

# THE CASE FOR INDUSTRIAL SHARES

The first question most people ask about investing in industrial shares is: why limit yourself to industrial shares in a country like Australia, one of the world's great resource producers? The answer is simple – industrial shares may provide higher levels of income, strong capital appreciation and lower volatility.

## INDUSTRIALS VS RESOURCES

The choice between resources and industrials will depend upon your individual circumstances, goals, income needs, and so on.

Generally, resources can suit investors looking for higher growth exposure. Over the past decade, resource shares have exhibited more of what fund managers call 'growth characteristics' – simply put, the rise in their share price has been greater than that for industrials.

However, those higher returns have come at the expense of increased volatility.

In fact, over the past 20 years, resources experienced volatility of 22% pa<sup>1</sup> compared to 13% pa<sup>2</sup> for industrials. Industrial shares have historically generated more consistent growth in capital and income.

Now let's look at the benefits of investing in industrial shares through the prism of four of the main factors investors consider when making any share investment, income growth, tax and inflation.

### 1. CAPITAL GROWTH

Capital growth occurs when the value of an investment increases over time. Under normal conditions, movements in a company's share price should reflect changing expectations of its profits. When you invest in shares with growth characteristics you may be better able to protect the value of your capital.

The tendency of industrial shares to grow in value over time is one of its key attractions.

Over the past 20 years, industrial shares returned 5.0% pa<sup>3</sup> in capital growth alone (excluding dividend payments).

**The ability of industrial shares to grow its share price is linked to the successful growth strategies they pursue within their business** – new product development, international expansion, entrance to new markets, and so on. These strategies underpin the sustainable capital growth of successful industrial companies.

### 2. INVESTING FOR INCOME

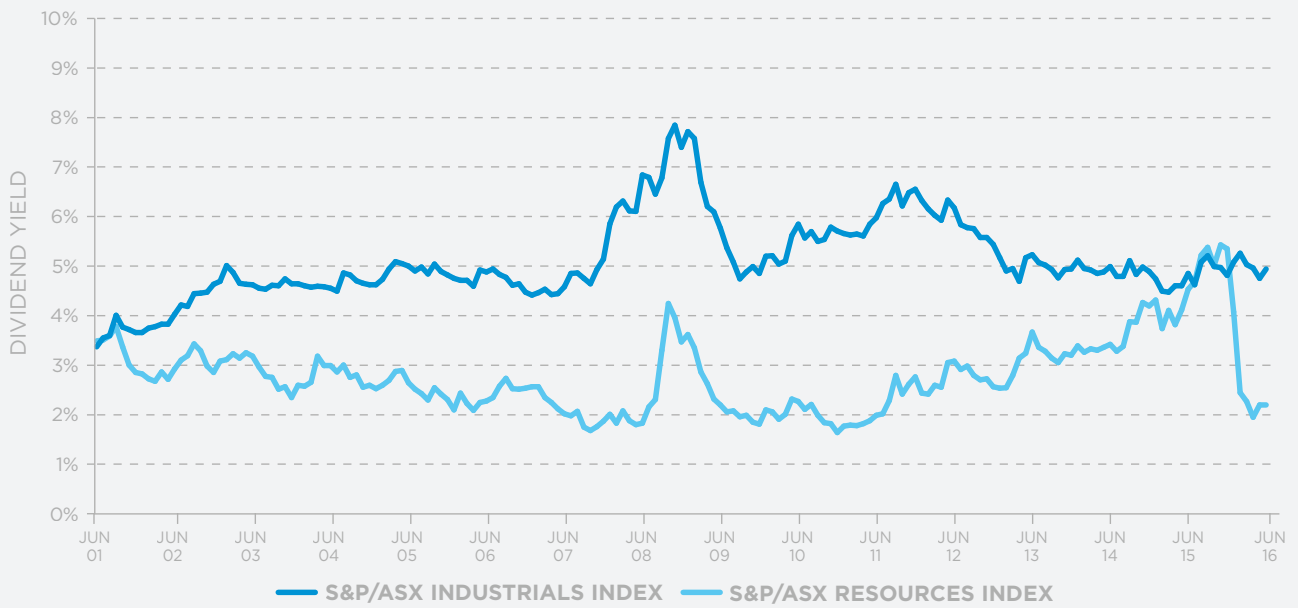
The income you receive from direct shares is in the form of dividends. Dividends are paid out of a company's earnings. Dividends generally increase as a company grows.

Industrial companies have historically paid strong dividends, with a sector average yield of 5.1% pa<sup>4</sup>. As industrials tend to operate in more predictable business sectors – banking, retail, manufacturing, etc. – its earnings are less cyclical and operations more flexible. This means they can prudently **pay out a large portion of its earnings as dividends – particularly in comparison to resources.**

Resource companies typically have very high capital expenses, such as equipment and machinery, and its profitability relies heavily upon the changing market price of the commodities they sell or use. As a result they are required to retain a large portion of earnings to provide a cushion against volatile market conditions. This naturally means they have less cash to pay out to shareholders.

