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INNOVA
ASSET MANAGEMENT

INVESTMENT MANAGEMENT INSIGHTS FOR PROFESSIONAL FINANCIAL ADVISERS

SLAUGHTERING SACRED COWS

FOCUS ON TOTAL RETURN, NOT DIVIDENDS, EVEN IN BEAR MARKETS

Blue-chip dividends are stable, tax-effective, and Australia's rank among the highest in the world – but they're not cash.

Yet many investors still believe that receiving dividends, rather than selling shares, can manage sequencing risk in a falling market. The maths just doesn't add up.

Take a client who needs to produce $100,000 income each year from an initial $2 million in assets. The following table compares a portfolio producing a consistent $100,000 dividend to a portfolio producing no dividends during a decade long bear market.

INCOME RETURN DERIVED FROM INVESTMENTS

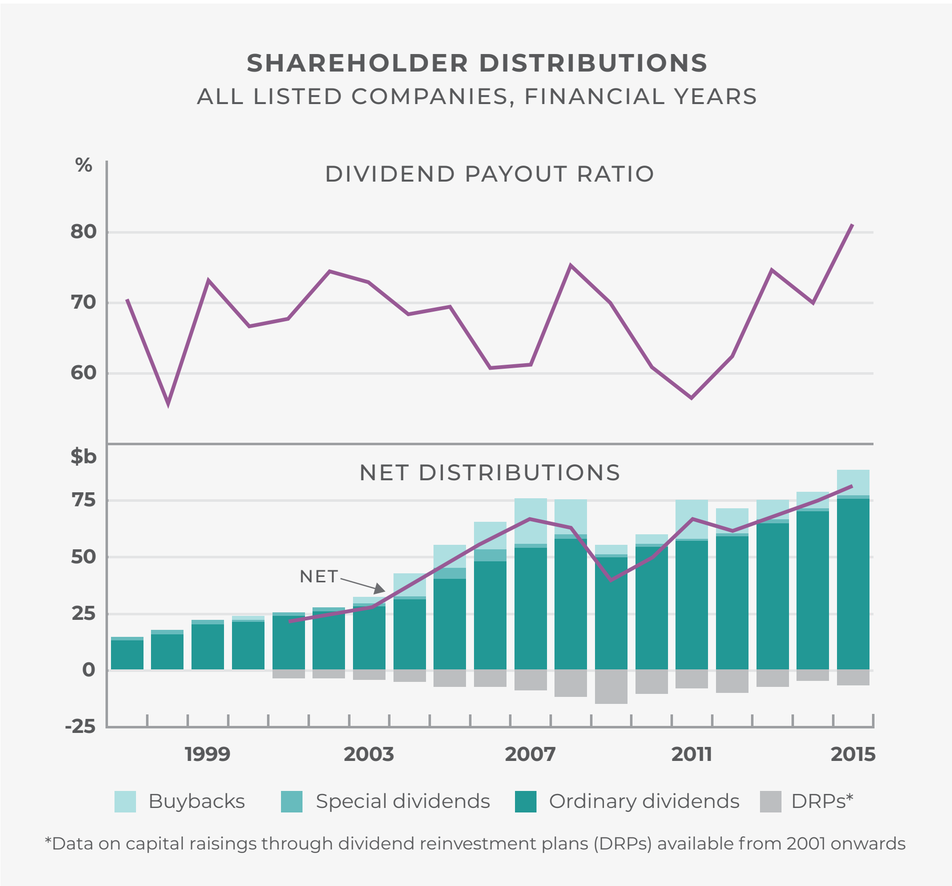
Year	Income Return	Capital Return	Total Return	Drawdown	Residual Capital
1	$100,000.00	-$400,000.00	-15.00%	-	$1,600,000.00
2	$100,000.00	-$120,000.00	-1.00%	-	$1,480,000.00
3	$100,000.00	-$130,000.00	-1.50%	-	$1,350,000.00
4	$100,000.00	-$30,000.00	3.50%	-	$1,320,000.00
5	$100,000.00	-$330,000.00	-11.50%	-	$990,000.00
6	$100,000.00	-$200,000.00	-5.00%	-	$790,000.00
7	$100,000.00	-$40,000.00	3.00%	-	$750,000.00
8	$100,000.00	-$50,000.00	2.50%	-	$700,000.00
9	$100,000.00	-$300,000.00	-10.00%	-	$400,000.00
10	$100,000.00	-$100,000.00	0.00%	-	$300,000.00

