based on various dates of purchase and gives us an idea of what our yield on cost might be. But, more importantly, it demonstrates that the longer one owns shares of a company, where dividends are regularly increased, the yield on one's original investment actually accelerates, over time.

This leads us to a critical investment principle of holding an income investment for the long-term. As long as the company continues to be a reliable producer of increasing income and maintains a conservative, long-term perspective, the ideal would be to hold such an investment forever.

The lesson here is that, since our objective is to obtain increasing income over time, our best measure of success in achieving this objective is to calculate our current Yield on Cost, for a specific investment, to see how it has increased over time.

If the Yield on Cost has continually increased over the life of our investment, there is very little reason for us to sell our shares.

With this simple calculation we can easily determine how well our income investments have performed for us when the temptation arises to sell our source of dependable income.

What a great way to measure the success of our investments! This is particularly true for an investor whose primary objective is to receive increasing dividend income over a long period of time!

A new income investment paradigm, therefore, is to find investments that pay high quality, increasing income, and keep them as long as they continue to produce a rising yield on cost over time. Once you've "got" this lesson, you'll not only receive an A in the class, but you'll also be able to build and maintain an income portfolio that is designed to last a lifetime.

**(Disclosure: Professor Lewis serves as adjunct professor in Math at MDU and moonlights as Realty Income's Chief Executive Officer.)**