Why growing $ income matters

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DNR Capital

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Capital growth and dividends each play an important role in delivering growth in dollar income over time. Capital is what income grows off, along with providing duration to the retirement funding pool well into the future, countering longevity risk.

There are a number of equity income strategies in the market, where objectives largely focus on yield (not dollar income) and largely ignore capital (and total returns). This can often come at the investors expense which we outline further below:

'High yield' or 'Value' strategies can satisfy retiree short term living expenses. However, we have found this often comes at the expense of long term capital preservation and growth potential. Stay alert to managers that have a pre-occupation with yield and yield alone.

'Derivative overlay' strategies can manufacture higher income and potentially provide downside protection, however they are costly and complicated and limit upside capture.

'Dividend stripping' strategies can also enhance short term income, however this can come at the expense of capital and turnover is typically much higher, increasing costs.

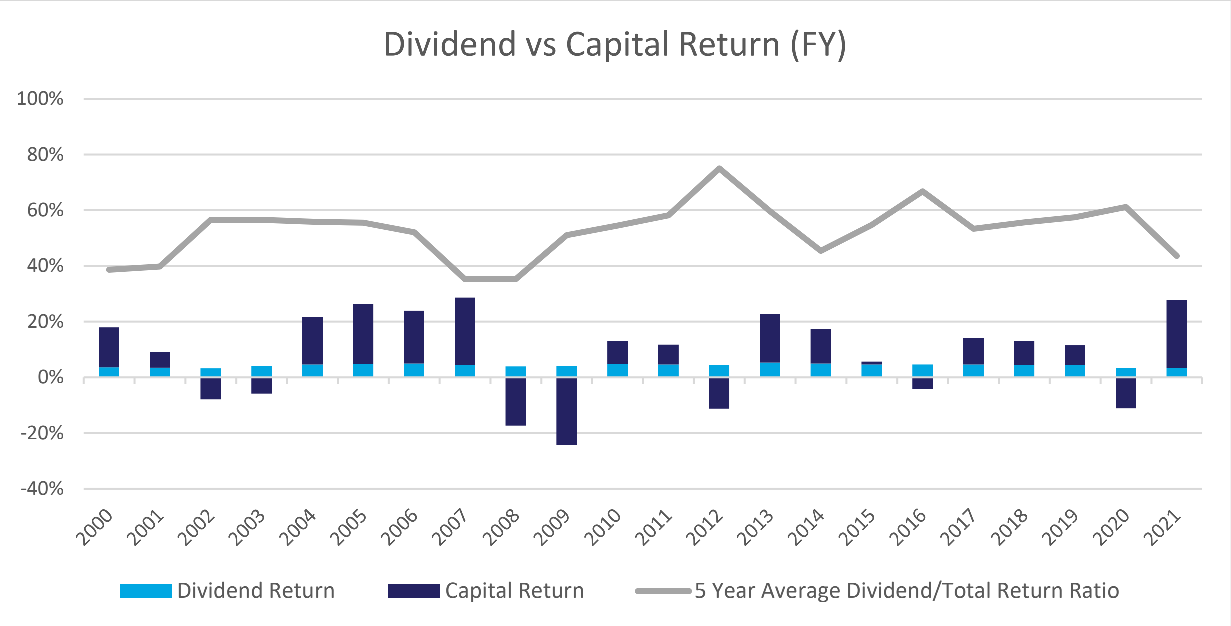
'Exchange Traded Fund (ETF)' strategies may have low management fees, however can lack transparency and trading costs are typically much higher.

DNR Capital strongly believes that a growing dollar income over time delivers the best outcome for retirees as they seek to offset inflation and look to maintain lifestyles in retirement.

To reflect this, the DNR Capital Australian Equities Income strategy has a dual objective based on both Income and Capital, which further differentiates us from the majority of our peers.

History of dividends

Dividends are a large contributor to total market returns, having contributed approximately half the ASX200 index returns since 1950. This is primarily due to the unique benefits of franking and remains a key defensive investment plank in Australia's investment case, relative to other markets. We expect this will remain the case.



