SHARES TARGET GROWTH TOO

Think about purchasing power when assessing dividend yields

LOOKING FOR AN EXTRA $25,000 OF INCOME from shares is simple. But simple does not mean easy. Picking up extra income without risking capital loss is the challenge and happily I have a few steps that will help achieve just that. But first, a dividend 101 lesson: If you buy a share for $2 and the company pays a dividend of 15¢ a share, your dividend yield is 7.5%. Many investors seek the highest possible dividend yields. But perhaps the single dumbest piece of advice perpetuated on sharemarket investors who desire income is to buy high-dividend-yielding stocks. If you are ever the recipient of this advice, zip up your wallet.

Buying the shares of financially weak or economically inferior companies simply because the comparison of price and dividend yields an attractive number, is as sure a way to lose real money as buying shares in One.Tel or ABC Learning Centres. Had you chosen these businesses, not only would have you lost dividend income but all your capital too.

But it's not just realised losses you should be concerned about. If you have $1000 right now, you could enjoy a very nice dinner for, say, six people. If you still only have $1000 in 10 years' time, that $1000 may only buy dinner for four people. You are actually worse off.

This loss of purchasing power is one of the single biggest risks facing retirees who believe they should stick with something "safe", such as fixed-income investments, when they retire. You need to go for growth – in income and in capital value. And you must do everything you can to mitigate the risk of opportunity costs.

Being invested in a business with poor economics – Qantas for example, whose share price today is lower than it was 10 years ago – means you will miss out on being invested somewhere the purchasing power of your money is protected and maintained. And even if you purchased shares in Qantas because it displayed an attractive dividend yield at the time, that would count for nought when the company suspended its dividend.

Look for discounts to value

Investing purely on the basis of an attractive dividend yield can be a cataclysmic one for your portfolio – just ask anyone who bought Telstra a few years ago because their adviser told them it had an attractive dividend yield.

So what does all this have to do with building an income-producing portfolio? Simply this: you don't build a great income-producing share portfolio by searching for high dividend yields. There is no point in earning $25,000 of income if you lose $50,000 in capital value.

You build great income portfolios by ignoring dividend yields and instead buying pieces of extraordinary businesses with strong cash flow and competitive advantages and with all the characteristics I list in my book, *Value.able.*

Extraordinary businesses are those with

HIGH DIVIDEND STOCKS

SHARES WITH LASTING QUALITY

COMPANY	ASX CODE	MQR[1]	FORECAST		PRICE	NO OF SHARES	AMOUNT INVESTED	INCOME
			INTR VAL[2] CHANGE	DIVID YIELD[3]				
Westpac	WBC	A1	3.4%	6.99%	$21.95	4086	$89,693	$6270
ANZ Bank	ANZ	A3	7.1%	6.44%	$22.00	3830	$84,270	$5427
Codan	CDA	A2	4.6%	6.40%	$1.25	12,000	$15,000	$960
Think Smart	TSM	A2	17.0%	6.37%	$0.68	11,911	$8100	$516
Nick Scali	NCK	A1	10.0%	6.29%	$1.51	7896	$11 924	$750
Cabcharge Aust	CAB	A3	6.9%	5.23%	$5.24	3816	$20000	$1046
Thorn Group	TGA	A2	6.9%	5.17%	$2.12	6842	$14 507	$750
Harvey Norman	HVN	A3	18.7%	5.09%	$2.51	13,944	$35000	$1782
Breville Group	BRG	A2	8.8%	4.73%	$3.35	5970	$20000	$946
JB Hi-Fi	JBH	A1	23.0%	4.47%	$17.00	4200	$71 404	$3192
Flight Centre	FLT	A2	7.9%	3.94%	$21.68	2767	$60000	$2364
Seymour Whyte	SWL	A3	20.7%	3.39%	$2.36	12,499	$29,499	$1000
							$459,396	$25,002

Share prices as at 1-Jun-11. [1]Montgomery Quality Rating [2]Intrinsic value [3]Dividend yield

An intrinsic value portfolio

It's now time to consider a portfolio that generates $25,000 a year in income.

To put together this list of stocks above, I have considered a number of things. First, the companies had to have received my A1, A2, A3, B1 or B2 quality rating. My team calculate quality scores for every listed company and they are ranked A1 down to C5. The very best A1 companies have the lowest probability of something awful happening to them. Of course, the share price could still fall but it has a better survival rate.

The second step I followed was that each company had to be trading close to its intrinsic value and its intrinsic value had to be rising at a good clip on current expectations. Finally, I ranked them by their dividend yield. The reason for the last step was that I could show you that by investing less for the same income, you could achieve some diversification.

