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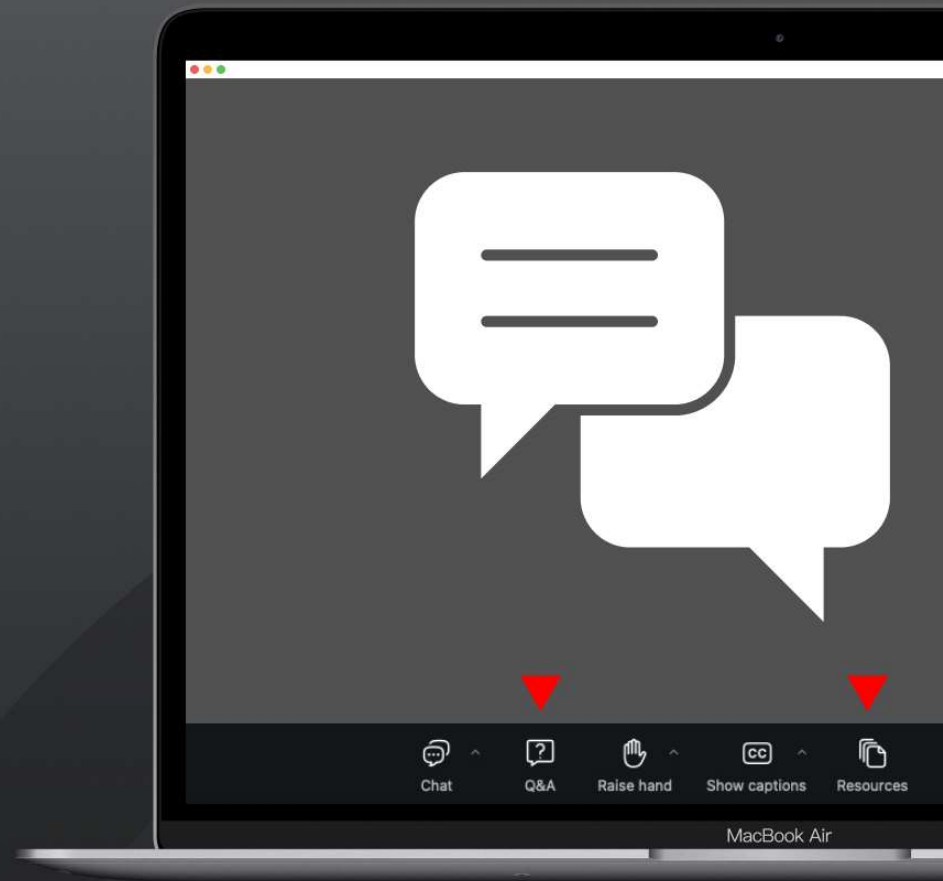
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# Morningstar retirement bootcamp

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**

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## Learning objectives

1. Understand the ways in which dividend ETFs can be used in a portfolio and what they will and won't provide for investors.

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## What is an income portfolio?

A dividend ETF or fund is a form of factor investing. Factor investing identifies certain characteristics that investors want and seeks to identify securities that have those characteristics. To evaluate a dividend ETF requires the following:

1. Understanding what you are trying to accomplish with an income portfolio
2. Understanding the criteria used to select securities
3. Understanding the criteria used to adjust the holding

## A case study of a hypothetical dividend ETF

There is an overall universe of 10 shares with the top 6 selected by the ETF which rank highest based on forward estimated dividend yield and weights the ETF by contribution to total dividends.

Top 6 shares are selected by forward yield

<b>Share 1: 5.5% yield</b>
<b>Share 2: 5% yield</b>
<b>Share 3: 4.5% yield</b>
<b>Share 4: 4% yield</b>
<b>Share 5: 3.5% yield</b>
<b>Share 6: 3% yield</b>
Share 7: 2.5% yield
Share 8: 2% yield
Share 9: 1.5% yield
Share 10: 1% yield

Shares are weighted based on the percentage contribution to the total dividends.

<b>Share 1: 22% allocation</b>
<b>Share 2: 20% allocation</b>
<b>Share 3: 18% allocation</b>
<b>Share 4: 16% allocation</b>
<b>Share 5: 14% allocation</b>
<b>Share 6: 12% allocation</b>
Share 7: 0 allocation
Share 8: 0 allocation
Share 9: 0 allocation
Share 10: 0 allocation

The total portfolio yields 4.42% and total income is .0442 cents

Equal weighted yield is 3.25% and total income is .0325 cents

## A case study of a hypothetical dividend ETF

The ETF goes through the ranking exercise twice annual at the end of the financial year and the end of the calendar year and the holdings are adjusted. All of the shares rose 10% with forward dividend estimates

In period 1 all shares go up 5% in price and the 3 highest yielding shares increase forward dividends by 1%, next 3 by 5% and the 4 lowest go up by 10%

<b>Share 1: 5.29% yield</b>
<b>Share 2: 4.81% yield</b>
<b>Share 3: 4.33% yield</b>
<b>Share 4: 4% yield</b>
<b>Share 5: 3.50% yield</b>
<b>Share 6: 3% yield</b>
Share 7: 2.62% yield
Share 8: 2.10% yield
Share 9: 1.57% yield
Share 10: 1.05% yield

Shares are weighted based on the percentage contribution to the total dividends.

