Equity income to address the income recession

By MLC

The Reserve Bank of Australia's (RBA) recent decision to cut the official cash rate for the third time in five months may have been great news for borrowers, but it was another blow to people significantly reliant on savings-interest related income.

As it was, interest rates on retail term deposits were barely ahead of inflation even before the most recent cut. The latest downward move in the official cash rate makes the income recession borne by many Australians even more severe.

Falling interest rates are the flip side of the post GFC market rally that has benefited assets ranging from real estate to shares, to bonds/fixed income, and infrastructure.

Cash has been the sacrificial lamb as falling global and Australian interest rates have lifted the value of other financial assets.

Australian savers can only look back nostalgically to the +7% interest that was being paid in mid-2008 on one-year bank deposits for amounts over $10,000.[1]

Bonds, traditionally regarded as another reliable source of cash flow, are also struggling to play their usual role as a relatively low risk income source.

Around 29 percent of all global government and corporate bonds, valued at around US$16 trillion, are currently trading with negative yields:[2] yields describe the relationship between fixed income prices and the regular income payments associated with them. Falling yields mean fixed income prices are up, while rising yields mean fixed income prices are going down.

In the case of negative yields, what this means is that investors who hold these negative yielding government and corporate bonds will get back less than what they paid if they hold those assets to maturity.

Negative yields and barely positive yields are a steep price to pay for income payments from bonds, these days. Despite this, the income cupboard isn't bare.

Shares, especially Australian shares, are a sizeable income provider owing to dividends paid by Australia's listed companies.

Consistency of Australian dividend yield

Mature companies, dominant in their industries, and thus well positioned to generate dividend income, make up a large proportion of the Australian share market. Think of the big retailers, health services providers, banks, utilities, and even mining companies when commodity prices are strong.

It's acknowledged that investors generally own shares for the potential of long-term capital gain. But dividends have made meaningful contributions to total Australian share market returns **(Chart 1)**.

[1] Reference to RBA data on one-year Australian bank deposits in *35 years of Australian interest rates*. https://www.ratesetter.com.au/investing/35-years-of-australian-interest-rates/ accessed 18 October 2019.

[2] The 29 percent figure is as of 31 August 2019 and is based on MLC Investments Limited's analysis of Bloomberg Barclays Global Aggregate index data sourced from Barra.

Chart 1: Dividends have been a sizeable portion of Australian share market returns

	All Ordinaries Australian Index Total Return (%)	All Ordinaries Australian Index Total Capital Return (%)	Contributions of Dividends to Total Return (%)
1950s	+15.3	+8.1	47
1960s	+14.0	+7.7	45
1970s	+8.6	+1.2	85
1980s	+17.7	+12.7	28
1990s	+10.6	+6.2	41
2000s	+8.8	+4.6	47
2010s*	+7.8	+3.4	56

*Data to 31 October 2019
Source: Maple Brown Abbott

In fact, dividends contributed 85% of total Australian share market returns in the 1970s. Even in the roaring 1980s — a period of market excitement and headline grabbing takeovers, mixed with the 1987 crash — dividends made up 28% of total Australian share market returns as **Chart 1** also shows.

Rising share prices improve investors' absolute long-term wealth, however, dividends help to fund year-by-year lifestyle.

Corporate Australia recognises the importance of dividends to investors and this explains the remarkable consistency of the dividend yield[3] over the past decade and more **(Chart 2)**. Through thick and thin, listed Australian companies have done their best to provide reasonable dividends.

An example from the GFC powerfully make this point.