Having produced the list, a couple of warnings. First, the intrinsic values can change. If a company announces a downgrade or the economic environment deteriorates, the company's performance and its value could decline. Value can also decline if interest rates rise. That's business.

Second, I have not been endowed with any special power to forecast prices. Even if the value of a company remains unchanged, its share price can halve. And, finally, you should seek and take personal professional advice before taking any action.

It will be interesting to watch this portfolio over the next few years, to see how it performs compared with the broader market and also to see if and how the income it produces grows.

Oh and remember this, you are buying into businesses. Business can be risky, competitive and influenced by factors outside the company's control. Because the risks are higher, the rewards can be too. It's one of the reasons why those in business populate the rich lists.

bright prospects or with a temporary issue that is being treated as permanent by the market.

When purchasing these businesses, do so not on the basis of an attractive yield, but on the basis of a steep discount to intrinsic value. The lower the price you pay, the higher your return. Extraordinary businesses, acquired at meaningful discounts to intrinsic value, will produce desirable income either in the form of dividends, buybacks or even from the sale of a few shares.

Extraordinary businesses are able to generate attractive rates of return on equity. High returns and low amounts of capital required to generate those returns means there is less capital required to be reinvested in the business and more free cash to be handed back to owners. As a shareholder, you are an owner.

Many investors seek the highest possible dividends

Capital versus cash

Let me show you what I mean. Suppose two businesses earn $1 million in profits from $10 million in sales.

One business, Company A, however has $10 million in capital tied up in property, plant and equipment running at full capacity. The other business, Company B, has only $1 million tied up in plant and equipment.

If we imagine that both companies wish to double sales and profits, we may assume that they need to also double their assets. In the case of Company A, the company will increase sales to $20 million and profits will rise to $2 million, but in so doing it will need to invest another $10 million back into the business. There is no free cash to distribute to owners.

Company B on the other hand will double sales to $20 million and profits to $2 million, but only another $1 million is required to be reinvested. Very soon there will be ample additional cash to hand back to owners.

Return on equity

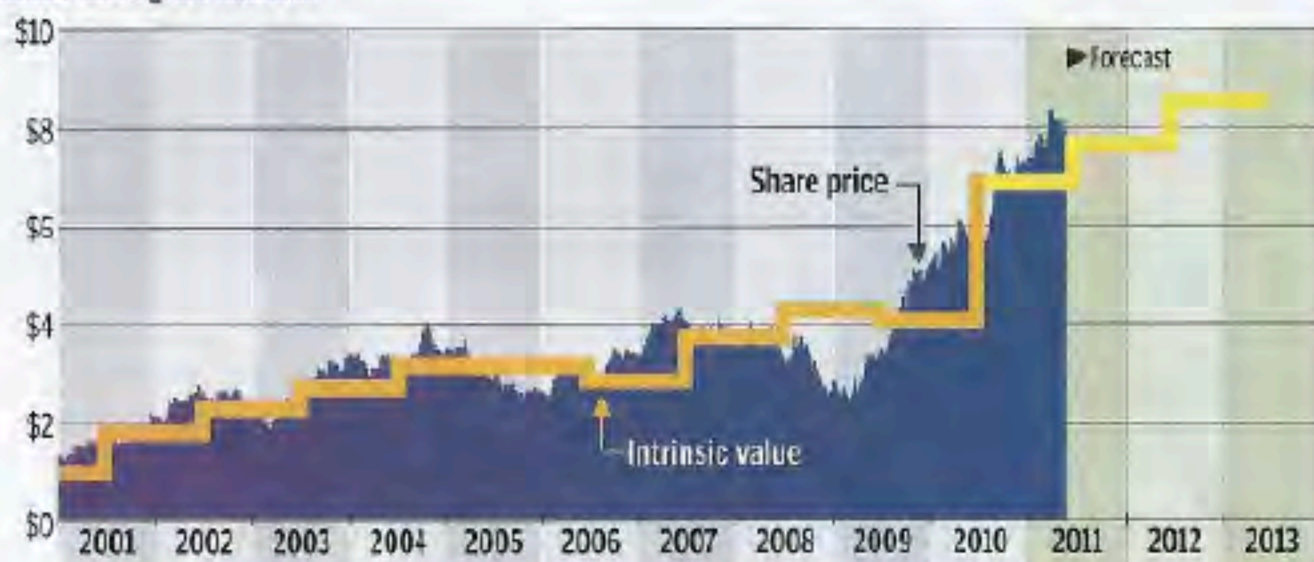
Businesses like Company B have high rates of return on equity, some competitive advantages to help sustain those high returns and, when they are available at cheap prices, produce returns more likely to match those being generated by the underlying business.

