

The Lost Decade and the Search for More Income

It might surprise you to know that there has been no capital gain from the ASX200 for a decade. So investing must be all about the dividends? It's reasonable to assume that income will become even more important as the proportion of Australians over the age of 65 rises, but are dividends the only way of generating income from shares?

You may recall our many warnings in 2015 that the chase for dividend yield was a fad propelling the share prices of big name, blue chip stocks higher but unjustifiably given the lack of support from underlying earnings growth. Explaining that the outlook for the banks, BHP and Telstra did not justify their lofty market valuations, we urged investors to review their overweight holdings in these issues.

Since then the share prices for these companies have fallen by a significant percentage and billions have been wiped from the retirement savings of millions of Australians. When BHP, for example, announced a progressive dividend, investors could not resist the temptation to hold on even in the face of repeated warnings that such a policy was unsustainable. When the company paid out a "progressive" fully franked dividend in Fiscal 2015, of \$1.68 it equated to a yield of 6.7 per cent on the then \$25 share price. The price today however reflects a \$10 capital loss, equivalent to six years of dividends.

The problem now is that many investors believe markets always or inevitably go up and this is just another cyclical sell off in the share prices of companies that will eventually recover.

At Montgomery we aren't so sure. It is already true that the Australian stock market as measured by the broad S&P/ASX200 is exactly where it was a decade ago on a capital basis and only dividends have seen investors through. But when so-called 'blue chip' companies cease paying dividends, reduce payments or lower payout ratios the impact to both income and inevitably capital requires a rethink of the conventional approach to investing in shares.

This paper proposes to demonstrate the benefit of the sell-off strategy; a different approach to shares and income generation to meet income needs versus buying shares with attractive dividend yields.

Before we begin we need to make some basic but important assumptions. The first is that we assume you will be investing in companies with the ability to generate high rates of return on reasonable amounts of incremental equity. A company that can retain large amounts of its profit and generate high returns on those funds is like an investor in a bank account generating a very high rate of interest and reinvesting all the interest. The interest earns interest and the balance grows quickly.

While the first part of this white paper repeats some of our earlier references to the importance of compounding, we conclude with a demonstration of the benefits of selling shares to meet income needs versus buying shares with attractive dividend yields.

Let's begin

There is some basic arithmetic that can demonstrate a superior choice to simply high dividend yields for those requiring income.

Table 1. High ROE Company paying out 100 per cent of earnings

	Year 1	Year 2	Year 3
Equity(b)	\$10.0	\$10.00	\$10.00
ROE	20%	20%	20%
EPS	\$2.00	\$2.00	\$2.00
POR	100%	100%	100%
DPS	\$2.00	\$2.00	\$2.00
Equity(e)	\$10.0	\$10.00	\$10.00
P/E	10	10	10
Share Price	\$20.00		\$20.00
Cash Flows	-\$20.00	\$2.00	\$22.00
IRR			10%

Yield = 10%

Lets begin with a yield-hungry investor, in the tax-free pension phase of their lives, chasing a company's shares with a high dividend yield and paying all of its earnings out as a dividend.

First, we assume the business described in Table 1 is able to generate a return on equity (ROE) of 20 per cent sustainably. Second, we assume to buy and sell the shares on an unchanged price earnings (P/E) ratio of 10 times. The final assumption is a payout ratio of 100 per cent.

We have assumed the only way the company can grow is to retain profits. There is no increases in debt (which increases the risks) and no dilutionary share issues to fund growth. The company's only source of growing equity is retained profits.

Table 1. demonstrates that an investor who purchases and sells shares in a company with an attractive rate of return on equity, a constant P/E ratio and a payout of 100 per cent will receive, as their return, an internal rate equivalent to the dividend yield at the time the shares are purchased.

A company with \$10 of equity, earning consistent and assumed 20 per cent returns on that equity, will generate earnings of \$2.00 per share in Year 1. Buying the shares on a P/E ratio of ten times next year's earnings of \$2.00 means an outlay of \$20.00.

