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Please submit questions via the Zoom interface

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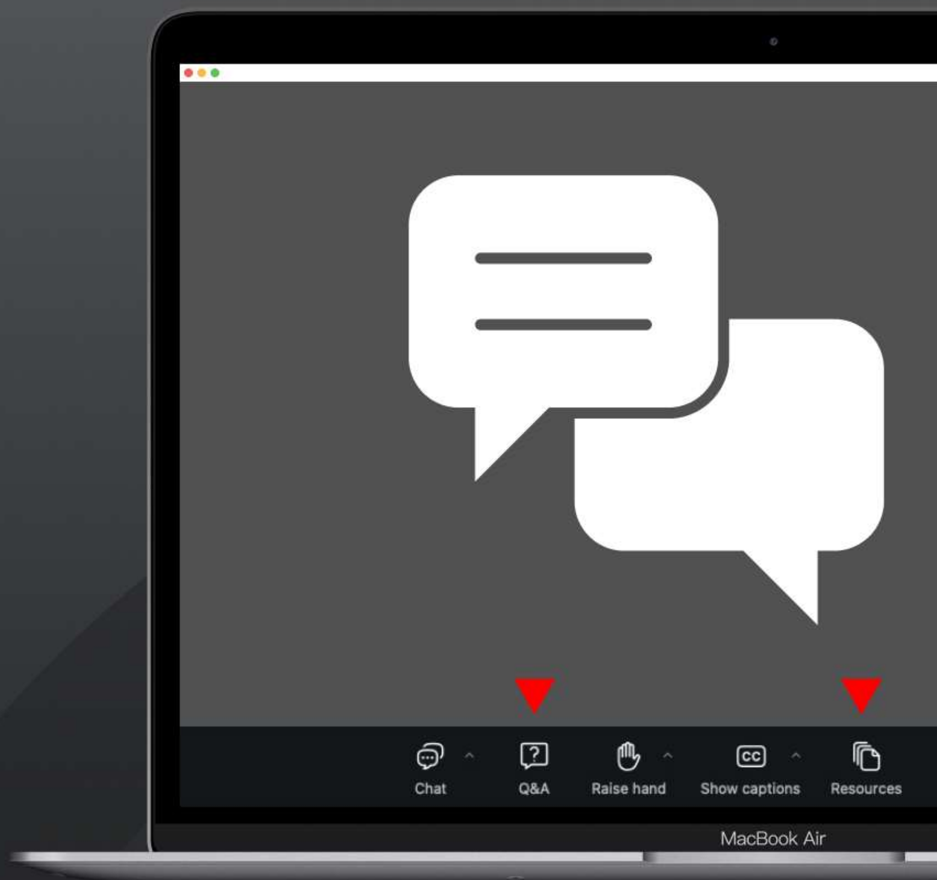


Morningstar retirement bootcamp

Tuesday 22 October | The case for and against income investing

Income investing remains controversial with some professional investors. We will walk through the arguments for and against income investing and if investors should consider pursuing this strategy.

Tuesday 29 October | Building an income portfolio

Investors love dividends but creating an income stream involves more than just picking the highest yielding shares. We will walk through the process to put together a portfolio.

Tuesday 12 November | Assessing individual income shares

A step-by-step process for assessing individual shares that can maintain and grow dividends.

Tuesday 19 November | Using ETFs to generate income

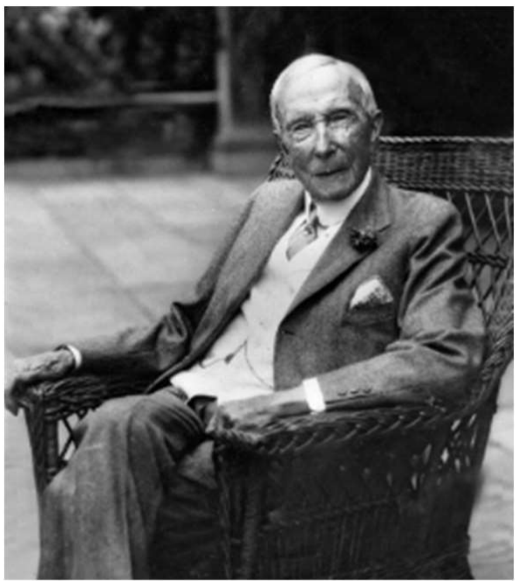
The structure of many dividend ETFs leads to lacklustre or non-existent dividend growth. Learn how to use ETFs as part of an income portfolio

Learning objectives

1. Understand the critiques of income investing and the arguments supporting income investing to determine if this is the right approach to acheive your goals.

