DIVIDENDS ARE KING

JOHANNESBURG: If you are going to invest in shares in an attempt to generate long term capital growth, you need to understand how this growth can be created. There are three main components to capital growth from shares: inflation growth, share price appreciation and re-investing dividends. Most investors don't fully appreciate the massive impact that dividends have on real capital growth. If you eliminate the impact of dividends from your share investments, you reduce your potential capital growth by as much as 60%.

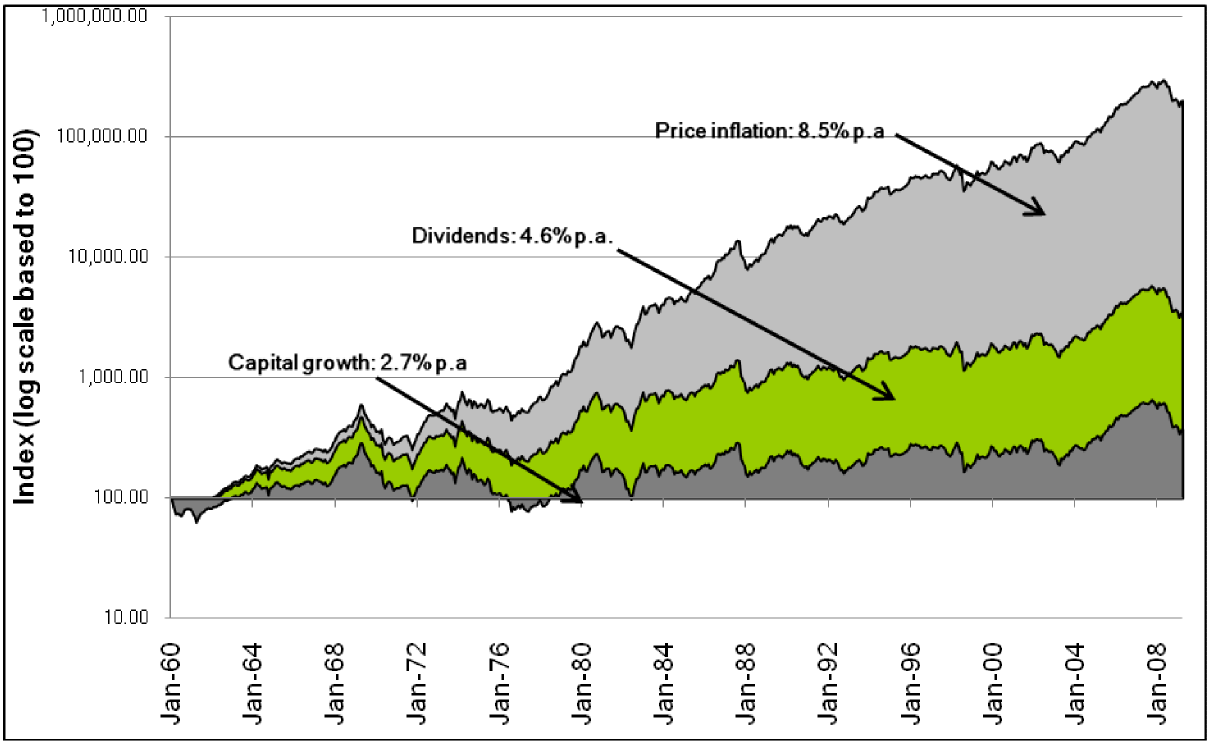
THREE PARTS TO CAPITAL GROWTH

If we analyse how investors benefit from equity investments, we see that their growth comes from three sources. The first source is the easiest to understand, shares increase in value over time with inflation. Your shares will not automatically increase in price by the inflation rate every year but revenues and profits will increase which will have an impact on share price performance. If your share portfolio has doubled in value over a five year period and inflation has averaged 6% per year then your shares have actually only grown by 9% per year in REAL terms.

The second source of capital growth is the actual share price movements that you see on a daily basis. As an example, when you buy a share at R2.00 and it moves to R4.00. If the share price rises faster than the inflation rate, you are getting real capital growth. Most investors would think that this is the only source of capital growth from shares. The biggest source of capital growth from shares actually comes from the re-investment of dividends from shares.

The graph below shows the growth you would have had if you had started investing in the JSE on 1 January 1960 and ended in April 2009. Over this time, the real growth on your capital was 7.3% per year. If you include inflation, the total growth was 15.8% per year. What is really important is to understand that dividends contributed more than 60% of the real capital growth. The graph shows that the actual price rise of a share will assist in generating real growth but you need to re-invest the dividends from the company every year to get the full benefits of share investing.

GRAPH A: FTSE/JSE All Share Index: Components of Total Nominal Return (Jan 1960 – Apr 2009)



Source: Data from McGregor BFA, method derived from Plexus Asset Management; analysis by Cannon Asset Managers

When stock markets are going through turbulent conditions, many investors do not re-invest their dividends which erodes their potential returns over time. The re-invested dividends increase your capital base for future dividend flows. As an example, if you currently own 1000 shares at R10.00 per share and you get a dividend of 30c per share, you can then buy more shares. When the company announces its next dividend e.g. 31c per share you will now have 1030 shares (as an example) earning dividends. This might seem like a small increase but these incremental increases have a large compounded impact over time.

Dividends are such an important part of share price growth that you would be better off not investing in shares if you don't get the dividends. The compounding effect of dividends will protect you from capital losses over time. You would actually be better off investing in Government bonds, the real growth is 2% per year and your market risk is much lower than shares.

The graph also shows the benefits of long term equity investments. If you are an equity investor and you only buy the index and re-invest your dividends, it is unlikely that you will lose money in REAL terms if you invest for periods of eight years or longer. From the graph you can see that there was only one eight year period since January 1960 where you would have lost money in real terms and that was if you invested at the market peak in the late 1960's and sold your shares in the late 1970's.

The graph also shows the real dangers of inflation, which I feel poses a far bigger threat to long term savings that stock market risk. Because the effects of inflation are not sudden and dramatic, we don't really feel them over one or two year periods. Unfortunately you will only really feel the full effects of inflation once it is already too late. In summary, the graph above paints a clear argument for investing some of your money in shares over the long term – almost no other asset class provide the same inflation protection.

HOW TO INVEST FOR DIVIDENDS

There are three main ways to invest in dividend generating shares: direct share purchases, ETF's or unit trusts. If you decide to buy high dividend yielding shares directly, look for companies that have a long track record of paying dividends. Try to understand the nature of the business so that you understand how these dividends are generated and whether they are likely to continue. More importantly, make sure the company has a dividend policy, this makes it more likely that the company will continue to pay dividends in future. Remember that property companies do not pay normal dividends, their income is earned from rent and so the full dividend is taxable.

If you decide on an Exchange Traded Fund (ETF) rather than a direct share, you could look at the Satrix Divi, ABSA eRafi Overall or Satrix Rafi. Whilst the Divi is the only one sold as a dividend investment, the Rafi's are also structured with dividends as a major filtering criteria. For investors who want to control their own investments but do not have the required skills to make direct shares purchases, these ETF's may be the best alternative.

The final alternative is to invest in Dividend Income unit trusts where you pay fund managers to choose individual shares that they believe are going to pay maximum income over the long term.