



clime.com.au
stockval.com.au
1300 136 225

for the love of dividends

Prepared by **Roger J. Montgomery**
Managing Director



Private Portfolio Managers

Permission to distribute must be requested by calling 02 9252 8522

To order **StockVal** subscribe online at www.stockval.com.au
or fax the order form at the end of this note to 02 9252 8422

This note is designed for educational purposes only and is not a solicitation to purchase or dispose of any security or financial instrument, derivative or managed investment scheme. Past performance is not a guarantee of future investment returns. No return of capital can be guaranteed or implied. Investment return and principal value of an investment will fluctuate so that the ultimate return may be more or less than the original cost. Interested parties should refer to the Financial Services Guide and specific service agreements for description of risk factors associated with our services and the financial instruments we invest in and/or trade. This document has not taken into consideration the financial needs and circumstances of the investor and is not intended to cause the purchase or sale of any financial instrument whatsoever. For specific advice related to your own needs, please speak to a financial adviser. The Clime Discrete Portfolio Service is offered by Clime Asset Management Pty Limited, a holder of Australian Financial Services Licence #221146. Clime Asset Management Pty Ltd 1300 135 532.

Australia's listed companies have long made capital allocation decisions based on the income demands of shareholders and their infatuation with franking credits. Recent changes to CGT and superannuation, however, could now allow companies to act more rationally and shareholders will be better off.

What I am about to present is heresy to legions of income-hungry, dividend fans.

What I am not saying is that all companies should pay all their profits out as a dividend. Indeed, there are some companies that should not retain a cent. Those companies – the ones with mediocre rates of return on equity – should distribute all of their profits to their shareholders. But there are a handful of companies that should suspend their dividends and retain all their profits. The reasons follow.

Australian investors, particularly baby boomers, are enamoured with their fully franked dividends. For years many investors have been swimming in dividends, blissfully unaware that they have missed out on much higher returns.

The removal of double-taxation of dividends, combined with years of advice that says retiree investors should emphasise income in their portfolios, has served to fuel a silent protest by Australian investors that has been so effective that corporate capital allocation now blindly follows the mantra to the significant cost of the very investors the mantra seeks to serve.

You may be financially significantly better off if some of the companies in which you own shares (those able to reinvest profits at high rates of return), stopped paying you a dividend.

Thanks to recent tax changes to superannuation and the treatment of capital gains, a long overdue return to rationality could now occur. Companies able to generate high rates of return on equity should reconsider their dividend payment policies. Sensible decision-making would result in higher returns for shareholders and greater certainty amid lower business risk.

Let's begin by explaining why investors are selling themselves short by insisting Australian listed companies – particularly those able to generate high rates of return on equity – pay earnings out as a dividend.

Take a company with \$10 of equity per share on its balance sheet. We'll assume the underlying economics of the business and its management combine to produce a steady 20% return on equity. As is often the case in Australia, we'll also assume that 50% of the earnings are paid as a dividend. In the first year, earnings per share will be \$2 and the dividend will be \$1. The retained \$1, which is not paid out as a dividend, increases equity at the end of the year to \$11. In year two the company again generates a 20% return, this time on \$11 of equity, producing earnings per share of \$2.20.

If we now assume that the stockmarket chooses to never re-rate or de-rate the shares and that they always trade on a price/earnings multiple (P/E) of 10, we discover that in year one, the shares will trade at \$20 (P/E 10 x \$2) and in year two, the shares will trade at \$22 (P/E 10 x \$2.20).

In year one, the investor received a dividend of \$1, and in year two a capital gain of \$2 for a total return of 15% but had the dividend not been paid, retained earnings would have been \$2 and beginning equity in year two would have been \$12. A 20% return on the new, higher equity of \$12 would correspond to earnings per share of \$2.40 in year two and had the company's shares continued to trade on a P/E of 10 in year two, they would be trading at \$24. The shareholder would have received a 20% return.

By insisting that management pay 50% of earnings as a dividend, or \$1, shareholders have robbed themselves of \$2 in capital gains. If the shares are held by a sixty-something baby boomer in a superannuation fund that is structured so that no capital

gains tax is payable, or if discount capital gains tax treatment applies where the asset is held personally, the difference is meaningful.

And the opposite is also true for companies generating a low rate of return on equity. Leaving everything in the above example unchanged, but changing the return on equity to 5%, you would generate a much higher rate of return on your money, if management elects to pay all of the earnings out as a dividend. If a company able to achieve only a 5% rate of return on equity indefinitely was to suspend dividends and retain 100% of the profits, your return from buying the shares and selling them at any time in the future on a P/E of 10, would be 5% per annum. However, if this company elected to distribute all of its profits to you as a dividend, your return would be 10% per annum.

For many years, it has been investment dogma that as you age, your portfolio should lean progressively away from “growth” and towards “income”. Unfortunately, all Australian companies irrespective of their return on equity, have been beholden to the irrationality of flawed financial advice for far too long. And Australian investors have missed out as a result.

Just how serious is the opportunity cost? Just how much has it cost investors to heavily weight their portfolio with income-producing assets in retirement? Academic research could put a value on it, but anecdotal evidence is sufficient to provide some insights.

In 1965, Warren Buffett purchased shares in and took control of Berkshire Hathaway, a tired manufacturer of suit liners, for \$14.75 per share. In 1967, he paid a dividend of 10¢ and then realised that as a superior manager of money, shareholders would benefit if he retained and compounded the profits rather than handing profits in the form of dividends to them to manage.

In 2007 – four decades later – Berkshire Hathaway shares trade at \$120,000 each because no dividends have been paid since 1967.

