PERENNIAL
VALUE
MANAGEMENT

Helping you Grow your Income

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About Perennial

Perennial Value is a specialist, active investment management firm. Formed in 2000 and led by well-known Value investor John Murray, Perennial Value's sole focus is to deliver excellence in funds management through equity ownership and the alignment of interests between key investment management staff and our clients. Perennial Value specialises in the following areas:

Perennial Value Australian Shares

Australian Large Caps, Shares for Income & Active Plus

Perennial Value Smaller Companies

Australian Small & Microcap Companies; and

Perennial Value Wealth Defender

Equity Risk, volatility management and trading

Perennial Shares for Income Trust

Stephen Bruce

Portfolio Manager, Perennial Value Shares for Income Trust

Stephen has been with Perennial Value for over 17 years. In addition to his Portfolio Management responsibilities, Stephen provides research coverage and analysis of the banking and healthcare sectors.

Growing your income for the long-term

Collapsing global interest rates, along with the lowering of future return expectations across most asset classes in the post-GFC world, has seen investing in higher yielding stocks become a very popular strategy in recent times. However, for more than 11 years, the Perennial Value Shares for Income Trust (the Trust) has been delivering regular, growing, tax-effective income for investors.

In this article, Stephen Bruce, Portfolio Manager of the Perennial Value Shares for Income Trust, shares his insights and outlines how investing in higher yielding stocks can be a very effective strategy for investors seeking to generate both a growing, tax-effective income stream and long-term capital growth. Stephen also looks at some of the pitfalls that should be avoided when investing in higher-yielding stocks.

Importance of dividends to total returns

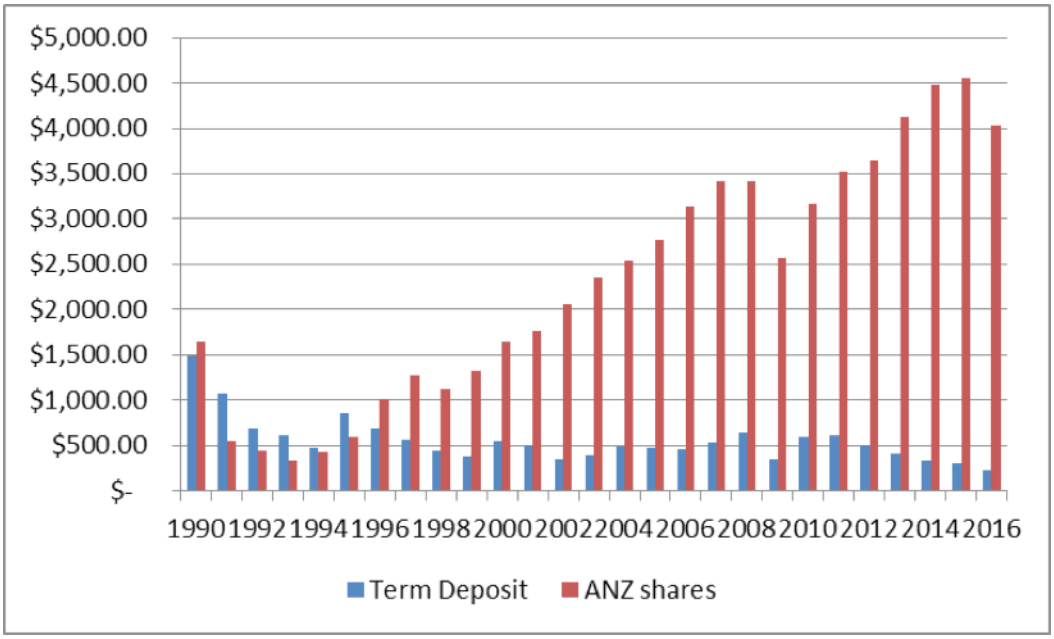
In the equity market, with its focus on capital gains, the role that dividends play in generating total returns is often underappreciated. For example, over the 50 years to 31 December 2016, the All Ordinaries Accumulation Index returned 11.9% p.a. Of this, 6.6% p.a. was derived from capital gains, while 5.3% p.a. was derived from dividends and their reinvestment. In other words, dividends accounted for 44% of the total return outcome over the period. This is even more significant if you also include the benefit investors receive from franking credits, with the dividends paid by the market being on average franked to around 75% since franking was introduced in 1987.

