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A Montgomery White Paper
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The Latest Fad: Part I

Instant income by way of dividend payouts, or nothing now in the interest of long-term wealth accumulation? *Roger Montgomery* weighs it up, so you can too.

The conventional attraction to dividends has stood Australian investors in good stead over the years. But the increasingly amorous interest in franked dividends, and in some cases, just the franking credits, may be about to produce an outcome that many investors vowed they would never repeat following the Global Financial Crisis.

The panjandrums at global fund manager Henderson Group reckon Australian firms have increased their dividends by an astonishing 89 per cent since 2009 to $44.5 billion. Henderson also noted the Australian increase was the greatest among the ten largest developed stock markets in the world. They further noted that the increase was more than double the 43 per cent increase worldwide over the same period.

Yielding future dangers

But much like yo-yos and hula hoops, when everyone's doing 'it', it seems the trend will never end. But end it always does, and while we cannot be sure of the timing, we can be certain that the pendulum will indeed swing the other way. For investors paying almost any price for that extra basis point of yield, and especially for those with leverage in the stock market or elsewhere, the reckoning may be painful.

In this (and the next) White Paper, we will present the conventional arguments for the attraction of dividends and propose an alternate view, ending with an explanation of the three reasons why we currently expect a boom in asset prices, followed by an inevitable bust.

Australia's population is on the cusp of a boom in retirees – whose top will not so much resemble a peak as it will a 45-year plateau. Everything that is now demanded by those aged in their 60s, 70s, 80s and 90s will be demanded in vastly higher quantities. Figure 1 reveals the massive generational avalanche that is heading unstoppably towards older age.

The reason why the conversation about the change in the population is so important today however, is because the biggest adjustments to infrastructure and habits must occur as the tide begins to rise. There are now three million people, or 14 per cent of the population, aged over 65. It is expected this number will triple over the next 35 years.

Figure 1. Australia's Generational Avalanche[1]

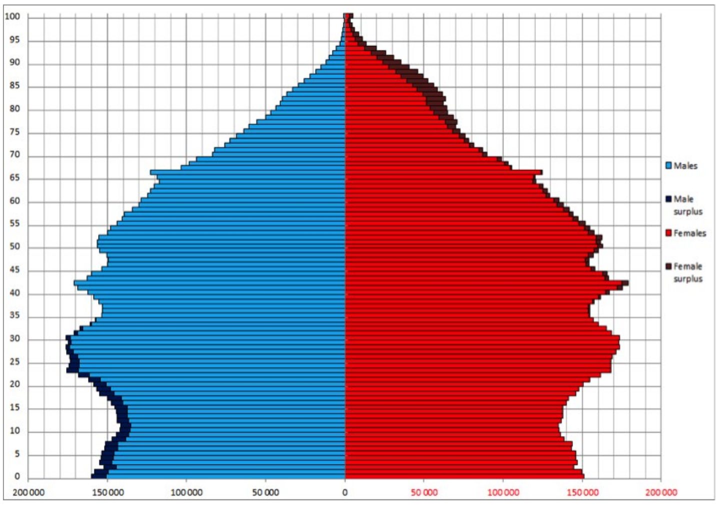
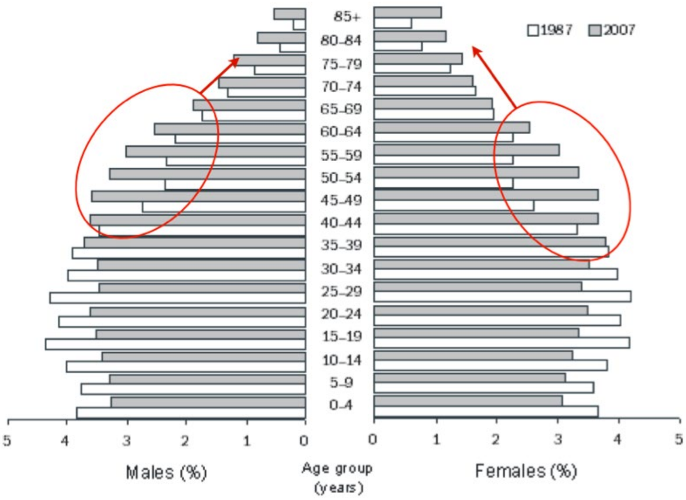


Figure 2 Illustrates the change in the population pyramid over the twenty years between 1987 and 2007. As you can see, the most dramatic increases in age cohorts has occurred, as baby boomers who were aged between 25 to 40 years old in 1987 have moved into the 45 to 60 year-old category 20 years later.