Everyone marvels at how Berkshire Hathaway’s shares have appreciated over the past 40 years. But the appreciation is not remarkable in the context of maintaining a greater than 20% return on growing equity and reinvesting rather distributing profits. Berkshire Hathaway trades at \$120,000 per share because Buffett has been able to generate high rates of return on ever higher amounts of equity. Any company whose business can sustain high rates of return on rising equity should adopt the same policy towards dividends.

And financial planners, who might have advised investors to sell Berkshire Hathaway in 1968 because no dividends were forthcoming, have provided flawed advice. If a Berkshire Hathaway shareholder needs income, they can sell a share and if they really want an entertaining year, they can sell two shares!

In the context of the new superannuation rules, selling shares to fund lifestyle and healthcare needs is not as silly as it first sounds. Shareholders would have greater value in their shares and would need to sell fewer units to fund the same outgoings.

If a company can generate high rates of return on equity, it should retain its profits. Shareholders will benefit from higher capital returns. This is why Warren Buffett is famously quoted as saying: “growth benefits the investor only when each dollar used to finance growth creates over a dollar of long-term market value”.

Often referred to as the \$1 Principle, Buffett is simply referring to return on equity. A high rate of return on equity justifies a company growing its equity by retaining earnings rather than paying dividends. A high rate of return justifies a company NOT paying dividends. “Growth benefits the investor”.

And by retaining earnings, the company will not need to raise as much fresh capital from shareholders, thereby diluting ownership, nor will it have to borrow as much.

The idea of suspending dividends however will be anathema to many Australian companies. “Our share price will collapse”, “our shareholders expect a dividend” will be the typical cries that managers – those not behaving like owners – will be heard making. Such cries, however, are irrational and reflect concern for the short-term impact on the share price (as irrational income investors sell out) rather than the long-term benefits to the shareholders who plan on remaining owners. For as long as management resists rational capital allocation, shareholders will be missing out on meaningfully higher returns. And a further point from the coal face, many Australian chief executives and chief financial officers can tell you what their dividend policy is but few can explain why.

These directors play in the revolving door of their company’s capital allocation departments paying dividends and then raising more capital for growth by issuing shares in the very same year, diluting shareholders’ ownership stakes or borrowing money and increasing the risk profile of the business for its owners.

Take JB Hi-Fi: its debt levels are unnecessarily high. In a hypothetical scenario where it pays no dividend and instead retains profits rather than borrowing, its balance sheet would be stronger, its return on equity ROE slightly lower perhaps, but its value and share price possibly double where it is today.

In such a scenario, why do Australia’s superior ROE generators insist on paying dividends? Shareholders would receive higher returns if they didn’t and balance sheets would be less geared – just look at Berkshire Hathaway.

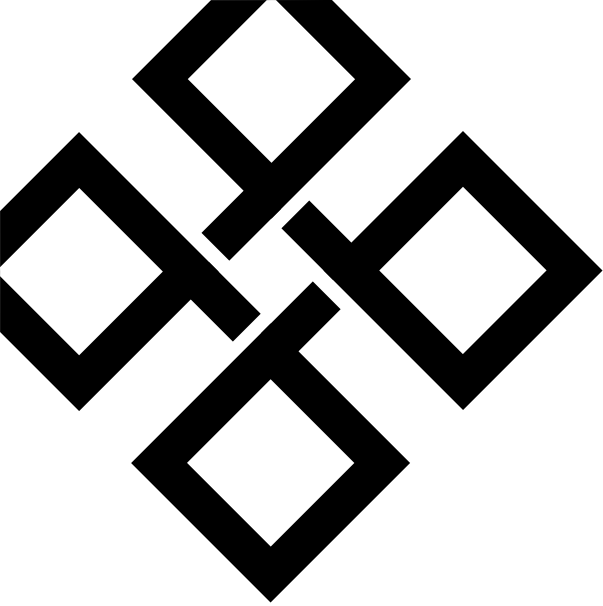
Now that superannuation is tax-free for most baby boomers and capital gains are discounted for investors who have held shares for longer than a year, there is no need to receive income at the expense of capital gains.

Investors in companies where management believe they can generate superior rates of returns on equity, should insist that they hang on to their earnings rather than cost shareholders returns, by paying those earnings out as a dividend.

The franking can be distributed later, when the returns, as measured against equity, plateau or decline.

Roger Montgomery is chairman of Clime Capital (ASX:CAM) and Chief Investment Officer at Clime Investment Management (ASX:CIW). This article first appeared in the Eureka Report on Friday, 21 September.





stockval

BE CERTAIN. BE SUCCESSFUL.

Do you want:

- ❖ To buy quality, undervalued companies?
- ❖ Independent, unbiased advice?
- ❖ To be certain AND successful?

YES, YES, YES! Then you need **StockVal** to guide you pass the guess work and help you identify wonderful companies based on their economic performance.

Subscribe to StockVal for 12 months for \$1795 and receive:

- A copy of the book **'Market Wise'** by Brian McNiven valued at \$30 FREE



PERSONAL Details

Dr / Mr / Mrs / Ms First Name _____ Last Name _____

Company name (if applicable) _____ ACN _____

Address _____

Suburb _____ State _____ Postcode _____

Daytime Phone _____ Mobile Phone _____

Fax _____ Email _____

PAYMENT Details

Please charge my credit card \$1795.00 (inc GST)

PLEASE CIRCLE VISA / MASTERCARD / AMEX / DINERS

EXPIRY

____ / ____ / ____ / ____

____ / ____



CALL 1300 136 225

FAX this form to 02 9252 8422

POST this form to PO Box R1297 Royal Exchange NSW 1225