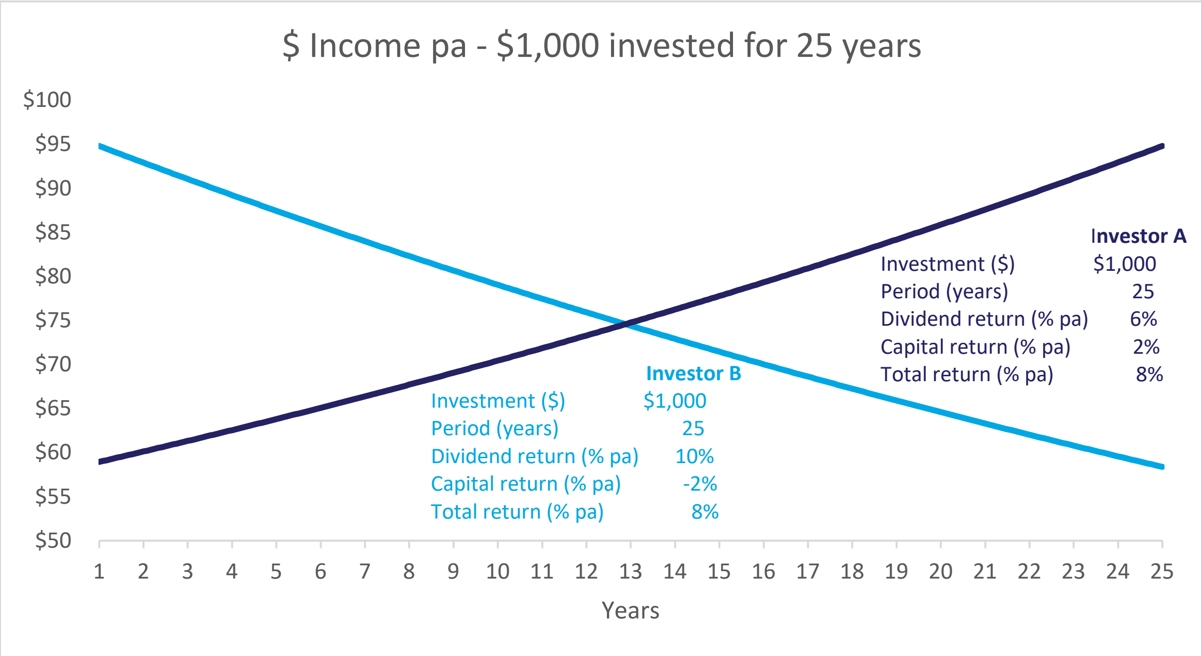
Source: Iress

High-yield strategies can be flawed

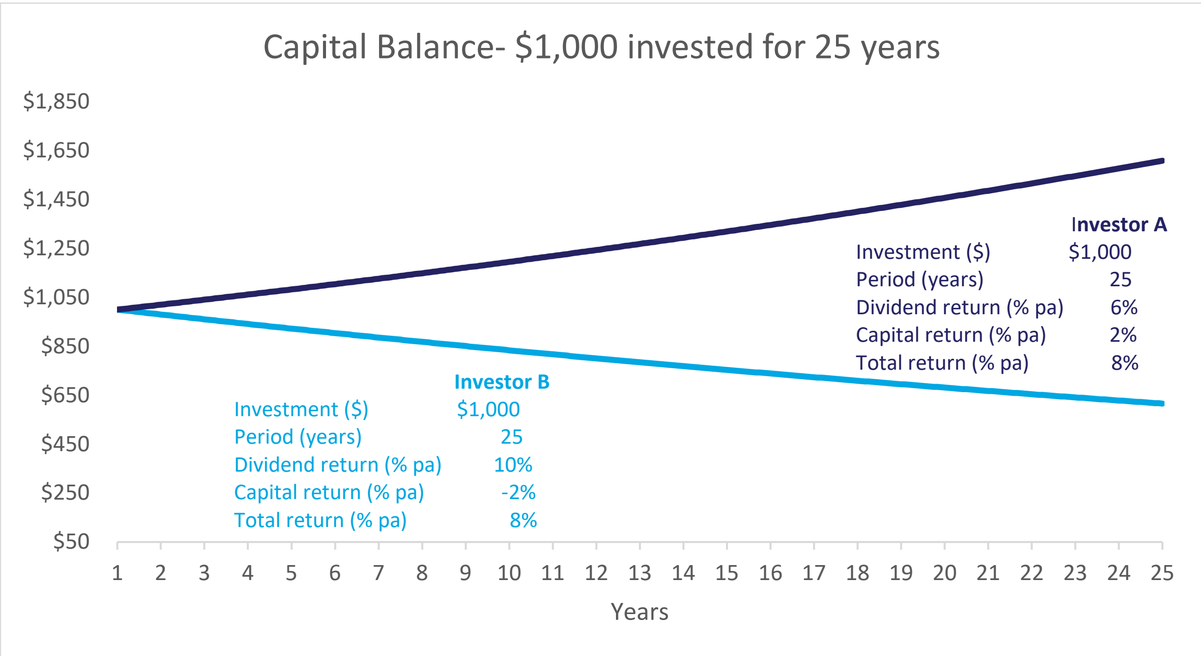
Following a strong recovery in dividends following the COVID-19 lows of 2020, it is important for investors selecting shares for an equity income portfolio to keep in mind that they need to choose stocks that are likely to pay a growing dividend over time and not just a high yield currently.