### CHART 1: HISTORICALLY INDUSTRIAL SHARES HAVE PAID STRONG DIVIDENDS

Historical dividend yields, June 2001 – June 2016



Source: FactSet

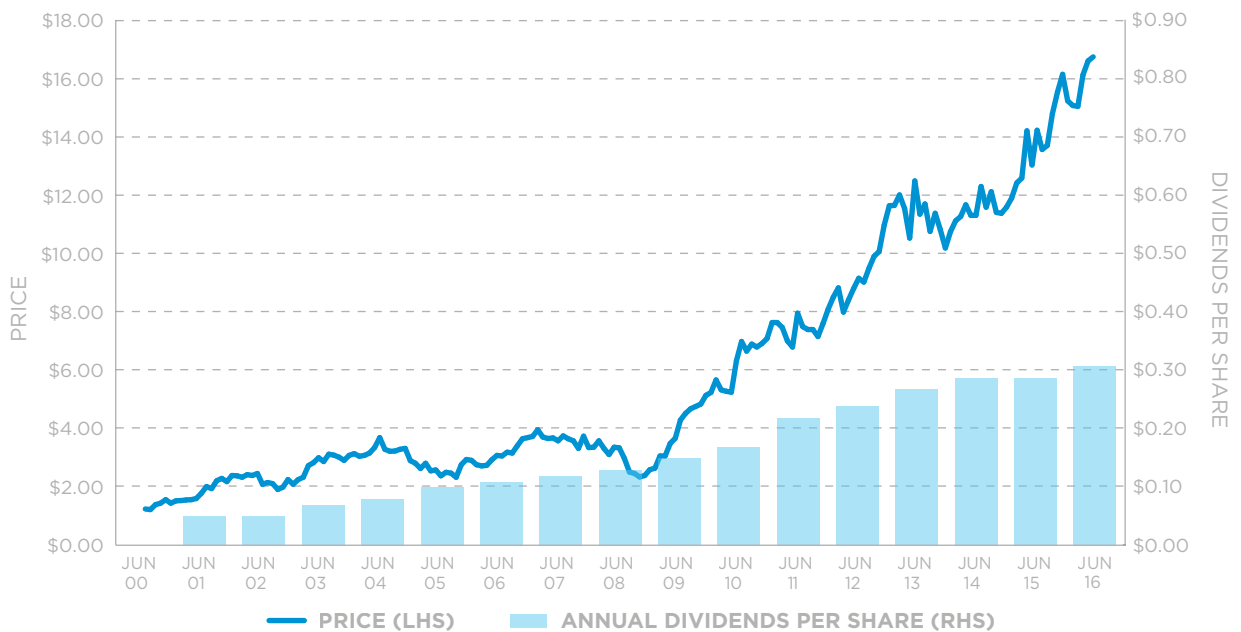
### CASE STUDY 1 - ARB CORPORATION

ARB Corporation is Australia’s largest manufacturer and distributor of 4x4 accessories. Having grown from a family garage in Melbourne, the company now has a large international presence and distributes its products to more than 100 countries around the globe.

Management’s unwavering focus on quality, product innovation and cost control has allowed the business to continually expand at a steady pace over time, maintaining consistently strong profit margins, earnings and cash flow.

### CHART 2: ARB CORPORATION HAS PROVIDED STRONG EARNINGS AND DIVIDENDS GROWTH

Share price vs dividends per share, June 2000 – June 2016



Source: Perpetual & FactSet

### 3. TAX-EFFECTIVE INCOME

Not only are industrial shares a good source of income, they can also be very tax effective. This is because Australian share income is taxed favourably through what is called ‘dividend imputation’, also known as ‘franking credits’. This means that if the company has already paid tax on its income, **you may be eligible to receive a tax benefit for dividends received from that company.** This is so tax isn’t paid twice on the same income.

### 4. PROTECTION AGAINST INFLATION

Inflation erodes your purchasing power and diminishes your real investment returns. So it’s important that your investments provide protection against inflation.

**Over the past 20 years, industrial shares have consistently generated both income and capital growth above the rate of inflation.**

This protection against inflation is one of the reasons industrial shares are often highly valuable to long-term investors – including those looking to fund their retirement.

**TABLE 1: GENERATING BOTH GROWTH AND INCOME WITH INDUSTRIAL SHARES: 20-YEAR RETURNS TO JUNE 2016**

	CAPITAL	DIVIDENDS	INFLATION
<b>Growth (% pa)</b>	5.0	4.9	2.5

Source: FactSet, RBA. Industrial shares measured by the S&P/ASX 300 Industrials Index. Returns are calculated from June 1996 to June 2016.