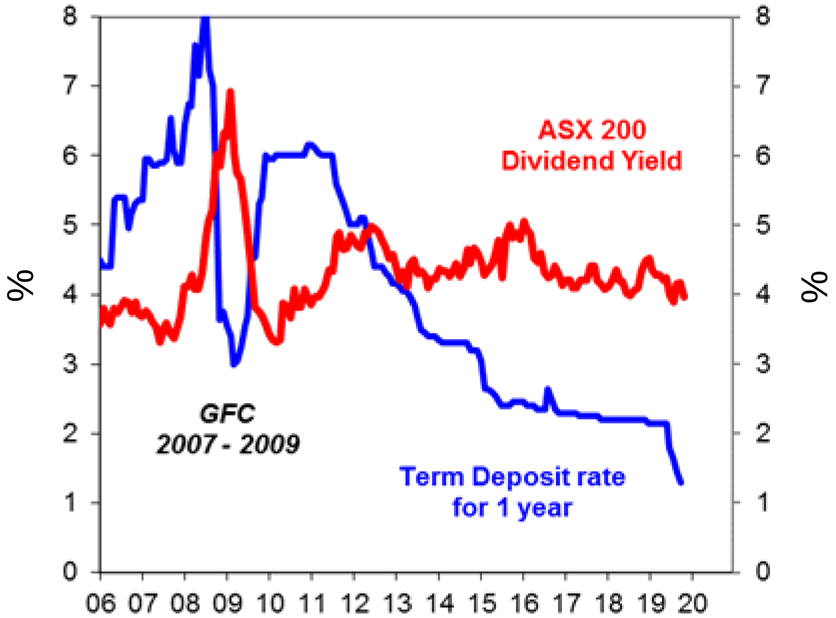
Woolworths' share price fell 21.5% in calendar year 2008 during the GFCs dark days. However, the 92 cents per share dividend that Woolworths paid to shareholders that year was 24% higher than the amount paid in the previous year.[4]

In other words, Woolworths' strong 2008 dividend payment dampened the worst effects of the GFC on its shareholders.

[3] The dividend yield or dividend-price ratio of a share is the dividend per share, divided by the price per share. It is also a company's total annual dividend payments divided by its market capitalisation/the market value of a company, assuming the number of shares is constant. It is often expressed as a percentage, as in Chart 2 of this article.

[4] Woolworths Limited annual report 2008 https://www.woolworthsgroup.com.au/icms_docs/183555_Annual_Report_2008.pdf, accessed 5 November 2019.

Chart 2: The Australian dividend yield has been remarkably consistent
Australian dividend yield vs 1-year term deposit rate



Source: Reserve Bank of Australia (RBA) Bulletin Table F4 of bank term deposits for 1 year for amounts over $10,000.

No doubt Woolworths' shareholders were grateful that the company went above and beyond that year. However, not every company has the resources to go above and beyond for one year, let alone sustain such high dividend payouts.

That's why it's important to look beyond companies' dividend payout ratios and dividend yields to uncover their sustainability.

Sustainable dividends more important than simply high dividends

There are situations where high dividend yields are the result of sharply falling share prices. There can also be instances where companies borrow to boost or even to pay dividends. Alarm bells should be going off in both instances. Neither is sustainable.

That's why we think that investors wanting to access dividend income should carefully look over dividend income funds provided by active investment managers.

Each active investment manager will have their own distinctive investment philosophy and process, but there will be a few commonalities across the dividend income funds available to Australian retail investors, including MLC IncomeBuilder.[5]

Investment managers will sift through the Australia share market and lean into companies with track records of reliable profitability, which underpins sustainable dividends.

Equally, investment managers will avoid under pressure companies unlikely to be able to provide sustainable dividends.

Finally, investment managers will, likely, also target companies paying dividends with high levels of franking, which can help to reduce investors' tax liabilities.

Low interest rates are bad for savers reliant on savings-related income. But there are alternatives, like dividend income funds.

Dividends from shares have boosted the living standards of generations of Australians. In an environment of ultra-low interest rates, dividend income funds can do the same for this generation of savers and investors.

[5] For more about MLC IncomeBuilder, please see https://www.mlc.com.au/adviser/investments/find-a-fund/our-funds/australian-shares/mlc-incomebuilder/at-a-glance