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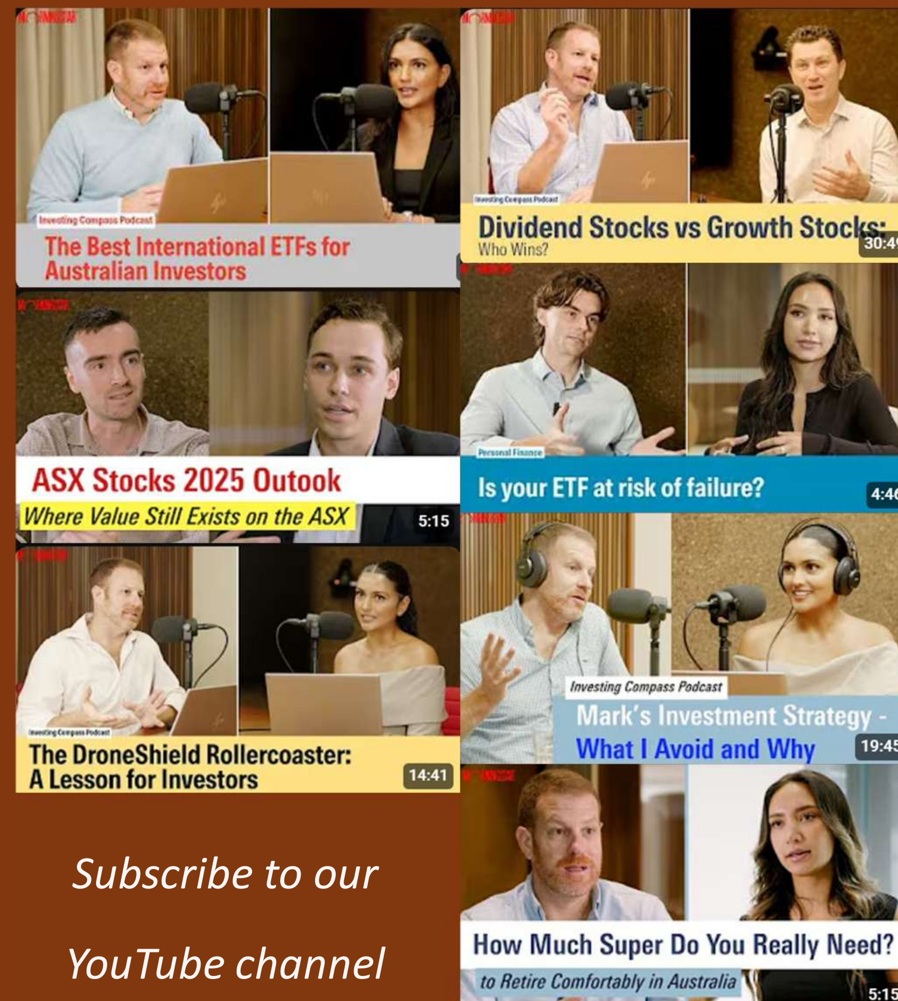

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Morningstar income investing bootcamp

Webinar 1 – Building an income portfolio

Webinar 2 – Assessing individual shares

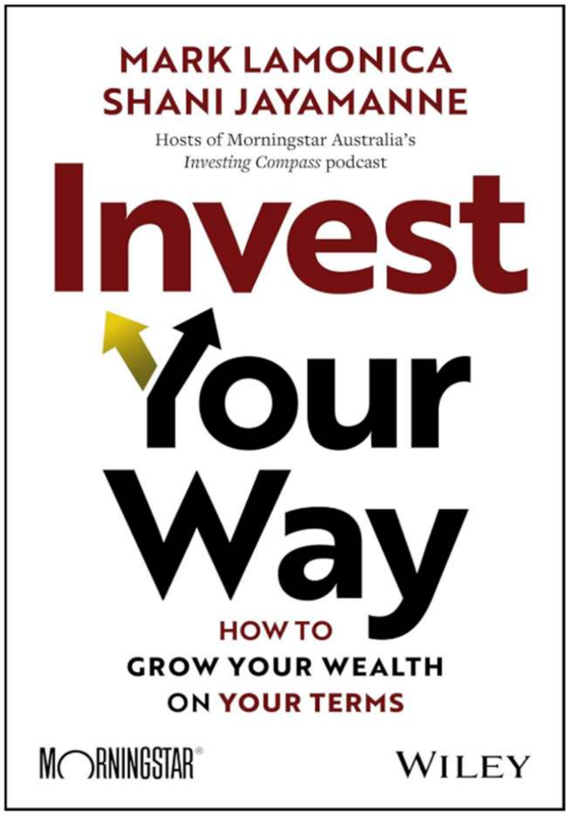
Webinar 3 – Using ETFs to generate income

Webinar 4 – Other income options (LICs, covered calls, dividend harvesting)

Learning objectives

1. Understand some factors to look for when buying dividend shares

Getting the foundations right



- The biggest issue many investors face is undermining their own outcomes by letting emotions influence decision making and making mistakes
- ETFs exacerbate these tendencies given the ease of trading, the proliferation of new ETFs and compelling marketing based on recent performance
- The key is adding structure to decision making by establishing goals, setting an investment strategy and developing a process to guide decision making

Attractive dividend paying shares

Dividend paying shares are not inherently attractive. It's that companies that consistently raise their dividends tend to create shareholder value.