Using Shares to **Generate Income**

Traditionally, when seeking income-producing investments, people have turned to fixed income investments such as term deposits, bonds or, more recently, hybrid securities. While these types of investments have their merits, dividend-paying shares can also be a very effective source of income for investors. This is particularly the case at the current time, with interest rates being very low. For example, 12 month term deposits are currently yielding only around 2.3% whereas the stock market is yielding around 5.8% when franking credits are included. However, the real benefit of using shares for income generation is not that the yield is higher today, but rather that the income stream from dividends can be expected to grow over time. This protects the investor from the impacts of inflation and is a critical difference between investing in shares versus fixed income investments and term deposits.

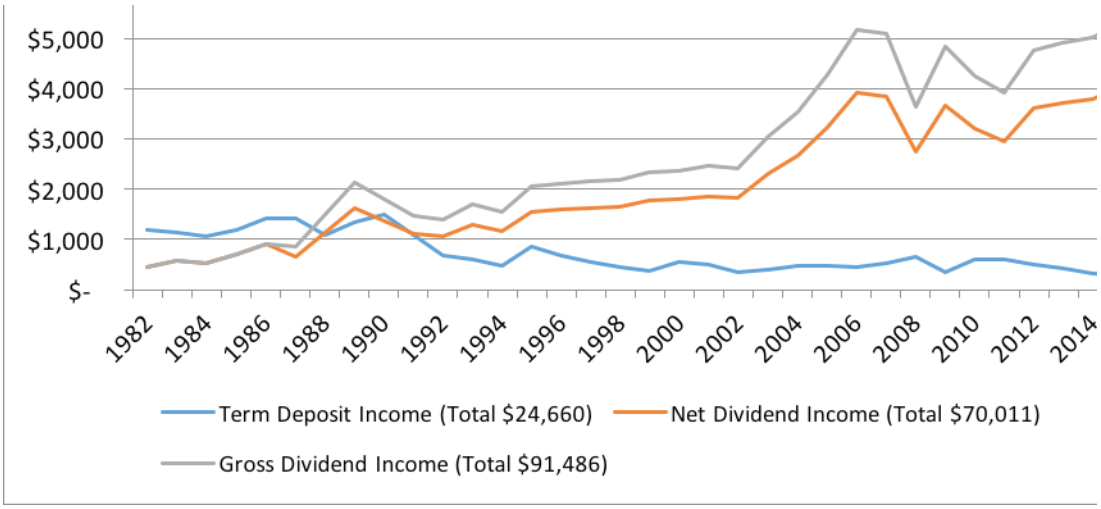
This can be shown clearly in Chart 1, which compares the dividend income from an investment in ANZ shares to the interest income from an investment in term deposits. It shows how, over the long-term, the income generated from a quality, dividend-paying stock can dramatically exceed that from term deposits.