The appeal of income investing

One of the challenges of investing is the seeming randomness of share price movements over the short-term. Many individual investors turn to income investing because it seems more tangible and can be used to reduce the influence of price movements on investor behaviour. Share prices go up, share prices go down……dividends keep coming in.



"Do you know the only thing that gives me pleasure? It's to see my dividends coming in."

- John D. Rockefeller

Critiques of income investing

Some investors are not so enamoured with income investing. Whether you are an income investor or not it is important to consider alternate views. Detractors of income investing have the following critiques:

1. Total returns should be the primary focus of investors

2. Dividends are inherently inefficient from a tax perspective

3. Paying dividends reduces earnings growth

4. Income strategies require investors to actively manage their portfolios

Total returns should be the primary focus of investors

Total returns combine returns received from dividends and capital gains which is the appreciation in the share price. Some people argue that focusing on dividends distracts investors from what is most important – total returns.

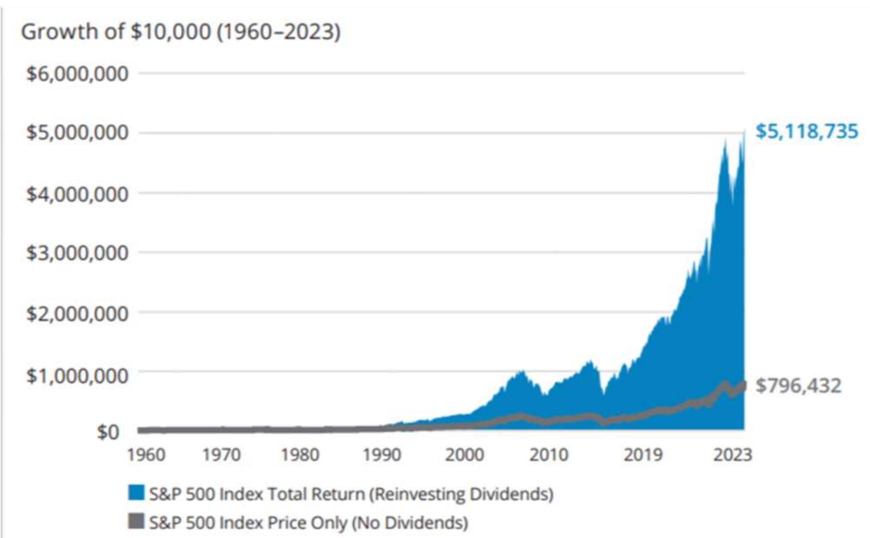
Share market returns come from three places:

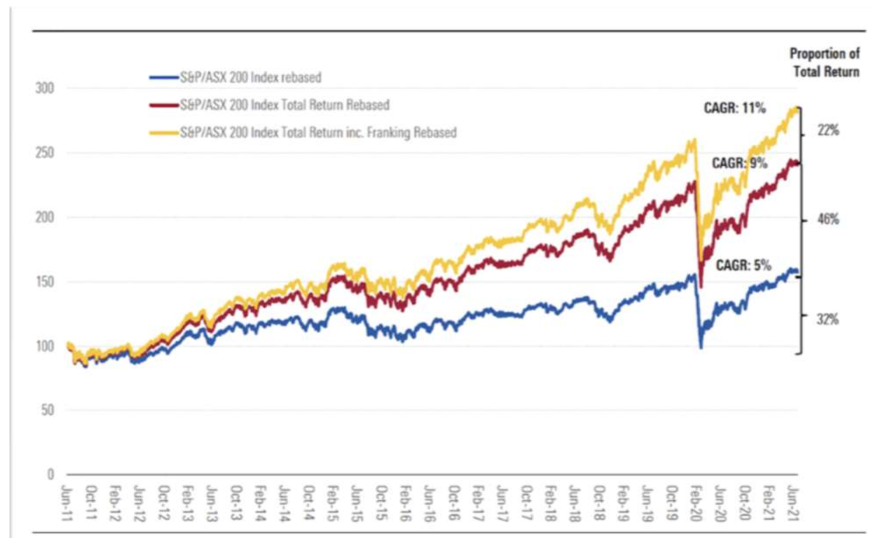
1. Dividends	←	If you concentrate too much on high dividends
2. Earnings growth	←	And own companies that don't grow
3. Changes in valuation	←	Valuations won't change or will go down

In this scenario the only source of returns are from dividends which may be counteracted by drops in valuations

Total returns should be the primary focus of investors

- 85% of the cumulative total return of the S&P 500 between 1960 and 2023 are from reinvested dividends and the power of compounding
- Dividends and franking credits comprised around 70% of the total return of the S&P/ASX 200 Index over the past decade





Source Hartford Funds & Ned Davis Research

Total returns should be the primary focus of investors

- Not only do dividends not detract from returns but if you own dividend payers that grow dividends you may achieve higher returns with lower risk

