

Australian Equities

Investing for income

Investment Management Research

Summary

- **An ageing population has sparked increased demand for share income funds, as retirees and pre-retirees seek regular long-term income and capital growth to maintain their spending power in future years.**
- **Falling cash rates and the fall-out in the listed property market, both traditional sources of income, means Australian shares should become an increasingly important source of investment income for investors.**
- **While dividends are expected to fall over the course of 2009, they still offer an attractive margin over cash – especially when taking into account the tax benefits of investing in shares.**

Shares remain a valuable source of income

Investing for the purpose of capturing the dividend return of quality companies is one of the oldest motivations for investing in shares. High quality companies have tended to produce a steady stream of dividends from year to year, and it is one of the few sources of income which generally rises over the long term to fight inflation.

While 2009 will be one of the more challenging years in which to select companies that can sustain their dividends – let alone grow them – there are some exceptional yields currently available which will provide attractive returns for investors seeking dividend income. And in the medium term, dividends are likely to resume their growth path.

Australian dividend investors are amongst the world's most fortunate. Not only do dividends in Australia tend to be higher than in most other major markets, but investors receive the benefit of tax paid on income by the company, via the imputation system. A 'franked' dividend received by an investor can produce an attractive return in itself which is significantly tax sheltered – making it even more valuable relative to other sources of income.

Popularity of share income funds

Somewhat surprisingly, funds which focus on dividends are not a big part of the managed funds landscape. In Australia, such funds comprise about 5.5% of wholesale Australian share funds, a figure which was little changed over the past year¹.

This was not always the case. With the introduction of the dividend imputation system in 1987, there was a rush of new products focusing on franked dividends – many of which were labelled imputation funds.

Their popularity was enhanced by a long run of outperformance from Australian bank shares, which tend to be some of the largest

producers of franked income. In the late 1980s and early 1990s, such share income funds produced both attractive income streams and strong total returns.

Imputation funds started to lose market share because of a range of factors. One of the most important was the disastrous performance of Australian banks in the recession of the early 1990s.

Another was the lack of attention paid to the income results of the imputation funds. At a time when capital gains were still taxed as income (with inflation indexation, but not the 50% discount on long gains that we enjoy today), high portfolio turnover often saw investors and their financial planners having to deal with enormous income distributions which were anything but tax effective. The largest imputation funds, which reached many billions of dollars in size, are now considerably smaller having waned in popularity.

Filling the gap were new funds which simply focused on outperforming the market, with the return coming as a (rather unpredictable) mix of unrealised growth, dividends and realised gains. Share income funds started to make a comeback in Australia in the early 2000s as the lessons of the 1990s were absorbed and factored into product development.

Overseas there is no such debate. Share income funds – generally going by the 'equity income' moniker – are one of the most important sectors of the individual investor share funds market. In the UK, for example, the share income sector is about £40 billion – half the size of the £80 billion All Companies Market – and more than 10% of the entire UK funds market². In the US there is a similarly successful share income sector.

In overseas markets, there is generally no equivalent to the Australian imputation system. Nevertheless, investors are attracted by the yields of share income funds, which tend to be high relative to the overall market (eg the US S&P 500 Index has often yielded only around 2%) and cash interest rates (which also tend to be significantly lower in the UK and US).

¹ Source: Plan for Life

² Source: Investment Managers Association, 31 July 2008

Trends in Australian investors

Research with financial planners by Tyndall has indicated increasing interest in managed share investments which place an emphasis on franked dividends, delivered in a tax effective manner. Important factors driving change in the market include:

- **The average tax rate of investors is falling.** Increasingly an investor's super fund – especially for the Self Managed Super Fund (SMSF) sector – is their primary investment vehicle, rather than holding shares directly. This means their tax rate moves from marginal rates of up to 46.5% down to 15%.
- **Investors are ageing.** As the baby boomers move into retirement, their financial assets move from the accumulation phase to the pension phase. They need to realise an income from their investments while also attempting to maintain the long-term purchasing power of their capital. And if their investments are held within a super fund, their tax rate falls again – to zero for assets in a pension division.
- **Investors favour yield.** Finance theory tells us that investors should be indifferent to income and growth. In practice, many individual investors have an aversion to consuming their capital, preferring to invest in a portfolio which will provide sufficient income to live on.

Limited income choices for investors

In 2009, investors seeking an income stream face the most challenging situation in decades. Interest rates have plummeted around the world, with Australia being no exception.

By the end of the March quarter, official interest rates are expected to be around 3% p.a., which means that interest rates on even high interest online accounts are likely to be under 4% p.a. For investors used to receiving interest rates of 7-8% p.a. or better, this will be a tremendous shock and a 50% cut in their interest income.