Figure 2. Baby boomers ageing 1987 – 2007[2]



Of course, another seven years has since passed and in 2014 the vanguard of the tidal wave are now aged between 52 and 67. Think of the things that this age group demand and you can be sure more of it will be needed in the next ten years. As today's 52 to 67 year olds head toward and into the 62 to 77 year-old cohort by 2014, the wave of change will be most obviously felt in the demand for services and products needed by those currently aged 67 to 77. Demand for these items will boom for twenty years or more.

[1] Australian Bureau of Statistics, *Population by Age and Sex, Australian States and Territories*, June 2007, www.abs.gov.au.
[2] IBID.

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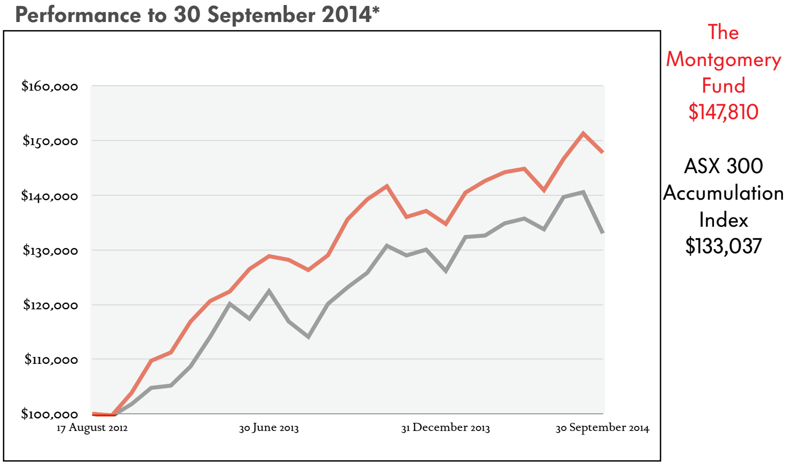
Performance to 30 September 2014*



Returns are since inception (17 Aug, 2012) of the Montgomery Fund and assumes distributions are reinvested.
Past performance is not indicative of future performance.

Minimum investment $25,000

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And one item that will most surely be in high demand through this period will be income itself. And that is what this paper is all about.

As baby boomers approach retirement, their interest in dividends increases. This is especially so just prior to retirement, as well as in the early years of retirement itself. These are the years that boomers celebrate their newfound freedom by spending more than they will in later years.

Of course, the fact that this is all occurring at a time when global interest rates are at record lows, is serving only to accentuate the demand for a higher income return than that currently available on cash deposits and bank bills.

The Current Context

It's unsurprising then, that dividends and capital returns have dominated the stock market narrative in 2014. Companies including BHP Billiton, the Commonwealth Bank of Australia, Suncorp, Rio Tinto, CSL and Boral have all delivered double-digit rises in dividends. In the case of Suncorp and Boral, the dividend increases were greater than 35 per cent. Wesfarmers increased its regular dividend by 10 cents or 5.6 per cent, whilst also paying a special fully-franked "centenary dividend" of 10 cents and an extra dollar per share of "special distribution" associated with an equity consolidation. Not to be outdone, Suncorp offered a 30 cents per share special dividend, while Telstra raised its final dividend for the first time in seven years at the same time it announced a $1 billion share buyback.

With Australia's taxation framework favourably disposed to dividends, especially for all those baby boomers (with Self-Managed Super Funds) referred to earlier, it's no surprise that dividends are expected by many to continue to increase, offering relatively attractive yields.

Are dividends a good thing?

The first observation offered by conventional investors, pundits and commentators alike, is that dividends represent a positive sign that company boards (made up largely of baby boomers who need the income) have heeded – or are being influenced by – the call of shareholders (SMSFs hold 16 per cent of stocks) demanding the income.

It is true that Australian companies have been notoriously bad at retaining and reinvesting their profits. Overpriced acquisitions outnumber the bargains that have added value to the acquiring shareholders, and expansion plans have gone awry with frightening regularity. As a result, shareholder wealth has frequently been destroyed and that means fewer cars, caravans, cruises, restaurant visits and grocery trips for the owners of those businesses.