<b>Share 1: 16.4% allocation</b>
<b>Share 2: 14.9% allocation</b>
<b>Share 3: 13.4% allocation</b>
<b>Share 4: 12.4% allocation</b>
<b>Share 5: 10.8% allocation</b>
<b>Share 6: 9.3% allocation</b>
Share 7: 0 allocation
Share 8: 0 allocation
Share 9: 0 allocation
Share 10: 0 allocation

The total portfolio yields 3.25% and the total income .0366

Equal weighted yield is 3.23% and total income is .0339 cents



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## What happened?

- The shares with the highest dividend yields had the slowest growth
- The shares with lower dividend yields had the fastest growth
- Share prices grew faster than the dividend growth in the highest yielding shares lowering the yield, share prices grew at the same pace as dividend growth in the middle yielding shares keeping the yield the same, share prices grew slower than the dividend growth in the lowest yielding shares and the yields rose but not enough to add them to the ETF
- For investors in the ETF the dividends shrunk given the rebalancing. For investors in the equal weighted ETF the dividends grew.
- This example is illustrative only. But the implication is that while dividend ETFs should mostly produce yields higher than the market yield in many 'normal' market environments the total dividends may drop.

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## In what scenarios does this happen?

- If projected – or historic – dividend yields of the highest yielding shares in the market drop the income from the ETF will shrink. This can happen if share prices grow faster than dividends for the highest yielding shares and if the dividends shrink for the highest yielding more than they increase for other shares.
- Income will increase for the typical dividend ETF if the dividend yields of the highest yielding shares in the market increase. This often happens if the market drops significantly or if dividend growth of the highest yielding shares outpace any market gains.
- There are further dynamics at play but in many ‘normal’ market conditions the income for a dividend ETF will drop.

ETF	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Vanguard Australian Shares High Yield (VHY)	\$4.71	\$3.15	\$4.65	\$4.81	\$3.23	\$2.09	\$3.17	\$3.84	\$3.43	\$4.24
Russell Inv High Dividend Aus Shrs ETF (RDV)	\$1.59	\$1.47	\$1.58	\$1.91	\$2.09	\$1.31	\$0.87	\$1.79	\$1.52	\$1.43

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## Does this mean investors should avoid dividend ETFs?

- Any investment is a tool – investors simply need to find the right tool for the job they are doing. Many dividend ETFs will struggle with generating sustained income growth but they likely will provide a yield higher than the market yield. For many investors this may be attractive.
- However, if a higher than market yield on a year-by-year basis is the goal it is critical that holdings within the ETF deliver dividends during the holding period they are in the ETF – an investor should look for criteria that avoids dividend traps.

# ETF evaluation

Criteria	Russel High Dividend Australia Shares ETF (ASX: RDV)				
<b>Selection criteria</b>	<ul style="list-style-type: none"> <li>The index uses four different criteria to score Australian shares and then picks the 50 shares with the highest scores for inclusion in the index.</li> <li>The score gives a 40% weighting to consensus forecast dividends. Another 20% is based off projected growth rate of the dividends which is also positive and forward looking. 20% of the score is based on historical dividends. The last 20% of the score is based on earnings volatility over the past 5 years.</li> <li>One difference in the Russell ETF is that it does not remove Real Estate Investment Trusts ("REITs") from the universe of potential holdings. A-REITs do not provide franking credits.</li> </ul>				
<b>Trailing yield</b>	4.19%	<b>Turnover</b>	27.41%	<b>Fee</b>	.34%
<b>Morningstar Medalist Rating</b>	Not covered				


































Sectors	Investment %			
<b>Cyclical</b>	Basic Materials	10.40	Commonwealth Bank of Australia	7.64
	Consumer Cyclical	11.07	BHP Group Ltd	6.54
	Financial Services	41.61	Westpac Banking Corp	6.11
	Real Estate	4.27	ANZ Group Holdings Ltd	5.78
<b>Sensitive</b>	Communication Services	3.86	National Australia Bank Ltd	5.43
	Energy	6.99	Telstra Group Ltd	3.61
	Industrials	8.05	Origin Energy Ltd	3.09
	Technology	0.00	Bendigo and Adelaide Bank Ltd	3.07
<b>Defensive</b>	Consumer Defensive	6.60	Harvey Norman Holdings Ltd	3.00
	Healthcare	1.80	Atlas Arteria Ltd	2.95
	Utilities	5.36		