INCOME RETURN DERIVED FROM DRAWDOWN				
Income Return	Capital Return	Total Return	Drawdown	Residual Capital
-	-$300,000.00	-15.00%	$100,000.00	$1,600,000.00
-	-$20,000.00	-1.00%	$100,000.00	$1,480,000.00
-	-$30,000.00	-1.50%	$100,000.00	$1,350,000.00
-	$70,000.00	3.50%	$100,000.00	$1,320,000.00
-	-$230,000.00	-11.50%	$100,000.00	$990,000.00
-	-$100,000.00	-5.00%	$100,000.00	$790,000.00
-	$60,000.00	3.00%	$100,000.00	$750,000.00
-	$50,000.00	2.50%	$100,000.00	$700,000.00
-	-$200,000.00	-10.00%	$100,000.00	$400,000.00
-	-	0.00%	$100,000.00	$300,000.00

The result is the same – the investor receives $100,000 p.a. and finishes with $300,000 because the value of the dividend is just one component of the share price. Paying out dividends results in a lower share price, just as retaining earnings shows in a higher share price.

There are some caveats to this example, such as the differing tax treatments between capital gains and dividends, as well as transactions costs.

However, the underlying message remains true: what matters is total return. If the total return is poor, you'll get a poor result. If the total return is good, you'll get a good result.



Sources: ASX; Morningstar; RBA

AUSTRALIA: THE LAND OF DIVIDENDS

It's been thirty years since dividend imputation – which eliminated double taxation of company profits for investors – was introduced in Australia. It is a key reason that our dividends are high by international standards.

Australian companies also lifted their dividends substantially in the years following the GFC despite modest earnings growth, driven by stronger shareholder demand for income and fewer viable investment opportunities in the eyes of company executives, according to a 2016 **RBA study.**

Many investors have come to rely on that income in place of anaemic term deposits and bonds but, while companies are reluctant to cut their dividends, in recent years we have seen several blue chips do just that (most recently **Telstra**).

Dividend income is clearly not the same as income derived from cash or bonds – it is a variable component of the total share price.

However, investing in high-dividend paying stocks can be a sound strategy in itself, but for separate reasons.

For example, there is some evidence that high dividend paying stocks globally outperform non-dividend paying stocks for the simple reason that management cannot make poor decisions (such as acquiring companies that don't add value) if they have already paid out the bulk of earnings to **shareholders**.

MANAGING SEQUENCE OF RETURN RISK

The **sequence of return risk** is a major issue faced by retirees. A period of negative returns that strikes when investors begin to withdraw their money, just as portfolios are at their largest, can be devastating.

However, the answer is not to view dividends as a separate income flow from total shareholder return.

The first step is to understand what the investor's goals are and how they will pay for them. This might include a range of sources such as savings, investments, government benefits, an inheritance, or employment income as part of a transition to retirement strategy. The certainty of each of these cash flows is an important consideration.

But if their goals are entirely funded by financial wealth, we need to understand their risk tolerance (their emotional ability to withstand losses) and risk capacity (their ability to absorb losses without affecting lifestyle) because they may need to generate more *total return*.

Total return is what matters if you want to maximise return for risk taken (and this risk level may be particularly low for retirees).

Dividends are just one component – although there is an inadvertent side benefit to an overt dividend focus - it can help manage investor behaviour during a bear market through a form of 'mental accounting'.

Many investors unfortunately suffer from fear during a bear market – if focusing on dividends for income can stop them from making poor decisions under stress, such as selling their entire portfolio, then that's a positive.

However, the benefit is behavioural rather than through direct higher returns. That doesn't make it any less valid though, and in fact may override any difference in performance between focussing on total return versus focussing on income.

Another effective way of managing behaviour and sequencing risk is to adopt a goals-based advice (or bucketing strategy). Setting aside essential living costs for a retiree or pre-retiree in a lower volatility strategy for those years when sequencing risk has the largest impact, means reducing the harmful impact of sequencing risk in a market downturn. This also modifies behaviour as investors have peace of mind knowing that even in a falling market their essential living costs are secure. They can then ride out the market downturn without drawing down on the investment strategies that may have suffered greater capital loss.

It is important to not get too caught up on the level of income generated by an asset or portfolio, because it is total return that matters, but while total return matters, behaviour matters even more.

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Dan miles is the Managing Director & Co-Chief Investment Officer of Innova Asset Management. Innova is a boutique risk-focused portfolio manager that has been managing client portfolios for 8 years. Innova was founded on the principles of providing robust and research-intensive insights to help investors meet their financial goals. The firm focuses on managing the multi-faceted nature of investment risks for clients.

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