The investor will then receive \$2.00 of dividends in each of the subsequent years. The reason the dividend doesn't grow is because the company has retained none of its previous years' profits – they're all paid out - and so the equity remains unchanged. Additionally, if the company's return on equity never changes (albeit an attractive return on equity) then the earnings cannot grow and because the payout ratio does not rise above 100 per cent, the dividends do not grow either.

If the investor pays \$20.00 for these shares, subsequently receives \$2.00 a year in dividends, and then sells the shares at \$20.00 (remember the P/E ratio remains unchanged and the earnings haven't grown) the return to the investor is a pre-tax 10 per cent per annum, which is equal to the dividend yield at the time the investor purchased the shares.

This represents the upper bound of their return – the dividend yield is the best outcome they can expect, unless they speculate successfully on an expansion of the P/E ratio. For that to occur, sentiment or popularity towards the company's shares would have to change and be correctly predicted. At Montgomery we consider ourselves investors rather than speculators so we would not buy shares presuming a market 'rerating' of the desirability of a company and its shares.

In simple terms, if you chase a high yield and the company pays all of its earnings out as a dividend, the yield is about all you should expect. Capital growth can only come through speculation. Speculation however is risky and that is what investors who chased the banks, Telstra and BHP back in 2015 are now finding out.

When it comes to dividends, less is more.

In Table 2, the only element that has changed is the payout ratio, which is now zero. Rather than paying out all of its earnings, as the company did in Table 1., this company pays none of its earnings as a dividend. Instead it retains all of the profits for growth, generating an additional 20 per cent of equity each year. One example of a company that has done this – retained all of its profits and generated 20 per cent returns on equity for five decades – is Berkshire Hathaway. Its share price has risen from US\$795 in 1983 – 33 years ago – to US\$200,000 each today.

Table 2. High ROE Company paying out zero per cent of earnings

	Year 1	Year 2	Year 3
Equity(b)	\$10.0	\$12.00	\$14.40
ROE	20%	20%	20%
EPS	\$2.00	\$2.40	\$2.88
POR	0%	0%	0%
DPS	\$0.00	\$0.00	\$0.00
Equity(e)	\$12.0	\$14.40	\$17.28
P/E	10	10	10
Share Price	-\$24.00		\$34.56
Cash Flows	-\$24.00	\$0.00	\$34.56
IRR			20%

Yield = 0%

The Company in Table 2. pays none of its earnings out as a dividend. An investor who buys and sells the shares on the same P/E ratio will experience capital and earnings growing by the rate of the retained ROE. In other words because the 20 per cent return on equity is retained, the equity grows by 20 per cent. And because the equity grows by 20 per cent and the return on equity is constant, the earnings grow by 20 per cent. If the earnings are growing by 20 per cent and the P/E ratio at which the shares are bought and sold is the same, the return to the investor will equal the rate of growth of earnings, which in this case is equal to the return on equity of 20 per cent.

Our hypothesis is that investors who chase higher yields, especially from companies that pay the bulk of their earnings out as dividends, are missing out on major financial benefits.

The corollary is that company Boards that acquiesce to shareholder demands for higher dividend payout ratios – especially where they are able to employ retained earnings at high rates of return – are ultimately doing their shareholders and their share price a disservice.

This is demonstrated in Table 3. below, which shows companies that retain profits not only grow their capital at a much faster rate (provided they have somewhere profitable to redeploy those funds), but also and inevitably grow their income at a much faster rate – even surpassing the higher yielding dividend payers.