# ETF evaluation

Criteria	iShares S&P/ASX Dividend Opportunities ETF (ASX: IHD)				
<b>Selection criteria</b>	<ul style="list-style-type: none"> <li>From the starting point of 300 constituents forming the S&amp;P/ ASX 300 Index, the methodology narrows the stocks universe down to 50 names. .</li> <li>The initial screens are set around profitability and sustainability to arrive at a list of eligible stocks. The sustainability screen excludes companies involved in controversial businesses and also those linked to violations of international standards or controversies related to ESG risk.</li> <li>Of the eligible stocks, only the top 50 stocks in terms of the 12-month forecast dividend yield make the final cut.</li> <li>The weighting mechanism of the final list of stocks is based on the dividend yield forecast and the market cap.</li> <li>There are stock and sector weight caps to ensure that the portfolio is not too skewed and is sufficiently diversified.</li> </ul>				
<b>Trailing yield</b>	5.51%	<b>Turnover</b>	48.79%	<b>Fee</b>	.23%
<b>Morningstar Medalist Rating</b>	Bronze				

Sectors	Investment %		
<b>Cyclical</b>			
Basic Materials	20.83	Rio Tinto Ltd	9.68
Consumer Cyclical	9.96	Fortescue Ltd	8.28
Financial Services	43.90	Westpac Banking Corp	8.19
Real Estate	0.00	Commonwealth Bank of Australia	8.17
<b>Sensitive</b>			
Communication Services	7.13	ANZ Group Holdings Ltd	7.62
Energy	0.00	Transurban Group	7.59
Industrials	13.04	National Australia Bank Ltd	7.45
Technology	0.22	Telstra Group Ltd	6.05
<b>Defensive</b>			
Consumer Defensive	4.92	QBE Insurance Group Ltd	3.53
Healthcare	0.00	Suncorp Group Ltd	2.85
Utilities	0.00		

## ETF evaluation

Criteria	SPDR MSCI Australia Select High Dividend Yield ETF (ASX: SYI)																																																
<b>Selection criteria</b>	<ul style="list-style-type: none"> <li>The universe is screened for durable and persistent dividends and has a minimum cutoff for return on equity, debt/equity, and earnings volatility.</li> <li>A price-performance screen removes the lowest 5% of securities with a negative one-year price return. To make the final cut, securities must carry a dividend yield greater than the broader MSCI Australia Shares Investable Market Index. The result is a portfolio of about 60 stocks, rebalanced twice a year.</li> </ul>																																																
<b>Trailing yield</b>	3.60%	<b>Turnover</b>	67.51%	<b>Fee</b>	.20%																																												
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## ETF evaluation

Criteria	Vanguard Australian Shares High Yield ETF (ASX: VHY)																																																							
<b>Selection criteria</b>	<ul style="list-style-type: none"> <li>FTSE Australia High Dividend Yield Index—an index Vanguard has exclusive rights to replicate consists of mostly large-cap companies with higher dividend forecasts among all the listed companies on ASX. Instead of choosing stocks based on their past historical distribution records, the FTSE index selects stocks based on their one-year consensus forecast dividend yields.</li> <li>After screening the universe by the dividend expectations, the selected constituents are weighted according to their free-float market cap. Thus, despite some sector skews, the portfolio carries a similar risk/reward profile as the broader market.</li> </ul>																																																							
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## Covered call ETFs

A covered call strategy can be used as a mechanism to generate more income from a portfolio of shares. It can also be used to offset the downside risk of the share dropping. For the income strategy the basic premise is that an investor with a portfolio of shares writes call options on positions within the portfolio and receives cash payments.

One example of a covered call strategy is the BetaShares Australian Top 20 Equity Yield Maximiser Fund (ASX: YMAX). We can compare this ETF to VHY. If an investor had purchased \$10,000 of each ETF on December 31st 2020, the investor that purchased VHY would have received a respectable \$2,227 in distributions. The YMAX investor would have received \$3,382.

However, this income has come at the expense of capital gains. Over the past 3 years the ETF unit price of YMAX rose from \$7.53 on December 31st 2020 to a price of \$7.99. That is 6.10% higher. Meanwhile, the price of a unit of VHY rose from \$57.43 to \$75.61 over the same time frame. That is close to 31.60% higher.



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## Dividend harvester ETFs

Dividend harvesting is a strategy that involves buying shares prior to their ex-date – the date owners of a share are entitled to a dividend – and then selling them after they are entitled to the dividend. On the dividend ex-date the share price will be reduced by the amount of the dividend. One risk to the strategy is if the share price falls more than the dividend paid while held the return can be negative although it will still deliver a higher yield.

An example of dividend harvesting ETF is the BetaShares Dividend Harvester Fund (ASX: HVST). The Fund's share portfolio is generally selected from the largest 100 Australian shares on the ASX, screened for high dividend and franking outcomes based upon expected future gross dividend payments. The share portfolio is rebalanced approximately every three months, with the aim of including the shares that are expected, within the next rebalance period, to provide the highest gross yield outcomes.

The ETF is currently yielding 5.80%. Over the past year the return is 24.82%.