> "In theory, publicly traded corporations have shareholders as their kings, boards of directors as the sword-wielding knights who protect the shareholders and managers as the vassals who carry out orders. In practice, in the past decade, managers have become kings who lavish gold upon themselves, boards of directors have become fawning courtiers who take coin in return for an uncritical yes-man function and shareholders have become peasants whose property may be seized at management's whim."
> – *Richard Puntillo, Professor of the School of Management at the University of San Francisco.*

Richard Puntillo's delightfully articulated general description of the current state of corporate governance is certainly a terrible indictment of corporate arrogance, and possibly, ignorance. This kind of behaviour has led to the sentiment exemplified by Perpetual Investments' Head of Equities Matt Williams, who was quoted in *The Australian Financial Review* as saying: "Unless management can convince us they have a better use for excess capital, we think they should maximise their ability to pay franked dividends back to shareholders."[3]

Mr Williams' sentiments are justified. When a company cannot generate a high return on equity, the company should be paying out its retained earnings.

However, if a company *can* generate high rates of return on equity, it is logical that earnings should be retained, irrespective of the demands and needs of shareholders. It is not the case that a particular class of shareholders are best qualified to influence the dividend payout policy of a company.

Nevertheless, it is true that the major banks, telco companies and an increasing number of resource companies are raising their payout ratios; in turn increasing the yield for income-hungry investors and simultaneously increasing demand for the shares – often providing incumbent shareholders with a capital gain to boot.

[3] *Australian Financial Review*, "Business Backs Growth Over Dividends", 24 August, 2014

It is easy to take your cue from prices. As share prices rise, investors can be lulled to conclude that their investment thesis was right even though the share price rises may not reflect that thesis, but be purely coincidental. The false sense of security gained from this virtuous circle sows the seeds of the inevitable fall.

In the case of rising dividend payout ratios, high quality companies must fundamentally be worth relatively less, not more. Despite this – share prices rise; diverging from fundamental value and creating a gap of hot air that increases the risk.

Indeed, not everyone is enamoured with the chase for yield, fed by what might be referred to as the 'payout party'.

No less than Glenn Stevens, Governor of the Reserve Bank of Australia (RBA) has questioned the fixation on high dividend payouts. He notes that the economy suffers when companies retain less profit for growth – a key driver of economic expansion.

According to our friends at UBS, Australian listed companies are rewarding shareholders with an all-time record 70 per cent payout ratio. Goldman Sachs (GS), looks at a slightly different metric, observing the average industrial-company payout ratio running at 50 per cent of free cash flow – cash flow being the capital available for investment once all the ongoing annual obligations have been met. According to GS, prior to the GFC, this number averaged 30 per cent, with 70 per cent reinvested into its business.

Why dividends might not be all they're cracked up to be

A company can do just four things with its profits. It can reinvest in itself for organic growth (we'll explain

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Returns to 30 September 2014

Code		Change	Outperfomance
MPF	**The Montgomery [Private] Fund**	**51.88%**	**-**
XNAJI	ASX 200 Industrials Accumulation Index	23.13%	28.75%
XTOAI	ASX 100 Accumulation Index	34.19%	17.69%
XJOAI	ASX 200 Accumulation Index	30.96%	20.92%
XAOAI	All Ordinaries Accumulation Index	27.86%	24.02%
XKOAI	ASX 300 Accumulation Index	29.12%	22.76%
XTLAI	ASX 20 Accumulation Index	38.55%	13.33%
XMDAI	ASX Midcap 50 Accumulation Index	15.95%	35.93%
XSOAI	ASX Small Ordinaries Accumulation Index	-15.91%	67.79%

Benchmarked returns are since inception (23 Dec, 2010) of the Montgomery [Private] Fund and assumes distributions are reinvested. Past performance is not indicative of future performance.

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when this is beneficial and when it's not another time), acquire other companies, buyback its own shares or pay dividends.

We believe the first and most valuable priority for a high quality business – that is, one able to generate high rates of return on incremental equity – is to reinvest and grow organically.

A company can invest to improve efficiency, duplicate itself in new geographies, diversify its product offering either horizontally or vertically, or invest in staff and brand enhancements that build business value and defences against existing and would-be competitors.

The next option is to acquire either another business; or, if nothing superior is available and one's own stock is available at an attractive price – one's own business.

A superior add-on, however, can add value far beyond the benefit that arises in the case of a buyback. And the importance of price and value cannot be understated when it comes to buybacks. A company's intrinsic value can be eroded materially by the repurchase of shares, just as surely as the overpriced acquisition of another business.

The final option for a company with excess cash is dividends.

We deliberately offer up this option as the final one, because 'last' represents the appropriate ranking in the list of options available to a business.

Of course, this sentiment does not reflect that of Australian company boards who put smooth dividend increases above almost all else.

The best way to explain why dividends should be the last priority for a business able to reinvest capital at attractive rates of return is to look at Table 1.