Table 3. Power of true blue-chips (not Telstra)

2005	M2	Telstra	CSL
Investment	\$100,000	\$100,000	\$100,000
Price	\$0.32	\$4.69	\$9.09
Dividend	\$0.01	\$0.28	*\$0.47
Yield	3.91%	5.97%	5.17%
Total Income	\$3,910	\$5,970	\$5,171
2015	M2	Telstra	CSL
Investment	\$3,006,250	\$117,697	\$1,016,942
Price	\$9.63	\$5.52	\$92.44
Dividend	\$0.32	\$0.31	\$1.69
Yield	3.32%	5.53%	1.83%
Total Income	\$99,807.50	\$6,508.66	\$18,591.86

*excludes special

It's not only about dividend yields

Investors in 2005 who invested \$100,000 in the higher, 5.9 per cent-yielding Telstra shares could have invested \$100,000 in the M2 Group. The major difference between these two companies was not just their yield. Telstra's management elected to pay the bulk of the company's earnings out as a dividend. Indeed, under Solomon Dennis Trujillo, Telstra's dividend exceeded earnings over a number of years. While Telstra's payout ratio was near 100 per cent, M2 Group's payout ratio was much lower. Table 2 revealed the desirable impact on returns from investing in a company that can retain earnings and reinvest those earnings at a high ROE. Table 3 puts that into practice.

Investing \$100,000 in Telstra in 2005 for ten years has produced an investment of about \$118,000 or an average annual compounded capital return of 1.5 per cent p.a. Many of you will jump to the defence of Telstra and point out that I have excluded the dividends from the calculations. But this article is about retirees who have been chasing income to spend on food and clothing and other essentials like BMWs and annual overseas holidays, so I have not assumed a reinvestment of dividends.

In 2005, the 5.9 per cent yield on Telstra shares equated to \$5,900 of fully franked income. Telstra has increased the dividend since then from 28 cents to 30 cents per share and the low increase reflects that fact that profits have not grown markedly. In any event, the income on the \$118,000 investment would be about \$6,500.

Contrast this with M2 where the ability to generate high returns on large amounts of capital have turned \$100,000 into \$3 million and importantly for those desperate for income, turned \$3,900 of dividends in 2005 into almost \$100,000 of fully franked dividends in 2015.

M2 is not an isolated example of the power of high rates of return on equity and the ability to retain profits. For example, CSL also displayed a less attractive dividend yield than Telstra in 2005, but was able to retain capital and compound it at an attractive rate, ultimately producing more wealth and more income.

Investors chasing the highest yielding blue chip shares are missing out on the returns and income available from true blue chips – the type that we prefer to fill our portfolios with. Investors are making an expensive mistake by eschewing those companies with lower yields today but are able to grow their income. Go for growing income, not the highest yield.

It is worth noting that Warren Buffett's company Berkshire Hathaway has paid only one dividend during Buffett's tenure, in 1967, and the company's Chairman later joked he must have been in the bathroom when the decision was made.

Nevertheless, the above example helps explain and give credence to Buffett's stance that using profits profitably, results in greater wealth for shareholders than paying dividends. Berkshire Hathaway's stock price increased by 700,000% between 1964 and 2015.

Take the Income? Next Steps

The biggest challenge for Australian retiree investors however is the requirement for income to put food on the table, pay for holidays and medical surprises. How can a retiree living from the income their investments produce possibly invest in Berkshire Hathaway when Warren Buffett pays no dividends?

Buffett's solution is a simple one – sell some shares.

Rather than reinvent the wheel we have chosen to reprint Buffett's examination below from Berkshire Hathaway's 2012 Annual letter and instead built a simple model (printed at the end of this Whitepaper) that visually demonstrates the advantages of owning and selling shares in companies that retain profits and profitably redeploy them. Feel free to tear off the Tables at the end of this Whitepaper to refer to as you read Buffett's explanation. And note that franking credits in Australia don't materially alter the arguments made for companies with attractive returns on equity and particularly for superannuation investors in pension phase – those that dominate the landscape for income-related investments.

"A number of Berkshire shareholders – including some of my good friends – would like Berkshire to pay a cash dividend. It puzzles them that we relish the dividends we receive from most of the stocks that Berkshire owns, but pay out nothing ourselves. So let's examine when dividends do and don't make sense for shareholders.

"A profitable company can allocate its earnings in various ways (which are not mutually exclusive). A company's management should first examine reinvestment possibilities offered by its current business – projects to become more efficient, expand territorially, extend and improve product lines or to otherwise widen the economic moat separating the company from its competitors.