Chart 1: Annual pre-tax income from $10,000 invested in 1982



Source: *Perennial Value. As at 30 September 2017*

Chart 2: **Annual income from $1,000 invested in 1982**



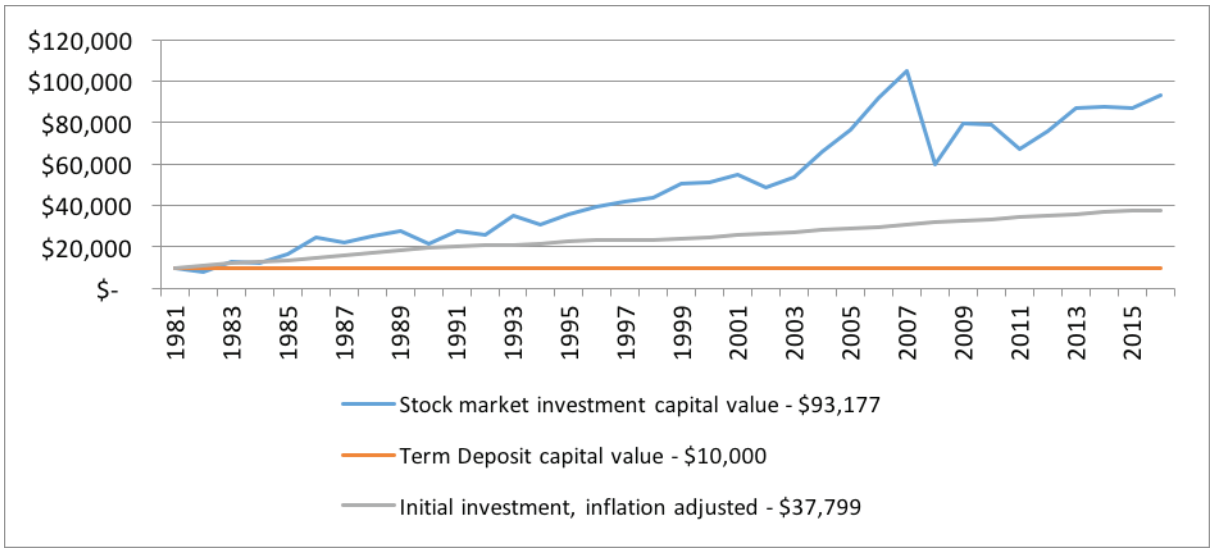
Source: *Perennial Value. As at 30 September 2017. For illustrative purposes, Gross Dividend Income assumes 75% franking level for All Ordinaries each year since the introduction of imputation was in 1987*

While Chart 1 relates to a single stock, the same holds true for the market as a whole. Chart 2 compares the dividend income from an investment in the All Ordinaries to the interest income from an investment in term deposits.

This growth in dividends is due to the fact that dividends are paid out of company profits and, as the economy grows over time, company profits tend to also grow at a similar rate to GDP which has grown at around 7% p.a. in nominal terms over the past 34 years (1). Over this period, dividends from the All Ordinaries have grown at a compound rate of 6.6% p.a. It is this growth in dividends which mitigates the impact of inflation which erodes purchasing power of an income stream which does not grow, such as that from a term deposit. The growth rate in dividends compares well to the inflation rate which has run at around 4% p.a. over the same period. By contrast, the annual income derived from an investment in 12 month term deposits is currently lower than it was 30 years ago on account of the current low interest rates (2).

In addition to a significantly greater income stream, shares offer the potential for capital growth. Over the same 34 year period referred to above, the capital value of an investment in the All Ordinaries has risen by some 830%, or 6.6% p.a., while the value of an investment in term deposits is, of course, unchanged. While the value of the share market investment has had its up and downs over this time, including most recently, the GFC, there have been far more ups than downs. Chart 3 shows how the capital value of an investment in the share market (in blue) has grown over this period, while the value of an investment in term deposits (in red) has stayed flat. Further, the green line shows what the initial investment would have been worth in today's dollars, i.e. adjusted for inflation. This shows that while the value of the investment in the stock market has far outpaced the rate of inflation, the investment in term deposits has lost nearly 75% of its value in real terms. Hence the saying that investing in term deposits means "going broke slowly".

Chart 3: Term Deposits versus All Ordinaries Value of a $10,000 investment



Source: *Perennial Value.*

Volatility of Dividend Income

One of the concerns when using dividends as a source of income is the volatility associated with dividend levels from year to year. While dividends on individual stocks and on the market as a whole do go up and down from year to year, there is also significant volatility in the income that can be generated from term deposits. For example, in 2009 during the GFC, dividends were cut across the market by approximately 29% from their 2008 levels. However, the reductions in interest rates by the Reserve Bank of Australia (RBA) has also seen term deposits fall sharply. In fact, an investor rolling a 12 month term deposit rate at the beginning of 2009 would have been offered a rate of only 3.55% - some 45% lower than that 6.45% they would have received in 2008 (3). Perennial Value's analysis finds that over the last 30 years the volatility of dividend income is very similar to that of term deposit income when measured over rolling 5-year periods (4).