Making life even more difficult has been the travails of the other traditional safe haven for income investors – listed property trusts. Listed property trusts should have been doing well. Until very recently, both rents and values have been rising strongly.

However too many trusts chased growth via development profits, other non-recurring income, and offshore assets – much of it funded by gearing. The distribution cuts across the sector caused by the failure of such growth strategies have been devastating.

The long standing ability to invest in a well diversified portfolio of listed property trusts to obtain a relatively high, secure income, with lower than average volatility, has been seriously impacted.

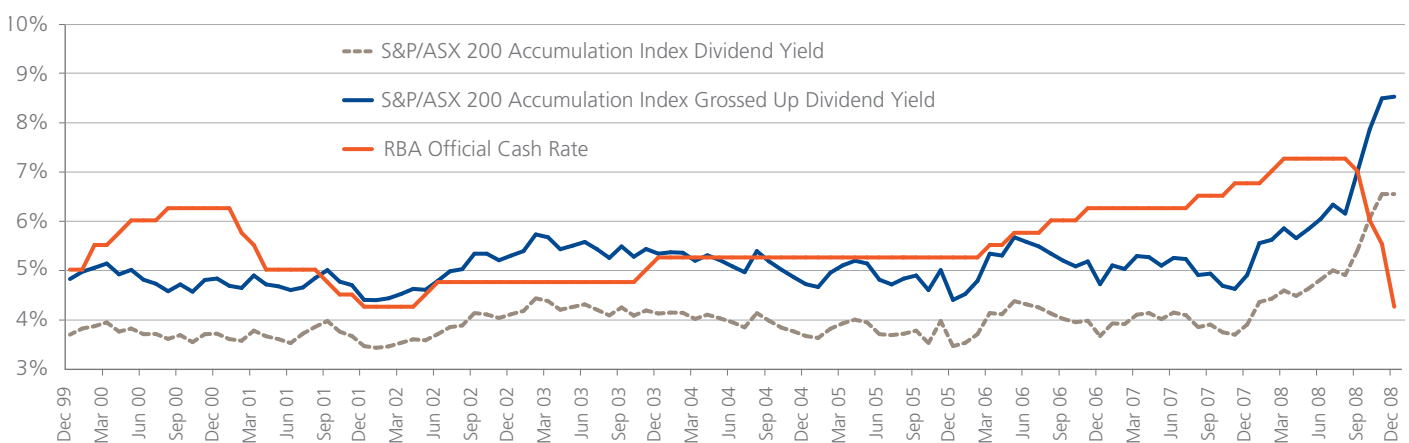
This leaves Australian shares as one of the best sources of investment income. The typical dividend return from the S&P/ASX 200 Accumulation Index is 3-4% p.a. but with the slump in the market, the current dividend yield is over 6% p.a., and over 8% p.a. if including the value of franking credits. Even allowing for dividend cuts, shares are an attractive option, as the example in table 1 demonstrates.

Table 1: Australian shares are an attractive source of investment income

| | |
|----------------------------------|------------------------|
| Current market yield | 6.6% p.a. ³ |
| Assumed medium-term market yield | 5.5% p.a. |
| Assumed franking | 75% |
| Income on \$100,000 portfolio | \$5,500 |
| Franking credits | \$1,768 |
| Equivalent to cash return of | 7.3% p.a. |
| Prospective cash returns | 4% p.a. |
| Additional income from shares | 3.3% p.a. |

Shares are relatively inexpensive at present and dividends would have to fall by more than half before they yielded less than the prospective cash return of 4% p.a. As chart 1 demonstrates, dividend yields are at a 10-year high despite impending record low interest rates.

Chart 1: Dividend yields are at 10-year highs



Source: JP Morgan, Reserve Bank of Australia

Using share income funds in a portfolio

Share income funds offer investors the following characteristics:

- Higher dividend yield than the overall market, even allowing for fees
- High franking credits, and some tax-deferred income
- Generally managed for lower turnover to reduce realised capital gains in distributions and
- Long-term capital growth as markets recover.

There is academic research⁴ which indicates that high dividend stocks outperform over the long term. They also tend to be less volatile with a portfolio beta of less than 1. That being said, the total return of share income funds can vary dramatically from the overall markets from one year to the next – they can significantly outperform in one year and underperform in another, even more so than a typical value style portfolio. The tracking error of share income funds tends to be high despite the low beta.

These characteristics provide a hint about how to use share income funds – as a way of enhancing a portfolio, rather than a complete income solution. Adding a share income fund to other income assets such as cash, term deposits, property and even credit will generally:

- Increase income
- Diversify income and
- Increase long-term capital growth.