"I ask the managers of our subsidiaries to unendingly focus on moat-widening opportunities, and they find many that make economic sense. But sometimes our managers misfire. The usual cause of failure is that they start with the answer they want and then work backwards to find a supporting rationale. Of course, the process is subconscious; that's what makes it so dangerous.

"Your chairman has not been free of this sin. In Berkshire's 1986 annual report, I described how twenty years of management effort and capital improvements in our original textile business were an exercise in futility. I wanted the business to succeed and wished my way into a series of bad decisions. (I even bought another New England textile company.) But wishing makes dreams come true only in Disney movies; it's poison in business.

"Despite such past miscues, our first priority with available funds will always be to examine whether they can be intelligently deployed in our various businesses. Our record \$12.1 billion of fixed-asset investments and bolt-on acquisitions in 2012 demonstrate that this is a fertile field for capital allocation at Berkshire. And here we have an advantage: Because we operate in so many areas of the economy, we enjoy a range of choices far wider than that open to most corporations. In deciding what to do, we can water the flowers and skip over the weeds.

"Even after we deploy hefty amounts of capital in our current operations, Berkshire will regularly generate a lot of additional cash. Our next step, therefore, is to search for acquisitions unrelated to our current businesses. Here our test is simple: Do Charlie and I think we can effect a transaction that is likely to leave our shareholders wealthier on a per-share basis than they were prior to the acquisition?

"I have made plenty of mistakes in acquisitions and will make more. Overall, however, our record is satisfactory, which means that our shareholders are far wealthier today than they would be if the funds we used for acquisitions had instead been devoted to share repurchases or dividends.

"But, to use the standard disclaimer, past performance is no guarantee of future results. That's particularly true at Berkshire: Because of our present size, making acquisitions that are both meaningful and sensible is now more difficult than it has been during most of our years.

"Nevertheless, a large deal still offers us possibilities to add materially to per-share intrinsic value. BNSF is a case in point: It is now worth considerably more than our carrying value. Had we instead allocated the funds required for this purchase to dividends or repurchases, you and I would have been worse off. Though large transactions of the BNSF kind will be rare, there are still some whales in the ocean.

"The third use of funds – repurchases – is sensible for a company when its shares sell at a meaningful discount to conservatively calculated intrinsic value. Indeed, disciplined repurchases are the surest way to use funds intelligently: It's hard to go wrong when you're buying dollar bills for 80¢ or less. We explained our criteria for repurchases in last year's report and, if the opportunity presents itself, we will buy large quantities of our stock. We originally said we would not pay more than 110% of book value, but that proved unrealistic. Therefore, we increased the limit to 120% in December when a large block became available at about 116% of book value.

"But never forget: In repurchase decisions, price is all-important. Value is destroyed when purchases are made above intrinsic value. The directors and I believe that continuing shareholders are benefited in a meaningful way by purchases up to our 120% limit.

"And that brings us to dividends. Here we have to make a few assumptions and use some math. The numbers will require careful reading, but they are essential to understanding the case for and against dividends. So bear with me.

"We'll start by assuming that you and I are the equal owners of a business with \$2 million of net worth. The business earns 12% on tangible net worth – \$240,000 – and can reasonably expect to earn the same 12% on reinvested earnings. Furthermore, there are outsiders who always wish to buy into our business at 125% of net worth. Therefore, the value of what we each own is now \$1.25 million.

"You would like to have the two of us shareholders receive one-third of our company's annual earnings and have two-thirds be reinvested. That plan, you feel, will nicely balance your needs for both current income and capital growth. So you suggest that we pay out \$80,000 of current earnings and retain \$160,000 to increase the future earnings of the business. In the first year, your dividend would be \$40,000, and as earnings grew and the one third payout was maintained, so too would your dividend. In total, dividends and stock value would increase 8% each year (12% earned on net worth less 4% of net worth paid out).

"After ten years our company would have a net worth of \$4,317,850 (the original \$2 million compounded at 8%) and your dividend in the upcoming year would be \$86,357. Each of us would have shares worth \$2,698,656 (125% of our half of the company's net worth). And we would live happily ever after – with dividends and the value of our stock continuing to grow at 8% annually.