The return for each category of S&P 500 shares between 1973 and 2025

Category	Annual returns
Dividend growers & initiators	10.22%
Dividend payers	9.20%
No-change in dividend policy	6.87%
Dividend cutters & eliminators	-0.96%
Dividend non-payers	4.21%
Equal weighted S&P 500	7.74%

The return for ASX listed shares in our coverage universe over the last decade

Category	Annual returns
Dividend growers & initiators	12.60%
Dividend payers	7.61%
Dividend cutters & eliminators	4.05%
Dividend non-payers	9.80%
Equal weighted ASX 200	8.70%

Returns do not include franking credits

How to find attractive dividend paying shares

There are several steps I use to try and find attractive dividend paying shares:

- Find companies that can stand up to the competition
- Find companies with limited external factors that influence how a company performs
- Valuation
- Dividend sustainability

Two examples:

- Woolworths (ASX: WOW)
- American Tower (NYSE: AMT)

Find companies that stand-up to the competition

When evaluating a share start with the competitive environment the company operates within.

Start with the customer. What influences purchasing decisions and why would they choose one product or service over another? Price, quality, confidence or are other factors at play? Are there substitutes or can they forgo purchasing all together?

Tips:

1. Remember your circle of competence
2. Look at the stats: Return on invested capital & margins
3. Use the Morningstar moat sources as a framework to evaluate the competitive environment:
    1. Switching costs
    2. Network effect
    3. Intangible assets
    4. Cost advantages
    5. Efficient scale

Find companies that stand-up to the competition

Woolworths: Wide moat

1. Switching costs: None as people can easily choose where to buy groceries
2. Network effect: None as the more people that use a grocery store have limited impact on the value of a store
3. Intangible assets: None as brand is a minor consideration for shoppers buying groceries
4. Cost advantages: Woolworths is the largest store which allows fixed costs to be spread over a larger network of stores
5. Efficient scale: None as grocery stores are not a limited market and there is significant competition

- Earnings before interest and tax is 5.6% or .70% above Coles
- Return on invested capital expected to average 12% compared to 7% cost of capital

Find companies that stand-up to the competition

American Tower: Narrow moat

1. Switching costs: High as mobile providers are responsible for paying to install equipment and moving equipment from one tower to another
2. Network effect: None
3. Intangible assets: None
4. Cost advantages: None
5. Efficient scale: Tower construction is capital intensive and each tower can hold equipment from multiple mobile providers which makes it economically counterproductive for competitors to build in the same area

- Returns on invested capital have consistently outpaced cost of capital over the last decade

External factors that influence performance

Different companies and different industries have varying degrees of external factors that influence performance. The more factors that influence how a company performs the less predictable the results.

Tips:

1. Diversification is not about how many holdings and asset classes are in your portfolio. It is about diversifying the factors that will influence the performance of the investments in your portfolio. In an income strategy the factors that impact future dividends should be considered.
2. The less predictable the outcome the larger the margin of safety is needed.

External factors that influence performance

Woolworths: Low uncertainty

1. Non-cyclical consumer defensive company with consumer spending modestly impacting results
2. Increased competition from new entrants like Costco and Amazon Fresh may change the current grocery landscape in Australia

External factors that influence performance

American Tower: Medium uncertainty

1. Non-cyclical company as mobile phones and data have become essentials in many countries
2. Technology changes are the biggest risk to the existing mobile phone landscape
3. Environmental factors like water and electricity and negative publicity are risks to the data centres business
4. Geo-political risks in developing markets

Valuation

If you are not going to create a discounted cash flow model you will use a relative valuation measure as the basis for the valuation. As an income investor I will typically compare the current dividend yield with historic yields along with other relative valuation measures.

Tips:

1. Relative valuation measures allow you to make comparison statement – stock A is cheaper than stock B, stock A is cheaper than it used to be, Stock A is cheaper than the market – but don't offer an absolute view on valuation
2. When making a comparison statement you need to a thesis on why something is cheaper and why the market is wrong – remember often the crowd is right.

Valuation

Woolworths:

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Div growth	9.68%	-7.84%	14.89%	-14.81%	13.04%	0.00%	-19.23%	11.11%	15.00%	7.83%
Yield	2.82%	2.39%	2.84%	2.74%	2.80%	3.41%	2.86%	2.34%		

Observations:

- Yield is historically low
- Dividend growth has been below inflation
- Strong dividend growth forecast by our analysts
- Growth of 7.64% need to hit ‘my target’ of 10% annual growth with dividend reinvestment
- Franking has been 100% the last several years

Valuation

American Tower:

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Div growth	20.00%	19.84%	15.01%	12.48%	10.07%	0.47%	4.94%	0.74%	5.40%	5.40%
Yield	1.64%	2.02%	1.78%	2.77%	2.99%	3.53%	3.87%	3.91%		

Observations:

- Yield is historically high
- Dividend growth has been above inflation historically but has slowed in the last several years
- Decent dividend growth projected by our analysts
- Growth of 6.09% need to hit ‘my target’ of 10% annual growth with dividend reinvestment

Dividend sustainability

I am looking for dividend growth but at a bare minimum sustainability is critical.

Tips:

- The dividend payout ratio is a useful measure as an indicator of dividend sustainability. However, it works less well in Australia where there is less of a stigma about dividend cyclicality
- Debt levels can be a useful measure but differ by industry
- Reserving enough capital to invest for earnings growth is critical as that will fund future dividends

Dividend sustainability

Woolworths: Exemplary capital allocation rating

1. Sound balance sheet
2. Strong internal track record for investment
3. High level of dividend payouts but a low growth business (target 75% dividend payout ratio)

Dividend sustainability

American Tower: Standard capital allocation ratio

1. Decent balance sheet
2. Some missteps in internal investments and sales of business units
3. 60% of funds from operation have traditionally been paid out