WORRIED ABOUT YOUR DIVIDENDS?

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“Worry is a dividend paid to disaster before it is due.”

Ian Fleming’s James Bond in “On her Majesty's Secret Service”

For many investors, one of the financial worries caused by the COVID-19 crisis is the slashing of company dividends. In this article, Stella McMullen, Senior Research Analyst, Perpetual Private looks at:

- what’s happening to dividends,
- how investors can adapt to the new low-dividend reality.

Dividend cuts – why and how much

By global standards, Australian listed companies pay relatively high dividends and many Australian investors rely on those dividends for income. One reason for this is that imputation credits can make dividend income very tax-effective.

This creates a feedback loop. Investors want big franked dividends, companies that pay them are in demand, this lifts share prices (and executive remuneration), which encourages higher dividend payouts. And so the loop loops on.

The COVID-19 crisis threatens that cycle:

- For some companies, the government-enforced lockdown shut their doors - think retail and international travel. As a result, Flight Centre has cancelled its dividend, and retail conglomerate Premier Investments deferred its payout.
- COVID-19 also presents a revenue challenge for traditional dividend-stocks like the banks - they are now facing soaring demand for mortgage ‘holidays’. ANZ and Westpac responded by deferring their dividend and NAB, controversially, paid a dramatically diminished dividend *and* raised more capital.
- To date, 38 ASX200 index stocks have suspended, deferred or cut dividends. More will likely do so.

The COVID-19 recession could cut dividends across the market by at least 30% (UBS estimates). The cuts will mostly come from cyclical industrial stocks and the financial sector. Resource companies like BHP, Rio Tinto and Fortescue and consumer staples like Woolworths and Coles should be the least affected.

Fortress Australia?

One nugget of good news is that in the aftermath of the GFC, corporate Australia built its capital reserves and now has much stronger balance sheets. Our banks are also better capitalised with a significant buffer against bad debts.

Australia is in a better position than most to weather the cytokine storm that is COVID-19. We're an island, our health and banking systems are in good shape, our budget position is better than almost all our global peers and to date, we've done an excellent job of limiting the virus' impact.

Perpetual Private's view is that dividends may return to normal by 2022. Should a vaccine or effective treatment arrive quickly, the return to normal profits and dividends could happen much faster.

To drop out, dance around or dip in?

But for investors in the habit of using dividend income to pay their bills, 2022 is a long way away. So how should they adapt?

It may feel like the obvious move is to drop out of the equity market and seek income elsewhere. While every investor's needs are different and should be discussed with a professional, there are strong arguments against this strategy:

- From a capital perspective, it means crystallising the recent capital losses caused by the COVID-19 market crash. If you're a long-term holder, selling out may also buy you a Capital Gains Tax bill.
- What are your alternatives? As we write, the official RBA cash rate is 0.25%. The yield on a Ten-Year Australian Government bond is under 1%. The income you can draw from cash, bond and term-deposit investments is, as a result, very low.

Chase returns

Similarly, staying in the sharemarket and trying to cleverly shift between companies who are expected to cut dividends (and into ones whose income profile is improving) is not as easy as it seems. By the time it becomes obvious that a company will cut its dividend, the share price will have already dropped to reflect that information. Trying to dance between companies in pursuit of dividends could leave you sitting in the wallflower seats with nothing to show for it.