"There is an alternative approach, however, that would leave us even happier. Under this scenario, we would leave all earnings in the company and each sell 3.2% of our shares annually. Since the shares would be sold at 125% of book value, this approach would produce the same \$40,000 of cash initially, a sum that would grow annually. Call this option the "sell-off" approach.

"Under this "sell-off" scenario, the net worth of our company increases to \$6,211,696 after ten years (\$2 million compounded at 12%). Because we would be selling shares each year, our percentage ownership would have declined, and, after ten years, we would each own 36.12% of the business. Even so, your share of the net worth of the company at that time would be \$2,243,540. And, remember, every dollar of net worth attributable to each of us can be sold for \$1.25. Therefore, the market value of your remaining shares would be \$2,804,425, about 4% greater than the value of your shares if we had followed the dividend approach.

"Moreover, your annual cash receipts from the sell-off policy would now be running 4% more than you would have received under the dividend scenario. Voila! – you would have both more cash to spend annually and more capital value.

"This calculation, of course, assumes that our hypothetical company can earn an average of 12% annually on net worth and that its shareholders can sell their shares for an average of 125% of book value. To that point, the S&P 500 earns considerably more than 12% on net worth and sells at a price far above 125% of that net worth. Both assumptions also seem reasonable for Berkshire, though certainly not assured.

"Moreover, on the plus side, there also is a possibility that the assumptions will be exceeded. If they are, the argument for the sell-off policy becomes even stronger. Over Berkshire's history – admittedly one that won't come close to being repeated – the sell-off policy would have produced results for shareholders dramatically superior to the dividend policy.

"Aside from the favorable math, there are two further – and important – arguments for a sell-off policy. First, dividends impose a specific cash-out policy upon all shareholders. If, say, 40% of earnings is the policy, those who wish 30% or 50% will be thwarted. Our 600,000 shareholders cover the waterfront in their desires for cash. It is safe to say, however, that a great many of them – perhaps even most of them – are in a net-savings mode and logically should prefer no payment at all.

"The sell-off alternative, on the other hand, lets each shareholder make his own choice between cash receipts and capital build-up. One shareholder can elect to cash out, say, 60% of annual earnings while other shareholders elect 20% or nothing at all. Of course, a shareholder in our dividend-paying scenario could turn around and use his dividends to purchase more shares. But he would take a beating in doing so: He would both incur taxes and also pay a 25% premium to get his dividend reinvested. (Keep remembering, open-market purchases of the stock take place at 125% of book value.)

"The second disadvantage of the dividend approach is of equal importance: The tax consequences for all taxpaying shareholders are inferior – usually far inferior – to those under the sell-off program. Under the dividend program, all of the cash received by shareholders each year is taxed whereas the sell-off program results in tax on only the gain portion of the cash receipts.

"Let me end this math exercise – and I can hear you cheering as I put away the dentist drill – by using my own case to illustrate how a shareholder's regular disposals of shares can be accompanied by an increased investment in his or her business. For the last seven years, I have annually given away about 4 1/4% of my Berkshire shares. Through this process, my original position of 712,497,000 B-equivalent shares (split-adjusted) has decreased to 528,525,623 shares. Clearly my ownership percentage of the company has significantly decreased.

"Yet my investment in the business has actually increased: The book value of my current interest in Berkshire considerably exceeds the book value attributable to my holdings of seven years ago. (The actual figures are \$28.2 billion for 2005 and \$40.2 billion for 2012.) In other words, I now have far more money working for me at Berkshire even though my ownership of the company has materially decreased. It's also true that my share of both Berkshire's intrinsic business value and the company's normal earning power is far greater than it was in 2005. Over time, I expect this accretion of value to continue – albeit in a decidedly irregular fashion – even as I now annually give away more than 4 1/2% of my shares (the increase having occurred because I've recently doubled my lifetime pledges to certain foundations)."