Pursuing a high-yield strategy, while ignoring other factors, is simplistic and fraught with danger. High yields can indicate companies are facing structural headwinds and dividends might be at risk of being cut. Some companies paying high dividend yields may actually have low, or even negative earnings growth going forward. This will limit future dividends and will likely impact their share price too. It is important to avoid these dividend traps.

In the following example, we have taken two investors (A and B). Over a 25 year period, they have produced the same total returns (~8% pa), however one has generated higher levels of capital growth compared to the other. In this scenario, Investor A is actually producing more $ income and has a larger capital base, compared with Investor B. This clearly demonstrates the importance of capital, in growing dollar income over time.



Source: DNR Capital



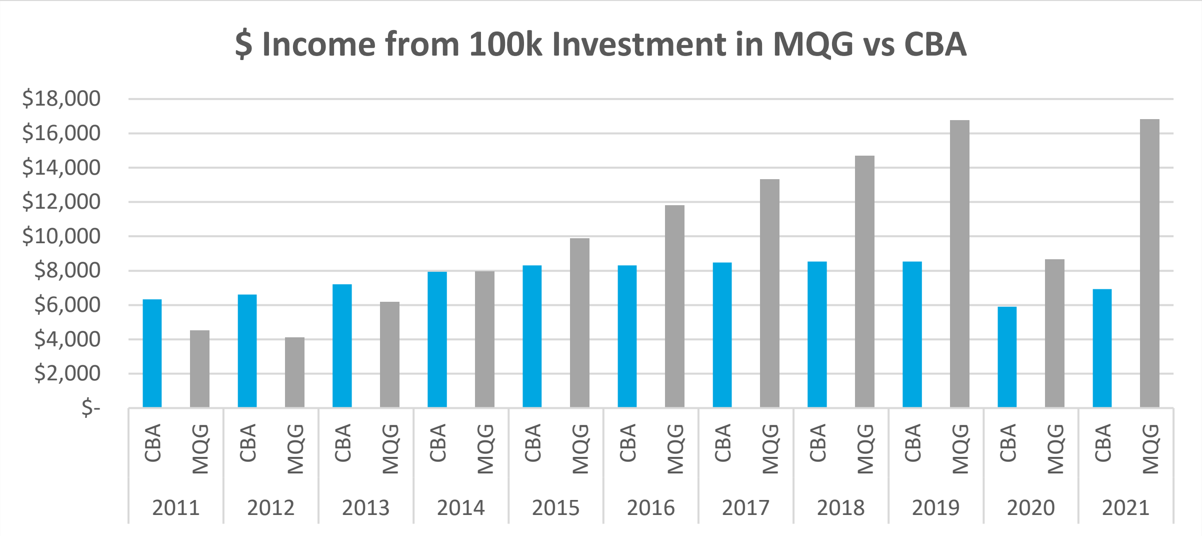
Source: DNR Capital

Case Study: Macquarie Group (MQG) vs Commonwealth Bank (CBA)

