FinancialInsights®
with Global Financial

September 2015

Dividend imputation's unheralded magic: It makes companies make better re-investment decisions

by Kate Howitt, Portfolio Manager – Fidelity *(Reproduced with permission)*

What a dreadful thing is the dividend-imputation tax system, if you believe its critics.

They allege the abolition in 1987 of the double taxation of company earnings paid out to individuals forces investors large and small to own too many shares, for it acts as a subsidy for equity investors.

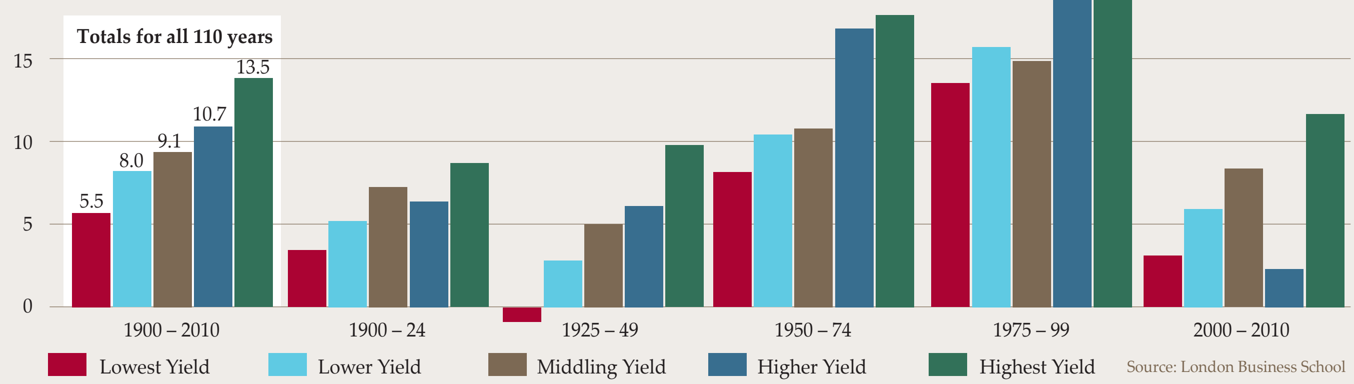
They charge that the system reduces the tax take, hinders the local corporate bond market, disadvantages debt-funding for infrastructure, deters Australian companies from investing abroad and shrinks the amount of money companies have to invest. As mining investment dives due to China's slowdown, some blame dividend imputation for a "chronic shortage of capital investment".[1]

Perhaps the most worrying criticisms of late came when the 2014 Financial System Inquiry under Chairman David Murray and the government's discussion paper on tax reform released in March questioned the value of dividend imputation.[2] For comments such as the statement in the Murray inquiry that "the case for retaining dividend imputation is less clear than in the past" hinted the system might end.

Some of these criticisms are true, to some extent. But if you want to judge how effective a tax is you have to look at its wider impacts – good and bad. For tax settings are more than just ways for the government to raise revenue; they can change the behaviours of corporate and individual tax payers within an economy for better or worse, often in surprising ways.

The decision by the Hawke government to abolish the double tax hit on dividends by allowing shareholders to claim a franking (tax) credit for some, or all, of the tax an Australian company had paid on its earnings has provided an unforeseen benefit, perhaps one that is still not fully appreciated by policy makers. The enchantment of dividend imputation is that it made Australian companies better manage their capital, which has made them sounder investments. In fact, franking credits explain much of the out performance of Australian stocks since 1988, the first full calendar year their benefits were felt. Policy makers in charge of the economy obviously have a wider remit than returns on capital and stocks. The mining boom, of course, has helped the Australian stock market climb in recent decades, as has 22 years without recession and, not to be

Chart 1: Total returns of highest to lowest yielding stock markets since 1900 (%)



Source: London Business School

Global Financial
134 Queen Street, Bendigo VIC 3550
PO Box 1246, Bendigo Central VIC 3552
T 03 4433 1184 | M 0438 783 836
E steven@globalfinancial.com.au
W www.globalfinancial.com.au

underestimated, the listing of some great business over the past 28 years.

But even when you exclude resources and IT stocks, analysis reveals how helpful franking credits have been for Australian stocks. And, yes, franking credits do reduce the amount of money company management has available for reinvestment. But that's the paradox of dividend imputation, for that's how it weaves its magic.

Perceptions versus the facts

In the five years before franking credits appeared, Australian listed companies paid out on average 42% of their earnings in dividends compared with 37% in the US where dividends are still taxed twice.

This percentage soared once Australian shareholders compelled management to hand over more tax-effective dividends. Since 1988, Australian companies have disbursed an average 70% of their earnings in dividends, whereas this average has dropped to 34% in the US over that time. The higher dividend-payout ratio in Australia naturally reduces the extent to which companies can reinvest without seeking more capital from others.

Conventional wisdom holds that companies retain more earnings when business opportunities are ample and fruitful. Therefore, larger dividends must signal a lack of attractive prospects. Orthodox thinking also assumes that high dividend stocks offer low-growth potential. The perception is that companies that return much of their earnings to shareholders have less to invest than companies that retain their profits.

Both these views, though, are not supported by the data.

Analysis by the London Business School shows that it is the highest-yielding stock markets that perform best. It found the highest-yielding stock markets returned 13.5% p.a. from 1900 to 2010 compared with 5.5% p.a. for the lowest-yielding markets. The analysis showed that the highest-yielding markets were the top performers over every consecutive quarter-century period last century and over the first decade of the 21st century, as Chart 1 shows.