Blending a share income fund with a traditional equity fund will also greatly reduce the risk of the investor's portfolio underperforming the market.

Let's have a look at an example. At present, retail investors are investing heavily in cash and term deposits. What sort of outcomes are they looking at? Assume an investor with the following \$100,000 portfolio:

- 50% cash yielding 4.75% p.a.
- 30% term deposits yielding 5% p.a.
- 20% property yielding 7.5% p.a., of which 20% is tax deferred.

As table 2 indicates, this portfolio produces cash income of \$5,375 before tax. This is quite a good return however tax makes a significant impact.

This portfolio has two other major problems:

- The income will decline as interest rates fall further and the term deposits mature.
- While it will protect capital, there is virtually no capital growth potential to ward off future inflation.

Now let's assume that the investor shifts 30% into a share income fund from their cash holdings, which even allowing for dividend cuts and fees, should still provide a yield of around 6.5% p.a.

As table 3 indicates, this portfolio produces a cash income of \$5,900, but also carries franking credits of \$627. So an investor in a pension division of a super fund will receive net income of \$6,527 – more than \$1,000 higher than the existing portfolio. And while the advantages are highest for low tax rate investors, this example shows that income investors in every tax bracket are better off by adding a share income fund.

In doing so, the investor also reduces their vulnerability to falling interest rates, and adds some long-term capital growth potential to their portfolio.

Table 2: Cash income example portfolio no. 1

| | Tax rate | Tax payable | Net income | Net yield after tax |
|---------------------------------------|----------|-------------|------------|---------------------|
| Tax at 0% (pension phase) | 0.0% | \$0 | \$5,375 | 5.38% |
| Tax at 15% (super accumulation phase) | 15.0% | \$761 | \$4,614 | 4.61% |
| Marginal tax at 16.5% | 16.5% | \$837 | \$4,538 | 4.54% |
| Marginal tax at 31.5% | 31.5% | \$1,599 | \$3,776 | 3.78% |
| Marginal tax at 41.5% | 41.5% | \$2,106 | \$3,269 | 3.27% |
| Marginal tax at 46.5% | 46.5% | \$2,360 | \$3,015 | 3.02% |

Table 3: Cash income example portfolio no. 2

| | Tax rate | Tax payable | Net income | Net yield after tax |
|---------------------------------------|----------|-------------|------------|---------------------|
| Tax at 0% (pension phase) | 0.0% | -\$627 | \$6,527 | 6.53% |
| Tax at 15% (super accumulation phase) | 15.0% | \$307 | \$5,593 | 5.59% |
| Marginal tax at 16.5% | 16.5% | \$401 | \$5,499 | 5.50% |
| Marginal tax at 31.5% | 31.5% | \$1,335 | \$4,565 | 4.57% |
| Marginal tax at 41.5% | 41.5% | \$1,957 | \$3,943 | 3.94% |
| Marginal tax at 46.5% | 46.5% | \$2,269 | \$3,631 | 3.63% |

The Tyndall Australian Share Income Fund

Tyndall has responded to the exceptional income opportunities now available, and the emerging needs of investors and their advisers revealed in recent market testing, by developing the Tyndall Australian Share Income Fund (TASIF).

TASIF complements Tyndall's well-regarded Tyndall Australian Share Wholesale Portfolio, which targets long-term total returns in excess of the market average. TASIF is drawn from the same universe and managed in the same Intrinsic Value style, but has an income emphasis:

- Its primary objective is to target an income stream of 2% p.a. higher than the grossed up yield of the S&P/ASX 200 Accumulation Index (distributed quarterly).
- Its secondary objective is to produce long-term capital growth through investing in undervalued companies.
- It focuses on after-tax returns by: targeting stock turnover of less than 40%; investing in stocks that provide franking credits or tax-deferred income; selecting stocks that have capital structures where off-market buy-backs or capital returns are likely; and using derivatives to manage tax exposures (but not for gearing purposes).

TASIF invests across a broad range of sectors, including resources, unlike other share income funds which have tended to be heavily overweight financials and utilities. As is typical of share income portfolios, TASIF is expected to exhibit low beta (about 0.85) and high tracking error. This can be attractive in highly volatile market environments.

Tyndall has 10 years' experience in managing share income portfolios for institutional customers, which has delivered insights into the issues and traps in managing these particular types of products for investors.

TASIF builds on Tyndall's deserved reputation for high quality Australian equities management delivered by a stable team in a corporate structure which has successfully aligned the interests of Tyndall, the investment team and investors. TASIF brings Tyndall's skills to institutional clients and individual investors needing income into the future.

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