Think about your return, *totally*

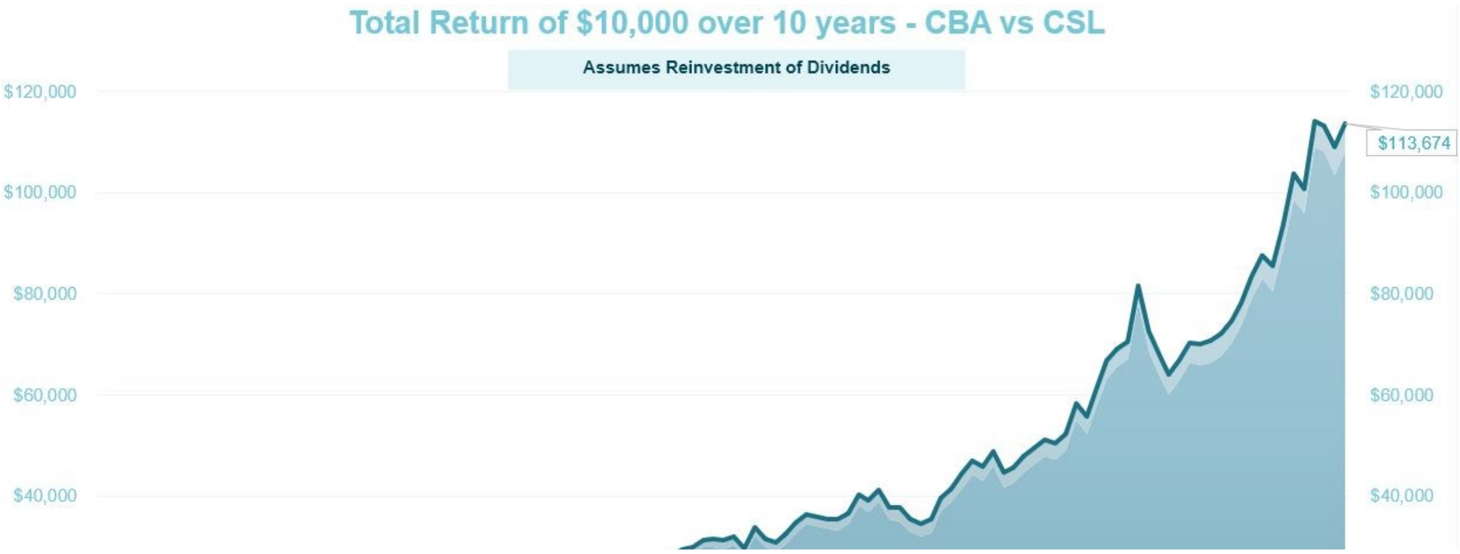
At Perpetual Private, whether we're managing large funds for institutions or individual portfolios for clients, we prefer a total return strategy. We want to own assets that generate superior long-term returns, regardless of whether that return arrives as capital growth or dividends/yield.

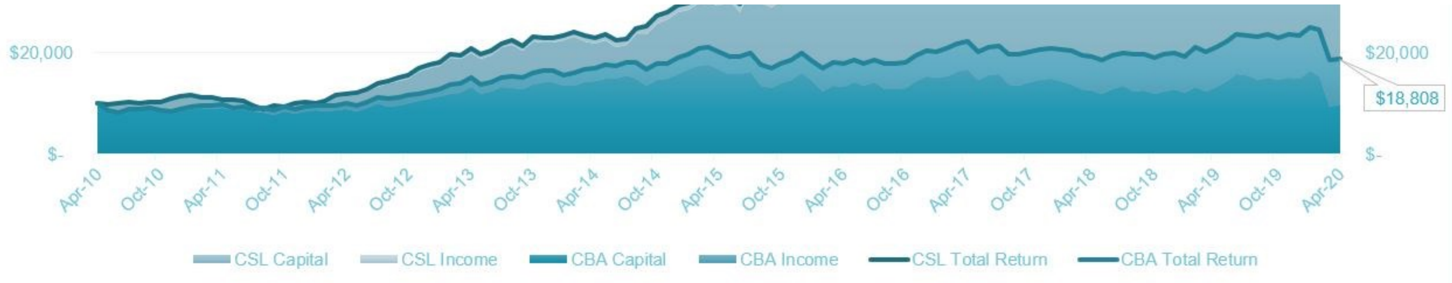
What does this mean for dividend starved investors? Simply put, your focus should be less on replacing lost dividend income – and more on **prudently** taking the cash you need from your portfolio – whether that cash comes from investment income or capital.

Let's use a case study to see how that approach works.

CBA or CSL?

We're comparing two well-known Australian companies at opposite ends of the dividend spectrum; CBA and CSL. The chart below makes the difference between these two companies even more stark.





Source: Perpetual Private, May 2020

CBA is one of the best-known brands in Australia. Like most of our banks, CBA has a generous dividend yield - 7.26% at the time of writing.

Crucially, over the past 10 years only 7.60% of its 88% total return can be attributed to a rising share price. Over 90% of the returns from CBA have come from dividends.

Conversely, CSL, a world-leading biotechnology firm, has a low dividend yield, currently averaging under 1%.

But in the past 10 years, CSL has delivered a cumulative return of over 1000%. Of this return, over 80% came from a rising share price. You can also consider the annual difference. Over 10 years, CBA delivered a respectable 6.52% per annum return – comfortably better than inflation. But for the same period, CSL returned over 27% a year.

Enough income for your outgoings?

These are impressive numbers which back up the statistical benefits of a total return strategy. But how does that turn into living income for investors?

1. As the CBA/CSL case study shows, a total return strategy may generate a significantly better overall return than an income-first strategy. If your total wealth is greater you have more capital to draw on when you need it.
2. A total return strategy is also based on the ability of assets to generate *growing* income streams. Again, CSL illustrates this – its share price appreciation means that if you've held CSL for 10 years, the income those shares generate today is higher (in dollar terms) than the income provided by CBA shares, even though the dividend yield from CSL is 6.26% less than that of CBA. To use a homely metaphor beloved of economists – a small part of a fast-growing pie is much more valuable than a large slice of a small pie.

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