

A Clear Direction Financial Planning

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Research Report

The Benefit of Australian Share Income over Time

The Purpose of this Report

Over time there are two benefits that we hope to receive from investing in shares. The first is that we hope that the shares we own will go up in value over the long term. As a statement of the blindingly obvious, this has not been happening in the short term. The second benefit that we hope to receive from owning shares goes to the 'first principles' of what shares are. Investing in shares means that we become a part owner of a company. That company earns some income, and each year a portion (on average about 60% to 70%) of that income is paid out to investors in the form of dividend.

The simplest analogy is to think of owning shares somewhat like owning an investment property. Over the long term you hope/expect that the property goes up in value – however you also receive income from that property in the form of the rent that the tenant pays. Over time the rental income will tend to increase – just as over time the dividends paid by shares tend to increase.

This report looks at the reliability and quality of income paid by shares over long periods of time.

Is This a Change in Focus Brought on by Market Volatility?

About three and a half years ago (during a period of strong share market growth) we wrote a book entitled 'A Clear Direction', about the basics of personal financial planning. We actually included a separate chapter in the book talking about the benefits of income from investments, including that investment income is the most efficient way to replace your 'working' income (salary, business income, farm income etc.).

A key focus for us has been the building of a strong and reliable income stream for clients.

Broad Benefits of Australian Share Income vs. Cash Income

The most common 'income investment' that we think about is cash.

At the moment (December 2008) the best cash accounts are paying interest of around 5% per annum.

There are two additional benefits that the income paid by Australian shares has over the income paid by a cash account:

1. The income paid by shares tends to increase over time and,
2. The income paid by shares often has a tax advantage, because as well as a cash dividend investors also receive franking credits.

The Current Situation in the Market – and the Tax Benefits of Australian Share Income

According to the Australian Financial Review (December, 2008), the average income paid by the Australian share market is 6.71%. We think that there is a reasonable chance that companies will decrease their dividends over the next 12 months. On this basis we have assumed that the average dividend is cut by 25%, which means that the average market dividend falls to 5.03%.

That means that for every \$10,000 invested in the average market fund – an index fund – the dividends paid will be around \$503 a year.

You can see that this is almost identical to the cash investment. \$10,000 invested in a cash account will provide an income of \$500 (i.e. 5%) a year.

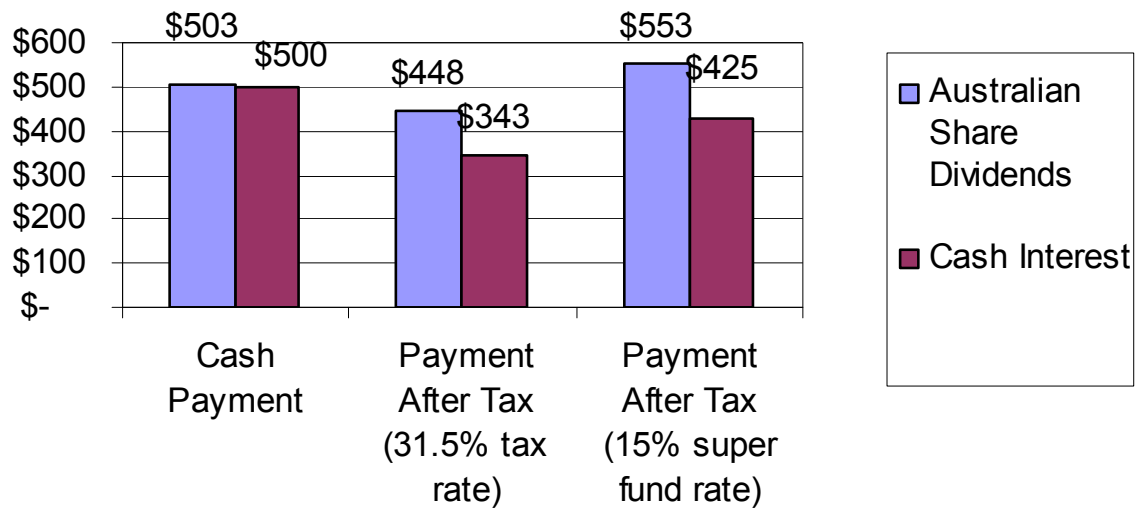
Now, for the cash account it is easy to work out the tax consequences. All of the \$500 income is taxable. An investor paying the average income tax rate of 31.5% would pay tax of \$157.50 in tax. They would be left with \$342.50 after tax. A superannuation investment pays tax at the rate of 15% so the tax would be \$75, meaning that \$425 is left after tax.

Share dividends, however, come with attached 'franking credits'. On average, \$500 worth of dividends from an index investment will also have \$150 worth of franking credits. These franking credits are effectively a tax reduction.