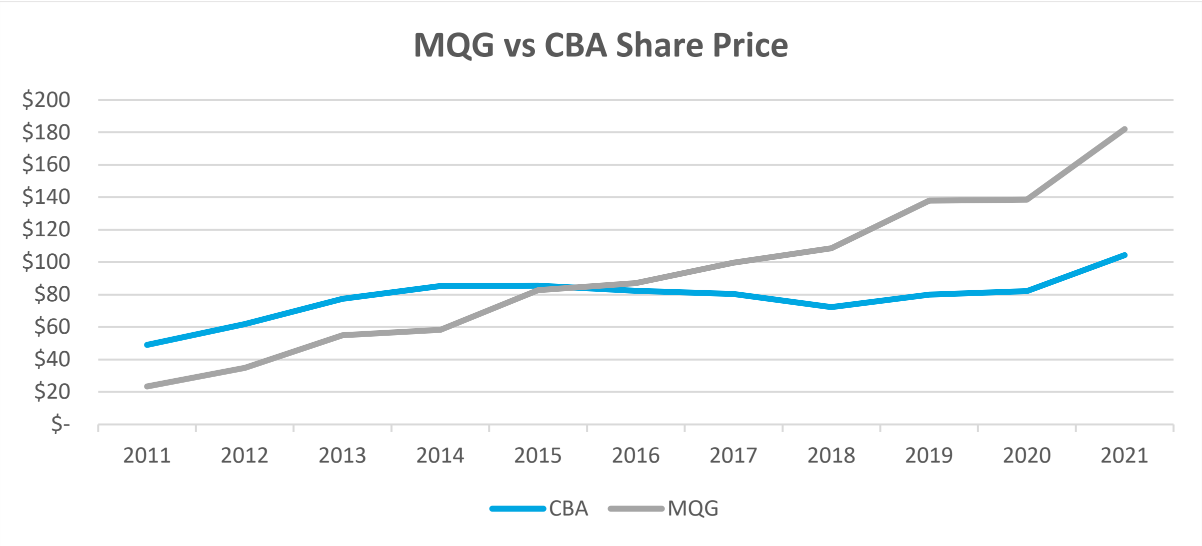
In the following analysis, we have compared an initial investment in Commonwealth Bank (CBA) versus Macquarie Group (MQG) over the last ~10 years. The following charts show the dividend profile (including our projections for FY21e) and share price over this period.

CBA's 2021 dividend is broadly in-line with 2011, whilst its share price has doubled. On the other hand, MQG's 2021 dividend has almost quadrupled since 2011 and its share price has increased by a factor of almost ~9x.

As such, the implied dividend yield on investment for MQG is currently ~16%, compared to CBA at around ~6%.



Source: Iress, Visible Alpha



Source: Iress

How is DNR Capital positioned?

Cash related products are not offsetting inflation, which means retirees have the unenviable decision to either keep working; cut spending or eat into their capital. Alternatively, retirees must diversify and consider higher allocations to income generating equities.

We seek to meet the short and long-term needs of retirees and provide a solid core exposure for income centric model portfolios.

We continue to see Australian equity dividends as a unique opportunity and continue increasing our conviction around equity income where outstanding opportunities are presenting themselves.

The DNR Capital Australian Equities Income strategy stands to benefit from four clear performance drivers over the next three-five years. These include:

1. **Favourable factor exposure** – the portfolio is diversified across a clear set of quality leaders which have pricing power and provide inflation protection (like a CSL or Wesfarmers); defensive companies that provide downside protection should the market correct (like a Coles or a Telstra), and COVID-19 recovery plays with notable value (like Scentre or SkyCity Entertainment).

2. **Ongoing dividend recovery** as the global economy reopens and the economy grows.

3. **Increasing payout ratios** as boards regain confidence and utilise franking credits, rewarding shareholders in a low yield environment.

4. **Strong demand,** given the continued search for income in a record low interest rate world.