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Investment Strategy

Understanding equity income funds

You may have heard of equity income funds, but what exactly are they? The term appears to be widely-used in Australia and internationally to describe a range of funds that share one common feature: they aim to generate income from investing in shares. But isn't this what most share investment strategies aim for, to invest in companies that are profitable now or at some point in the future and will return these profits to shareholders through dividends. And should investors care whether they get profits through dividends or capital gains, surely it's the total returns that matter.

In reality taxes can influence investor preferences. For example dividends in Australia typically carry franking credits, which are valuable to most Australian taxpayers, yet shares held for more than 12 months receive a capital gains tax discount when they are finally sold. This tends to favour capital gains over dividends for individuals on the top marginal tax rates. All else being equal we would prefer $1 of capital gains over a $1 of fully franked dividends, particularly if we don't have a current income need and the shares are part of a long term retirement strategy. If the company can reinvest that $1 and turn it into $1.20 of capital gains even better. However, for investors on lower marginal tax rates, including super funds, $1 of franked dividends may have greater after-tax value than $1 of long-term capital gains.

Leaving aside the tax preferences, dividends are also important to investors for other reasons:

Dividend signalling. When company management announces that they are increasing dividends this can signal that they are more confident about the company's future earnings. In contrast companies that cut dividends are telling investors that profits are falling or that they need to preserve capital by paying out a lower proportion of earnings.

Capital management. Dividends can also show that management has a strong focus on capital management. Companies which pay out a large part of their earnings in the form of dividends are less inclined to hoard cash on their balance sheet or feel obliged to spent cash on acquisitions or marginal investments. This means that their balance sheets can be structured with the optimal use of debt to enhance returns to shareholders. If additional capital is needed at the time of an investment or acquisition, it can be funded through a share issue or through a dividend reinvestment plan.

In emerging markets, companies that pay out dividends also show that they may have better corporate governance than companies that don't share profits with shareholders through dividends.

Franking. Franking credits built up at companies through payments of corporate taxes have no value until the company pays out dividends, at which time they become valuable to shareholders as tax credits or even cash rebates. Therefore companies that hoard franking credits and don't pay out sufficient dividends are wasting or eroding the value of the franking credits.

Valuation. A share entitles the shareholder to receive dividends, capital upon winding up and to vote at shareholder meetings. Therefore academic theory suggests that the value of a share is really just the present value of its future cashflows – i.e. future dividends.

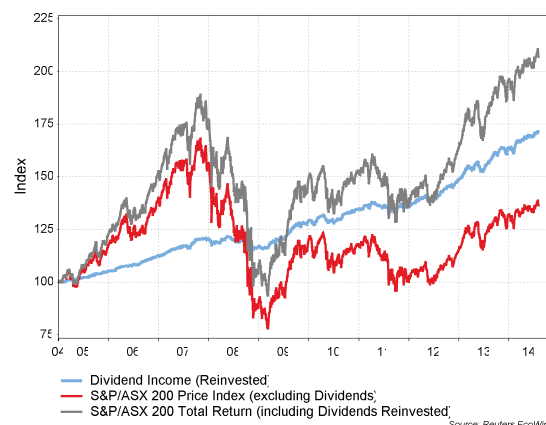
Companies which do not pay out stable and growing dividends, often because they are loss-making, become much harder to value and share prices tend to be more volatile e.g. mining explorers, internet companies. This is because estimating future dividends is subjective, whereas valuing companies such as Proctor & Gamble, which has paid of a dividend every year since 1890 and has increased its dividend every year for the past 58 years) is much easier given the steady income.

Also academic studies have shown that companies which pay dividends have provided better returns than the broader sharemarket while non-payers of dividends have underperformed the broader share market.

A large part of total returns. Over long time horizons such as 10 years, studies have shown that dividends and franking credits have made up 60% of total shareholder returns. In periods when sharemarket returns are low, such as 1970s, dividends make up a much higher proportion of the total returns.

Inflation hedge. Over time, corporate revenues, profits and dividends should keep pace with inflation and in times of higher inflation, when companies increase the prices of their goods and services, dividends should rise more quickly.

Power of Dividends



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Understanding equity income funds (continued)

Compounding and dollar-cost averaging. By reinvesting dividends back into companies through a dividend reinvestment plan, particularly relevant in a superannuation fund that is in accumulation mode, dividends can be used to purchase additional shares (often at a small discount to market) over a range of market conditions and at a range of prices.

When share prices fall dividends will buy more shares (i.e. when dividend yields are high) and vice versa when the market is trading at high prices (i.e. low dividend yields). Over time this reinvestment and compounding of income means that the final value of the portfolio should be higher than was the case if the dividends were simply placed in a bank account.

For these reasons, equity income funds or investment strategies that target dividend-paying companies should perform better over the longer term than broader equity investment strategies that simply target the highest growth stocks and are not focussed on the dividends or likely dividends coming from the company that they invest in. However, is this always the case and does this mean that we should simply invest in companies that have the highest dividend yields?

The answer is no. For example it's possible to think of equity investment strategies such as private equity and venture capital where the companies don't pay dividends to shareholders but rather use surplus cashflow to pay down high debt levels or reinvest in a high growth business. And private equity and venture capital strategies have been shown to deliver better long term returns than public equities over longer term time periods.

Studies have also shown that it's not always the companies with the highest dividend yields that are the best future performers. This is because companies with high dividend yields may be value traps – they are cheap with a high dividend yield for a reason – e.g. a miner where the mine's reserves are about to be depleted or another company where the dividend is unsustainable and likely to be cut. Alternatively they may be a bank stock with low growth prospects or where dividends could be cut in a downturn because of regulatory requirements.

Therefore a strategy focussed purely on dividend income and not on a combination of income and growth potential is unlikely to be successful over the longer term. Most equity income funds therefore try to generate higher income than the market with growth potential that is in line with or slightly lower than the overall market.

In addition to actively managed equity income funds, there are also passively constructed ones which use filters and rules to exclude non-dividend payers and low dividend stocks, or companies with an erratic dividend history. Other types of equity income funds may also use option writing to generate additional income on the portfolio. These are called buy-write funds and they essentially sell off part of a stock's potential future capital gains in return for an up-front option premium, which can be paid out to unitholders in the fund along with any dividend income.

So before investing in an equity income fund, you should make sure that you understand how the portfolio is managed, whether it has a large exposure to particular sectors such as banks or property trusts, the degree to which future capital gains may be capped through option writing (if used) and the level of franking and portfolio turnover which will impact the tax profile of the fund.

By Nick Ryder, Investment Strategist, NAB Private Wealth