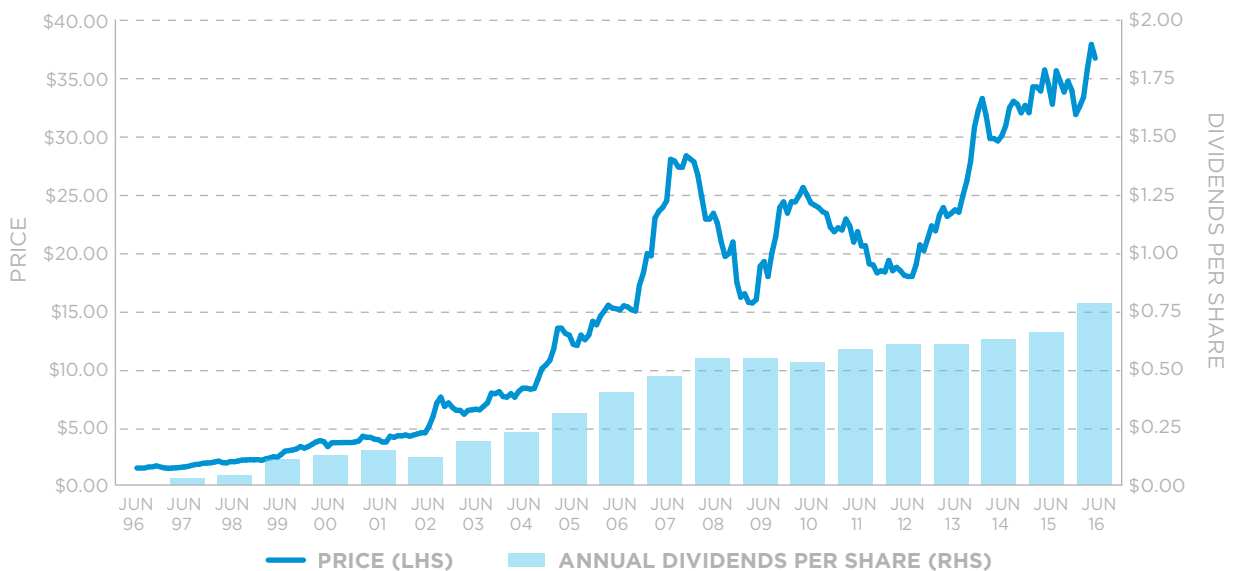
### CASE STUDY 2 - REECE AUSTRALIA

Harold Reece opened the first Reece plumbing hardware store in 1920. Today, the company has over 570 branches throughout Australia and New Zealand and has become a household name in bathroom supplies. The company has a long history of successful store roll-outs and expansion into new product lines.


Supported by a strong brand name and a reputation for quality, Reece have built a dominant position in their market. As evidence of this, Reece have delivered earnings growth of 15% pa since 1996. This earnings growth is reflected in the long-term rise in its share price, as reflected in the chart below.

**CHART 3: REECE INVESTORS HAVE ENJOYED SHARE PRICE RISE OVER THE LONG TERM**

Share price vs dividends per share, June 1996 to June 2016



Source: Perpetual & FactSet



**‘The Perpetual team  
has consistently  
shown an ability to  
unearth quality  
companies trading  
at cheap valuations.’**

**MORNINGSTAR REPORT,  
13 NOVEMBER 2015**

## **HOW DOES AN INDUSTRIAL SHARE FUND FIT INTO A BALANCED PORTFOLIO?**

Every investor has different needs for income and growth, a unique tax situation, and a personal risk tolerance. You need to consider all these four factors when making investment decisions.

Over the past 20 years, Australian industrial shares have delivered income **and** capital growth at levels that have comfortably beat inflation at a level of volatility or risk that is lower than both resource shares and the overall Australian market.

## **MORE INFORMATION**

If you would like more information about the benefits that industrial share funds can offer, talk to your financial planner. You can find out about the **Perpetual Industrial Share Fund** on our website: [www.perpetual.com.au](http://www.perpetual.com.au).

- 1 Annualised volatility of historical monthly returns of the S&P/ASX 300 Resources Price Index from 30 June 1996 to 30 June 2016.
- 2 Annualised volatility of historical monthly returns of the S&P/ASX 300 Industrials Price Index from 30 June 1996 to 30 June 2016.
- 3 Annualised return of the S&P/ASX 300 Industrials Price Index from 30 June 1996 to 30 June 2016.
- 4 Average dividend yield of S&P/ASX 300 Industrials Accumulation Index from June 2001 to June 2016.

As at 30 June 2016, **Reece Australia** was held in the Perpetual Industrial Share, Perpetual Concentrated Equity, Perpetual Australian Share, Perpetual Geared Australian, Perpetual Smaller Companies, Perpetual Ethical-SRI. As at 30 June 2016, **ARB Corporation** was held in the Perpetual Industrial Share, Perpetual Smaller Companies, Perpetual Ethical-SRI.

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## **MORE INFORMATION**

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