Average Annual Returns and Volatility by Dividend Policy
S&P 500 Index (1973-2023)

	Returns	Beta	Standard Deviation
Dividend Growers & Initiators	10.19%	0.89	16.15%
Dividend Payers	9.17%	0.94	16.90%
No Change in Dividend Policy	6.74%	1.02	18.64%
Dividend Cutters & Eliminators	-0.63%	1.22	25.07%
Dividend Non-Payers	4.27%	1.18	22.20%
Equal-Weighted S&P 500 Index	7.72%	1.00	17.76%

Source Hartford Funds & Ned Davis Research

Income investors are not giving up the potential for high total returns if the focus isn't simply on high yields

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Dividends are inherently inefficient from a tax perspective

- A dividend and a capital gain is either taxed at an investor's marginal tax rate or at 15% if the assets are in super during the accumulation phase. The difference is that an investor can choose when to sell appreciated shares and realise the capital gain. The tax on a dividend is due when a company decides to pay a dividend.

- There are several advantages to capital gains over dividends:
  - Having the power to determine when a taxable event occurs is advantageous. An investor could decide to sell shares when they are in a lower marginal tax bracket.
  - If the investment is held in super the investor can wait until they are in pension mode and there may be no taxes.
  - There is a discount on long-term capital gains if an investor holds shares for more than a year.

Dividends are inherently inefficient from a tax perspective

While there are obvious advantages to capital gains there are some mitigating factors.

- For Australian investors buying Australian shares franking credits act as an offset to any taxes.
- There are also some situations when investors don't get complete choice on when to sell. Investors sell shares to rebalance a portfolio or because there is a better opportunity to invest the funds. Investors also sell shares because they need the money. If an investor needs to sell at an inopportune time that is also not in the best interest of an investor.
- While dividends are a taxable event an investor gets a cash payment. And that has value. Nobody would argue that people should quit their jobs because salaries are taxed.
- A dividend is a tangible way to extract a return from the purchase of a share with an unknown future.

Paying dividends reduces earnings growth

The argument is that if a company reinvested the cash in the business to fund growth instead of paying dividends an investor would ultimately be better off. For Australian investors buying Australian shares franking credits act as an offset to any taxes.

Traditionally new companies retain all of their cash flows to fund growth.

As they mature and growth opportunities dissipate part of the cash flow is diverted to dividends. A company that operates in an industry with little growth may pay out almost all their cash flows in dividends.

Paying dividends reduces earnings growth

This argument assumes that management are great stewards of investor capital. A more nuanced view of this argument could assume:

- That many management reams make poor decisions including making unwise acquisitions, lavishing excessive perks and pay to employees and funding growth projects that earn low returns on the investment.
- What prevents poor decisions is discipline. And discipline typically comes from having restraints in place. That is why most companies have policies and structural frameworks to govern spending.
- Another form of discipline is scarcity. A dividend imposes discipline through scarcity. A dividend is ultimately a choice but having an investor base that values dividends is an impediment to reckless spending that puts the dividend in jeopardy. And having a dividend policy that dictates a certain percentage of earnings are paid in dividends further amplifies this discipline.

Income strategies require investors to actively manage their portfolios

The theory is that everyday investors are not capable of selecting individual shares and trying to pursue an active strategy to generate income leads to poor results.

- I agree that passive investing is a great approach for investors.
- However, I also believe there is nothing holding back individuals from picking shares if they are willing to educate themselves, put time and effort into the endeavour and establish a structure to make good decisions.
- This argument also ignores the fact that there are other avenues to pursue an income strategy. There are passively managed ETFs and funds that follow an income strategy. And there are actively managed ETFs and funds where the decision making can be outsourced.

Why I am an income investor

The way that many professionals invest is inconsistent with income investing. Many professionals constantly churn their portfolio to try and take advantage of where we are in the economic cycle, prevailing conditions and to own shares with ‘catalysts’ for shot-term gains.

Income investing is a buy and hold strategy to take advantage of dividend growth and dividend reinvestment.

I am an income investor for the following reasons:

1. **It imposes behavioural discipline on my approach:** Income investing encourages a long-term outlook, ignores speculative investments, reduces the influence of emotions, and has a natural contrarian bias.
2. **It makes it easier for me to evaluate individual investments**: Evaluating income producing securities involves an assessment of current and future cash flow generation for higher quality and mature businesses. It does not require an opinion on changes in valuation levels or an assessment of emerging industries within a wider range of potential outcomes.
3. **It algins with my investment goal:** My goal is for more portfolio to support the quality of my life now and into the future which aligns with generating a growing stream of passive income.