In illustrating the benefits of growth over income, we run the risk of having you incorrectly conclude that we don't desire income. Nothing could be further from the truth. Our first prize is actually a business that can throw off large amounts of cash and continue to grow profits meaningfully. Such ability, however, means the company in question can actually generate very high and growing rates of return on retained capital. Dividend yields don't tell us anything about the economic return we can expect from owning shares in a company. Let's look at Table 1 as an example.

Table 1.

	The Business						The Market	
Year	Beginning Equity ($)	Return on Equity (%)	Earnings ($)	Payout Ratio (%)	Dividends ($)	Ending Equity ($)	Price-earnings Ratio	Share Price ($)
1	1.00	20	0.20	50	0.10	1.10	10	2.00
2	1.10	20	0.22	50	0.11	1.21	10	2.20

Source: www.rogermontgomery.com/valueable-book/

Table 1 illustrates the importance of the dividend payment policy to the returns an investor obtains.

In this table, we have a company that generates an attractive 20 per cent return on its beginning equity. The management of this company has decided that being all things to all people is a noble endeavour. They have elected to keep 50 per cent of the earnings for 'growth', while the other 50 per cent will be used to support the share price by sending a signal to income-hungry investors that they too can rely on the company and management for dividends.

But as I am about to demonstrate, a tree cannot produce both apples and oranges and expect each to ripen.

The investor who demands that a company with ongoing bright prospects for high rates of return on equity also pay a dividend are engaging in what I have previously referred to as 'genetic modification' of the useless kind.

As you can see in Table 1, the company generates 20 cents of earnings (or a 20 per cent return on its beginning equity of $1) in the first year. Management then pays out 50 per cent of this 20 cents in earnings as a dividend (a 10 cent dividend), and retains the other 50 per cent (10 cents), ending the year with $1.10 of equity.

If we assume that the stock always trades at 10 times the earnings of the company, or the market is always willing to buy and sell the shares on a price-to-earnings (P/E) ratio of ten – that is, the P/E ratio remains constant – then the shares will trade at $2 in year one.

In the second year, the company again earns a 20 per cent return on beginning equity of $1.10 – or 22 cents. In the second year, if the P/E ratio remains constant, the shares will trade at $2.20.

Note that in its first year, the company retained 10 cents for 'growth'. And because the shares rose from $2 to $2.20, the company effectively turned the 10 cents of retained earnings into 20 cents of market value. If every dollar the company retains can be turned into $2 of market value, it should retain all the dollars it can. Conversely, by paying out ten cents of earnings as a dividend, which it did, the shareholders missed out on another 20 cents of market value growth. That's one expensive dividend!

An explanation

If the company had retained all the profits it generated in the first year, paying *no* dividends, then the equity at the end of the first year would have been $1.20. Had the company then generated another 20 per cent return on equity in year two, earnings per share would have been 24 cents. Similarly, had the P/E ratio remained constant (and it's more likely that it would have risen), then the share price would have been $2.40.

So while shareholders received a ten-cent dividend, they have missed out on 20 cents of capital gains.

This simple example demonstrates that it's the payout ratio (or capital allocation policy) that's ultimately regulated by management, which determines the return to shareholders, not the dividend yield. If we can agree with the concept that the higher the price you pay, the lower your return – then we can also agree that the cheapest stock or the best value is the one that offers the highest total return.

Going back to our example, if the shares are purchased in year one and sold in a future year at that same P/E ratio, the returns change based on how much of the earnings are paid out as a dividend, and how much are retained and compounded by the company.

If the company pays all of its earnings as dividends, the return to a shareholder who bought and sold the shares on a P/E ratio of ten and collected all the dividends, would be 10 per cent per annum.

If half the earnings are paid as a dividend, the return from buying the shares, collecting the dividends and then selling the shares at a future date, would be 15 per cent per annum; and if no dividends were paid and the company retained and compounded all of the earnings, the return would be 20 per cent per annum.

The highest return, in this example, comes from receiving no dividends at all.

Many investors, particularly those in a zero-tax environment, might be upset that no dividends were paid and that they have missed out on the franking credits. But their capital gains are tax-free too, and the total return from selling enough shares to produce an equivalent amount of income will, over time, be higher.

In Part 2 of *The Latest Fad*, we'll take a look at another example that demonstrates just how much more money you could make investing in businesses that don't necessarily pay the best yield today. We'll complete the two-part series with an explanation of the three reasons investors might be rewarded for their folly but will need to dance close to the door.

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