Take for example the four-wheel drive parts and accessories manufacturer and distributor ARB Corporation. In 2002, ARB's shares traded at $1.88 ahead of yielding a dividend of just 4.25%. To earn an income of $25,000 you would have to purchase $588,235 worth of shares.

In 2002, that $588,235 would have also

ARUNAS

ARB Corporation



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Dividends per share (DPS)	$0.25	$0.07	$0.08	$0.10	$0.11	$0.12	$0.13	$0.15	$0.17	$0.60	$0.25	$0.28	$0.31
Dividend yield	15.4%	2.55%	3.31%	2.90%	3.74%	3.93%	3.26%	4.20%	5.01%	7.49%	3.10%	3.47%	3.89%

bought you 159,846 shares of Qantas at $3.68, yielding 4.62%.

And that's where the similarities end.

Today your $588,000 investment in Qantas is worth $313,298 and you would have received dividends totalling $228,579. The relatively low rate of return reflects the poor economics of that business. Your investment in ARB will also reflect the economics of the business, but in this case, those economics are far superior.

After receiving dividends of $456,820 since 2002, the market value of your ARB shares is now just shy of $2.5 million.

It's not about the dividend yield

As you can see, it is not the dividend yield at the time of purchase that will determine your return and the protection of your purchasing power – the yield in 2002 for ARB and Qantas was virtually the same. Instead, you need to purchase shares in extraordinary businesses rather than mediocre ones and you need to buy them at discounts to their intrinsic value.

Now take a look at the chart above. This is a 10-year chart of ARB, with both the price and intrinsic value (what the shares are really worth) for ARB Corporation plotted over the past 10 years and with two years of forecasts. You will also see the annual dividends and dividend yield (based on a June 30 share price) each year.

This chart is very powerful for us because it helps us see immediately whether a company is one whose shares we want to own.

The first thing you will notice is that the dividend yield has not been particularly attractive for any of the past 10 years, although it was pretty stable and consistent.

At any point over the past decade, there would have been a great many companies that offered higher dividend yields than ARB Corporation. One example that comes immediately to mind in addition to Telstra and Qantas is Amcor. All would have also been regarded as blue chip and you might have received some comfort from the fact that many advisers had them on their "buy" list. But none has produced the returns available from owning ARB.

The second thing you will notice is that the intrinsic value, which is based on the economic performance of the business, is much higher today than it was 10 years ago. I have found share prices, over the long run, will tend to follow my estimate of intrinsic value (as has been the case with ARB Corp), so you want to buy shares in businesses whose intrinsic value is rising.

By way of contrast, Qantas's intrinsic value is less than it was a decade ago, and its share price is less than it was 10 years ago too! To rub salt in the wound, Qantas then stopped paying dividends altogether. This is a prime example of why the high-dividend approach to investing is a cataclysmic one for your portfolio. **M**

ROGER MONTGOMERY

Roger is a portfolio manager at Montgomery Investment Management and author of best-selling stock market guide book *Value.able*. Order your personally signed copy at www.rogermontgomery.com.

Tax aspect of a second income

Fixed-interest securities

Investors are fully taxed on any interest they receive or they reinvest (e.g. a term deposit or commercial bill that matures). No tax is withheld for residents at the source (e.g. the bank) as long as they have provided their tax file number.

If the proposed savings discount is introduced as planned, taxable interest will be discounted by 50% in 2012-13 up to a maximum of $500, and up to a maximum of $1000 in later years. Any excess interest will be fully taxed as normal.

Property

Capital gains tax (CGT) applies to any capital growth in the value of the property, when it is sold. If the property has been owned for at least 12 months, the taxable capital gain is discounted by 50% (for individuals).

Tax deductions for expenses incurred include the interest on any borrowings used to purchase the property, meaning net losses incurred from negatively geared rental property investments can be offset against other income.

Special building allowance and depreciation deductions apply for various items of capital expenditure relating to the property, both on original construction and when undertaking renovations. These can make a valuable contribution to the overall return on the investment.

Shares

Dividends can be fully or partly franked, meaning that there is a tax credit (known as a franking credit) attached to the dividend in recognition of the 30% tax already paid on the money by the company. This significantly increases the net after-tax return from share investments.

For those on a marginal tax rate of 46.5% their net tax rate can reduce to just 23.57% on dividends received. For those on a marginal tax rate of 30%, the tax bill on a franked dividend is negligible.

Share investments have the same CGT rules as property.

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