Tables 4 and 5 display the equity and market value changes as well as dividend cash flows that Buffett describes in his argument that receiving no dividends from high return on equity companies is superior and selling some shares is superior to receiving dividends.

Of course Buffett's example looks at a company that might be unlisted. Once listed, the fact remains that shares prices do rise and fall and therefore there is some risk that an investor is forced to sell more shares at lower prices during a market wide sell off. This is known as sequencing risk – the risk that early declines might result in insufficient capital with which to grow towards the intended goal.

But Buffett addresses this two ways. Highlighting the fact that his holding is now indeed worth more, despite the sales, since 2005 (a period that includes the global financial crisis) the argument reminds investors to invest long term and that there should be less concern when companies able to consistently generate solid returns on equity are favoured over those simply paying high yields.

Secondly, what remains silent is the fact that this investment does not represent 100 per cent of the investors portfolio. Just as Buffett holds investments outside of Berkshire, so to do most investors hold investments outside of their equity portfolio. When a diversified portfolio that includes real estate, cash and other investments are considered, investing in true blue chips (that can retain and compound earnings) rather than conventional higher yielding blue chips, and selling shares along the way appears to be a more lucrative and sensible strategy.

Few companies listed in Australia retain all their earnings - the fact that franking credits have zero value to a company's earnings almost compels Company Boards to pay at least some of the earnings to shareholders. The discussion above however remains a useful reminder to all investors – and especially those that are at, in or nearing retirement - that they should invest in businesses with terrific growth prospects even if the dividend yield is not that high today. Alternatively invest with a fund manager that favours them because the expectation should be both greater wealth and more income.

Buffett: We'll start by assuming that you and I are the equal owners of a business with \$2 million of net worth.

Buffett: The business earns 12% on tangible net worth – \$240,000 – and can reasonably expect to earn the same 12% on reinvested earnings.

Buffett: Furthermore, there are outsiders who always wish to buy into our business at 125% of net worth. Therefore, the value of what we each own is now \$1.25 million.

Buffett: So you suggest that we pay out \$80,000 of current earnings and retain \$160,000 to increase the future earnings of the business. In the first year, your dividend would be \$40,000.

Table 4. Investing For Dividends

Year	Equity(b)	ROE	Earnings	Dividends	Equity(e)	P/Book	Market Value	Market value stake held by 50% owner	Dividends	MV CAGR	Div CAGR
1	\$2,000,000	12%	\$240,000	\$80,000	\$2,160,000	1.25	\$2,500,000	\$1,250,000	\$40,000.00		
2	\$2,160,000	12%	\$259,200	\$86,400	\$2,332,800	1.25	\$2,700,000	\$1,350,000	\$43,200.00	8.00%	8.00%
3	\$2,332,800	12%	\$279,936	\$93,312	\$2,519,424	1.25	\$2,916,000	\$1,458,000	\$46,656.00	8.00%	8.00%
4	\$2,519,424	12%	\$302,331	\$100,777	\$2,720,978	1.25	\$3,149,280	\$1,574,640	\$50,388.48	8.00%	8.00%
5	\$2,720,978	12%	\$326,517	\$108,839	\$2,938,656	1.25	\$3,401,222	\$1,700,611	\$54,419.56	8.00%	8.00%
6	\$2,938,656	12%	\$352,639	\$117,546	\$3,173,749	1.25	\$3,673,320	\$1,836,660	\$58,773.12	8.00%	8.00%
7	\$3,173,749	12%	\$380,850	\$126,950	\$3,427,649	1.25	\$3,967,186	\$1,983,593	\$63,474.97	8.00%	8.00%
8	\$3,427,649	12%	\$411,318	\$137,106	\$3,701,860	1.25	\$4,284,561	\$2,142,280	\$68,552.97	8.00%	8.00%
9	\$3,701,860	12%	\$444,223	\$148,074	\$3,998,009	1.25	\$4,627,326	\$2,313,663	\$74,037.21	8.00%	8.00%
10	\$3,998,009	12%	\$479,761	\$159,920	\$4,317,850	1.25	\$4,997,512	\$2,498,756	\$79,960.19	8.00%	8.00%
11	\$4,317,850	12%	\$518,142	\$172,714	\$4,663,278	1.25	\$5,397,312	\$2,698,656	\$86,357.00	8.00%	8.00%

Buffett: After 10 years our company would have a net worth of \$4,317,850 (the original \$2 million compounded at 8%) and your dividend in the upcoming year would be \$86,357.

