HOW SHARES GROW

Shares are the best asset class for generating long term capital growth. Over the last 50 years, shares have grown by 8% per year above inflation while all the other asset classes; including residential property, cash and bonds have provided much less growth (1% - 2.5%) per year above inflation. If shares are your preferred asset class, it is important to understand how your growth will be generated so that you can make the best possible investment decisions. Surprisingly, dividends should be your main focus as they make up the greatest portion of equity returns over the long term.

ITS ALL ABOUT THE DIVIDENDS

Two different investment firms have done fantastic research on the actual source of growth (or performance) from the stock market over long periods of time. Both of them found that re-invested dividends were the greatest contributor to growth. Research by Cannon Asset Managers found that dividends accounted for more than 50% of the growth above inflation over the long term. This is vital information for anyone who invests in shares. If you have not been using dividend income as a criterion for selecting shares, you are most probably limiting your potential growth over the long term. More importantly, you need to be very careful about selecting companies that don't pay dividends.

Nedgroup Investments found that there were two other factors that generate returns in addition to dividends. Their formula for equity growth is: Earnings Growth + Dividends + PE changes. It is important to understand these three components and what they mean to you. The first component is changes in PE ratios. Nedgroup equates these PE changes to the impact of sentiment on the market. As an example, if investors become worried about a particular sector of the market (e.g. bank shares in the Financial Crisis) they might sell all the shares in the sector at any price. Over shorter periods of time, sentiment can play a massive role. However over the long term, Negroup found that sentiment has no impact on real stock market growth. In other words if you are a long term investor in a particular share, market sentiment should not be a factor in your investment decisions.

The second component of stock market returns is Earnings Growth. This is a proxy for real economic growth (Real GDP Growth) and contributes approximately 3.5% of the annual equity performance over the long term. This means you need to consider a country's economic growth potential when making an investment decision on a particular share. If Earnings Growth accounts for more than 40% of a share's long term return – you need to be comfortable that the economy (and therefore the company) will have strong growth over the long term. If the economy has limited growth potential, even well managed companies will struggle to increase their profits thereby limiting their share price growth. This means you have to be fairly certain that your preferred stocks can perform miracles when faced by severe headwinds.

Re-invested dividend income is the third component and accounts for the remaining 56% of real growth potential offered by the share market. This means you should focus on companies that have a long track record of paying dividends that have increased over a number of years. If you decide to invest in a company that does not pay dividends, you are relying on a change in the price of the share only. History has shown that this has little chance of rewarding long term investors. This does not mean that the company's share price will not increase, however it means your investment risks are much higher.

QUALITY CONTROL IS IMPORTANT

Unfortunately, you cannot simply invest in companies that pay good dividends in the hope that you will generate superior long term growth. You will still need to do your homework on each company before committing your capital. Some poor quality businesses try to maintain a high dividend yield in an effort to attract unsuspecting investors. These businesses often pay out more money than the company can afford. This means that there might not be sufficient re-investment in the business which limits the company's long term growth prospects. A good example of this is some of the smaller listed property companies that pay a higher income percentage than their larger competitors. This makes them very attractive to potential investors as the business' value is underpinned by properties; making the perceived risk lower. However many of these properties might be poor quality and might not be maintained properly. This means that you are actually buying a basket of poor quality assets that are continuously losing value. Eventually, the value that underlies your business will not be there any more.