Private Wealth Management
Deutsche Bank

DBrief

JUNE 2010 | ISSUE 09

Dividends still count

Paul Wharton

Tax is always an issue for investors, but tax policy can result in perverse incentives: the law of unintended consequences applies with some force.

One of the unsung policy achievements of the Lawson chancellorship in the late '80s was the idea of "fiscal neutrality", meaning that there should be no differentiation between taxes on capital and taxes on income. Making the top rate of income tax equivalent to the tax on capital gains removed at a stroke much of the incentive to arbitrage between income and capital, removing the need for excessive tax planning and thereby improving capital allocation and eliminating misguided tax incentives.

Though many will be upset at CGT rising under the new coalition government, it will have one useful spin-off – to refocus the minds of investors on the important issue of income. Under the previous position, where the highest rate of marginal income tax was 50% and that of Capital Gains Tax a rather less challenging 18%, investors were clamouring for CGT-liable investments and abjuring those generating income.

The problem with this strategy is that it ignores two fundamental issues:

1. Markets quickly price in one-off changes, in this case making CGT assets more expensive than they otherwise would be. Investors already pay a high price for capital taxable assets.
2. Non-income-generating assets are almost always more risky than those not generating income.

Thus a quite rational investment strategy aimed at generating high after-tax returns through avoiding income-generating assets would almost certainly push the investor into a risky portfolio in junior assets, where capital values can and do fluctuate sharply.

Tax-driven investment runs the real possibility of pushing investors higher up the risk curve than they really want to be. In the good times this leads to unexpected windfalls and a feeling of wisdom; in the bad times it means an often equally unexpected loss of capital and reduced capacity to earn additional income, resulting in a long-term reduction in personal living standards.

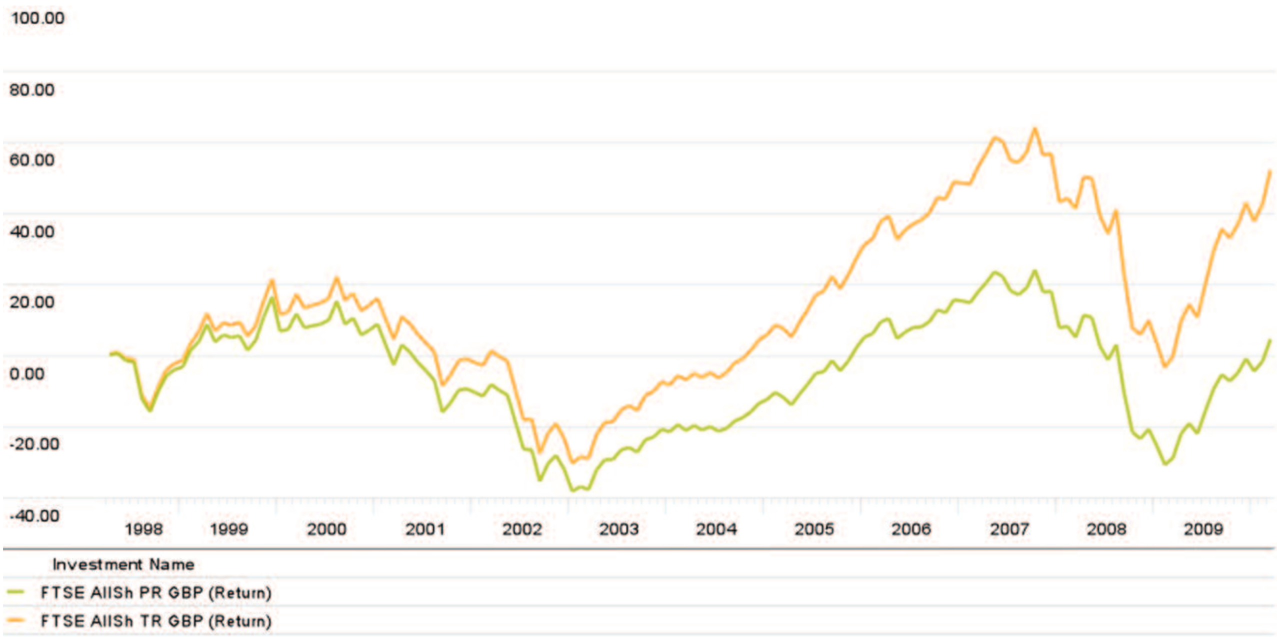
The core issue is that a surprisingly large part of the return to investors from property, bonds and equities comes from the income those assets generate. Capital gains are notoriously fickle, whilst dividend payments are much less glamorous but much more dependable; very much the investment "tortoise". Just how important dividends are can be gleaned from the charts.

It can be seen that since 1998 the capital return from the stock market has been all but zero. The total return, just about 50%, has come entirely from reinvested dividend income. So investors trying to achieve a high net return from capital assets have been sorely disappointed and have a seen real deterioration in the value of their capital.

The right chart shows the performance of the FTSE 350 High Yield Index as compared to the All-Share. In capital terms there has been no progress at all; the income return is equal to 100% of the performance.