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Buffet: After 10 years our company would have a net worth of \$4,317,850 (the original \$2 million compounded at 8%) and your dividend in the upcoming year would be \$86,357.

Buffett: and as earnings grew and the one-third payout was maintained, so too would your dividend. In total, dividends and stock value would increase 8% each year (12% earned on net worth less 4% of net worth paid out).

Buffett: There is an alternative approach, however, that would leave us even happier. Under this scenario, we would leave all earnings in the company and each sell 3.2% of our shares annually

Buffett: Because we would be selling shares each year, our percentage ownership would have declined, and, after 10 years, we would each own 36.12%.

Buffett: Since the shares would be sold at 125% of book value, this approach would produce the same \$40,000 of cash initially, a sum that would grow annually. Call this option the “sell-off” approach.

Table 5. The Sell Down Method

Year	Equity(b)	ROE	Earnings	Divid -ends	Equity(e)	P/ Book	Market Value	ownership Post sale	\$ from Sale	Remaining Stake	Value of equity remaining for 50% owner	Value of market worth for 50% owner
1	\$2,000,000	12%	\$240,000	\$0	\$2,240,000	1.25	\$2,500,000	96.80%	\$80,000	\$2,420,000.00		
2	\$2,240,000	12%	\$268,800	\$0	\$2,508,800	1.25	\$2,800,000	93.70%	\$86,733	\$2,623,667.20		
3	\$2,508,800	12%	\$301,056	\$0	\$2,809,856	1.25	\$3,136,000	90.70%	\$94,032	\$2,844,475.03		
4	\$2,809,856	12%	\$337,183	\$0	\$3,147,039	1.25	\$3,512,320	87.80%	\$101,946	\$3,083,866.05		
5	\$3,147,039	12%	\$377,645	\$0	\$3,524,683	1.25	\$3,933,798	84.99%	\$110,526	\$3,343,404.22		
6	\$3,524,683	12%	\$422,962	\$0	\$3,947,645	1.25	\$4,405,854	82.27%	\$119,828	\$3,624,785.12		
7	\$3,947,645	12%	\$473,717	\$0	\$4,421,363	1.25	\$4,934,557	79.64%	\$129,912	\$3,929,847.03		
8	\$4,421,363	12%	\$530,564	\$0	\$4,951,926	1.25	\$5,526,704	77.09%	\$140,846	\$4,260,582.96		
9	\$4,951,926	12%	\$594,231	\$0	\$5,546,158	1.25	\$6,189,908	74.62%	\$152,699	\$4,619,153.62		
10	\$5,546,158	12%	\$665,539	\$0	\$6,211,696	1.25	\$6,932,697	72.24%	\$165,550	\$5,007,901.59	\$2,243,539.91	\$2,804,424.89
11	\$6,211,696	12%	\$745,404	\$0	\$6,957,100	1.25	\$7,764,621	69.92%	\$179,483	\$5,429,366.59		

Buffett: Under this “sell-off” scenario, the net worth of our company increases to \$6,211,696 after 10 years (\$2 million compounded at 12%).

Buffett: Moreover, your annual cash receipts from the sell-off policy would now be running 4% more than you would have received under the dividend scenario. Voila! – you would have both more cash to spend annually and more capital value.

Buffett: After 10 years, we would each own 36.12% of the business. Even so, your share of the net worth of the company at that time would be \$2,243,540.

Buffett: And, remember, every dollar of net worth attributable to each of us can be sold for \$1.25. Therefore, the market value of your remaining shares would be \$2,804,425, about 4% greater than the value of your shares if we had followed the dividend approach.

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