Further, while term deposit rates have continued to fall, dividends quickly began to recover and are now above their previous levels, while 12 month term deposit rates have hit new lows of around 2.3%.

Benefits of investing in high-yielding shares

While the discussion above has dealt with the dividend yield on the overall market, those looking for income may be better served with a portfolio weighted towards higher-yielding stocks. This has the benefit of increasing the level of income generated and also of potentially producing a less volatile portfolio, as higher-yielding stocks tend to be larger, more mature businesses and predominantly in the industrials rather than the resources sector.

In addition, various models have shown that strategies which involve investing in shares which have sustainable dividend yields may outperform other strategies, not only on an income basis, but also a total return basis (5). While there are no conclusive reasons as to why this may be the case, some of the possible explanations are as follows.

Firstly, stocks with a moderate to high dividend payout ratio may make on average better investment decisions. The logic is that if a portion of earnings are paid out to investors, less is available for reinvestment. Given that management will prioritise their investment spend from highest expected return to lowest, this forced capital rationing means that the more marginal investment propositions may not be pursued. An alternative explanation is that by only investing in companies which clearly have a high and sustainable dividend payout, companies with a high level of gearing and therefore risk are avoided. In addition, "blue sky" companies, without a proven business model or a track record or earnings, are also screened out. This is particularly important, given that part of investing, is avoiding the big bad mistakes.

Pitfalls in **High-Yielding** Shares

While there can be clear attractions to investing in higher-yielding stocks, it is critical to avoid the so called "yield traps". These are stocks which look attractive on the basis of their high dividend yield, but where underlying problems in the business could exist.

In this sense, the name of the game is sustainability. In other words, a stock should only really be considered as possessing a high dividend yield if that dividend yield is sustainable and able to grow. Factors that influence the sustainability of the dividend relate to the earnings outlook for the business. For example, are there adverse structural or cyclical factors on the horizon? Or does the company have an appropriate level of debt?

Or could a need for debt reduction result in a reduction in the dividend? It is also very important to ask, "Is the yield a true cash yield or a manufactured yield?" A "true cash yield" is one where the dividend is being paid out of operating cash flow, whereas a "manufactured yield" is one which is paid out of increased debt taken on the back of asset revaluations or similar. This was a strategy employed by many entities in the "easy money" days prior to the GFC where investors were lured into highly-geared and risky vehicles by a supposedly attractive yield. The results were predictable, and for many investors, disastrous.

Outlook for dividends

While there is, of course, a considerable degree of uncertainty, the global economic outlook is generally positive, with growth improving modestly in most major markets, led by the US, while the domestic economy is best described as subdued but sound. Overall, this is supportive of corporate earnings growth and therefore increased dividends. In addition, corporate Australia has been undergoing a period of deleveraging for several years and corporate balance sheets are now in very good shape, further underpinning their ability to maintain or grow dividends in the near term. Longer-term dividend growth should continue in line with economic growth, as it has historically.

(1) Dividend yield on the All Ordinaries, assuming no reinvestment.

(2), (3) RBA data.

(4) Measured as the co-efficient of variation over rolling 5-year periods from 1982 – 2012.

(5) Based on backtesting results of the Goldman Sachs "Sustainable Dividend Model" from 1997 to 2012.

About the Perennial **Value Shares for Income Trust** (the Trust)

The Trust invests in a portfolio of financially sound companies which demonstrates superior dividend yield characteristics to the overall stock market, with the aim of providing investors with an attractive level of tax effective income. Since inception in December 2005, the Trust has delivered a distribution yield, including franking credits of 8.0% p.a., while also outperforming the index on a total return basis.

For a copy of the Product Disclosure Statement for the Perennial Value Share for Income Trust, please contact us on 1300 730 032 or visit www.perennial.net.au/pds.

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