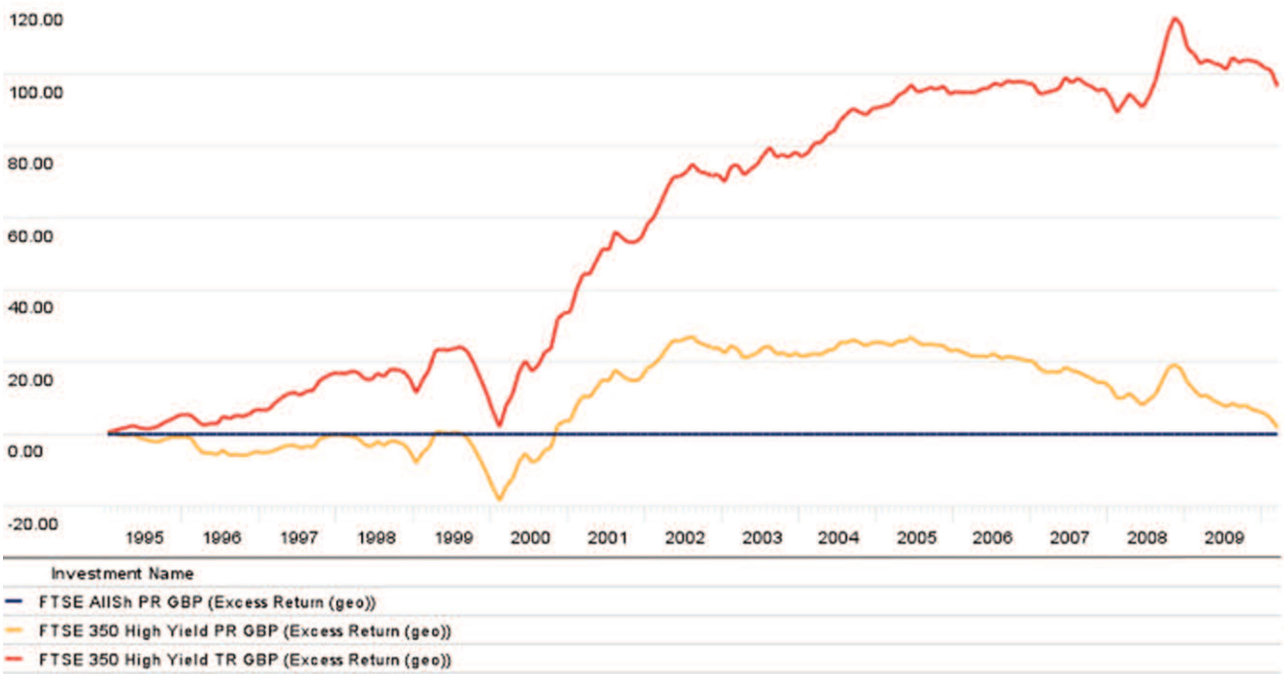
The other issue is that dividends generally grow, providing cost-of-living indexation. The capital value of a company that is providing a

Cumulative return since inception 1st October 1998



Source: Morningstar Direct

Cumulative return since inception 1st October 1995



Source: Morningstar Direct

sustainable flow of rising income to its shareholders is rightly highly valued. Earnings and dividends are what we invest for – anything else is speculation – but, as it turns out, income strategies can also morph into growth strategies.

More growth means more shareholder dividends

The Western economies are currently wrestling with the fall-out from the financial crisis. This is fundamentally a crisis about growth. The debt build-up allowed the European economies, including the UK, to grow at a faster rate than was sustainable. Insufficient equity was built up to support the debt created. The upshot is probably slower but more sustainable long-term growth in the West.

There are three ways to grow a company's earnings:

1. The economy increases in size, whole economy profits grow, company profits grow.
2. Company A steals market share from Company B. Whole economy profits remain static, but shareholders in A benefit at the expense of shareholders in B.
3. Companies cut their way to stronger profits through cutting costs. Margins are maintained for a time, but the growth horizon is strictly limited – in aggregate we can't cut our way to growth in the long term, so this is temporary.

The Western economies are dealing with insufficient growth, are currently driving their costs down (we are seeing stronger margin expansion than revenue growth) and are facing the challenge of innovation from new international competitors.

Here sits the opportunity: what we call "emerging" economies are rapidly becoming young, developed economies, and many of their innovative businesses are maturing into solid-dividend-paying multi-national firms benefiting from high domestic growth rates and international markets that value their increasingly high value-added production. Income investing does have an exciting side after all.

Traditionally regarded as risky, some emerging markets and companies are now offering investors that same combination of revenue growth, stable balance-sheet and rising dividend flows that were once associated with the big blue-chip names of the developed world. And all of this delivered in the context of faster-growing economies.

The Chinese economy leads the way, growing at close to 12% this year. But India, South Korea, Turkey and Brazil all exhibit growth rates that are the envy of the West. Opportunities for profitable expansion grow with the economy. It would not be surprising to find that companies like TATA Steel, Cemex, Electrobras, Ambev, SingTel & TSMC become as well known to investors in the future as GlaxoSmithKline, BP, Caterpillar and Philips were to investors in the past.

Income investing is fundamentally what investing is about. Income has its origins in economic growth. Investors should go where that growth can be found in the emerging world, but the old world toolkit of economic and financial analysis remains as valid as ever. The source, growth and sustainability of income offer a valuable compass needle to the investor in a world where the only certainty is uncertainty.

Paul Wharton is Chief Investment Strategist, Deutsche Bank Private Wealth Management UK

This piece first appeared in the FT publication, Investment Adviser, on June 14 2010.

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