Looking at Australia's total shareholder returns before and after franking credits also shows that high-dividend markets are better places to invest. Research by Jefferies shows that from 1982 to 1987, the rest of the world (212% return) outperformed Australia (190%). But from 1988 to 2014, Australia (935%) outshone foreign markets (435%).

What explains the outperformance of high-yielding markets and Australia since 1988?

In Australia's case, some credit goes to the recent mining boom and the oligopolies that many of Australia's big companies enjoy. But many other countries benefit from these two drivers of returns. Thus the answer to the question lies in the question; it is the large dividend payouts (reflected in higher yields) that explain the better total shareholder returns.

The unheralded link between dividend imputation and higher returns is two-fold. The first is that it leaves Australian managers with only enough money to invest in the best projects. This frugal reinvestment means companies pursue fewer, better and lower-risk projects. Since these are more robust projects, there are fewer duds.

In other countries, management tend to invest in more projects and more dubious prospects. The other underappreciated force boosting total returns is that franking credits promote "scrutinised reinvestment". Because companies must get outside equity and debt investors to agree to major reinvestment decisions, the investment dollar is allocated more effectively than if the decision was just left to management.

Studies confirm the perhaps-counter-intuitive result that high-payout firms generate the best earnings growth over time

Arnott and Asness (2003) used 130 years' worth of data to produce one of the first major studies to challenge the thinking that companies retain more earnings when growth opportunities are ample and fruitful.[3]

Zhou and Ruland (2006) backed Arnott and Asness. By using data over 50 years, their paper showed that high-dividend-payout companies tend to experience "strong, not weak, future earnings growth".[4]

Admittedly, more investment means a higher GDP this year and some economically viable projects are foregone under dividend imputation. But there is less risk of management authorising flops.

A stock market swarming with companies with bigger payout ratios, higher yields, larger returns and better governance retains a greater share of local savings and entices more money from abroad. This, in turn, lowers the cost of capital for listed companies.

Can we prove that Australian companies invest only in the best projects?

The best measure by which to show this is to use the cash flow return on investment or CFROI measure devised by Credit-Suisse HOLT.[5]

By this yardstick, Australian companies under the dividend imputation stand out.

Australia's CFROI stood at 4.2% p.a. from 1982 to 1987, not far below the rest of the world's CFROI of 4.8% p.a. over

Global Financial
134 Queen Street, Bendigo VIC 3550
PO Box 1246, Bendigo Central VIC 3552
T 03 4433 1184 | M 0438 783 836
E steven@globalfinancial.com.au
W www.globalfinancial.com.au

those years. The measure for Australia soared to 8.6% p.a. between 1988 and 2014, well above the rest of the world's 6.2% p.a. outcome.

When the distorting sectors of IT, metals and minerals are excluded, the results show the same outperformance by Australia.

The added magic of dividend imputation is that, under our superannuation system, franking credits make investors, companies and even the government winners in the long term. At the moment, about 5% of the ASX's market cap is paid out each year as dividends. Much of this money flows to Australian equities managers and people saving for retirement who typically reinvest this cash in stocks.

This indirectly benefits the companies whose stock is bought because it lowers their cost of capital.

It directly benefits IPOs and companies conducting capital raisings.

What about retiree investors, those living off savings?

At this stage in their life they need investments that deliver income. Franking credits – and the high payouts that franking promotes – make stocks attractive to them.

The government's motive for creating compulsory superannuation was to ensure more retirees paid their own way. Investments in growth assets such as equities help achieve that goal.

Conclusion

In the short term, if the government abandoned dividend imputation it would no doubt boost its tax receipts. But over the longer term, it would end up with lower-returning businesses claiming more tax breaks for the debt they carry and more people to support on the aged pension. That's not magic. That's sorcery.

[1] Alan Kohler. "Kick the dividend addiction." The Drum. ABC website. 28 August 2014. http://www.abc.net.au/news/2014-08-28/kohler-kick-the-dividend-addiction/5700610

[2] The Financial System Inquiry final report. Appendix 2 on page 278. 7 December 2014. http://fsi.gov.au/publications/final-report/

[3] Robert D. Arnott and Clifford S. Asness "Surprise! Higher dividends = higher earnings growth." Financial Analysts Journal, Volume 59, Number 1. 2003

[4] Ping Zhou, CFA, and William Ruland. "Dividend payout and future earnings growth." Financial Analysts Journal. Volume 62. Number 3. 2006.

[5] CFROI is an estimate of the average real internal rate of return, earned by a firm on the portfolio of projects that constitute its operating assets. A firm's CFROI can be directly compared against its real cost of capital (the investors' real discount rate) to establish whether a firm is creating (or destroying) economic wealth. Importantly, CFROI values are also directly comparable across time, industries, and countries. Key adjustments in the CFROI calculation include capitalising off balance sheet items (e.g., operating leases, pensions); capitalising research and development; adding back all non-cash items; accounting for inflation and determining a company asset life (which assists with determining how much cash flow will be earned over a realistic time period).

Global Financial

134 Queen Street, Bendigo VIC 3550
PO Box 1246, Bendigo Central VIC 3552
T 03 4433 1184 | **M** 0438 783 836
E steven@globalfinancial.com.au
W www.globalfinancial.com.au