That means that an investor on the average income tax rate of 31.5% pays only \$55 in income tax, meaning that after tax \$448 of the \$503 dividend remains. For a superannuation fund the results are even more impressive. The franking credits are more than the tax payable, so the super fund effectively receives a tax refund as well as the cash dividend. The after tax return is the \$503 dividend plus a \$50 tax refund - \$553 in total.

The following graph shows how the cash income from both a cash investment and an Australian Shares investment at the moment is very similar – and how after tax the Australian share income becomes much more effective.

December 2009 - Australian Share Dividends and Cash Interest - including after tax



Australian Share Income Grows Over Time

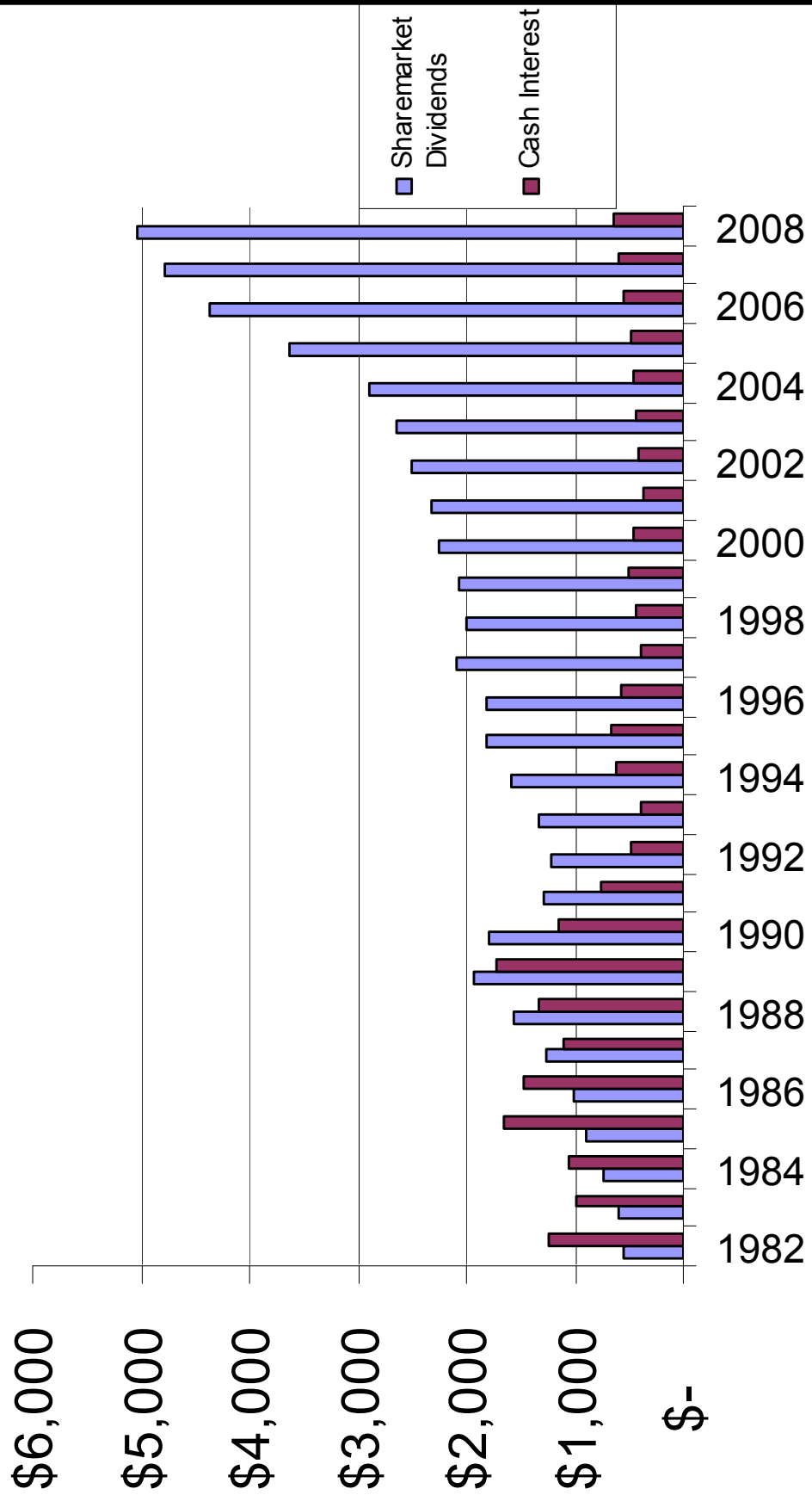
The Reserve Bank of Australia keeps investment statistics on share market income and average cash interest rates dating back to 1982. We have also sourced data from the Australian Bureau of Statistics for inflation, so we can see what impact inflation has on the cash interest and Australian Share interest over time.

This gives us a good opportunity to compare the income over time from an investment in the share market with an investment in a cash account.

The following graphs shows:

- An initial investment of \$10,000 into the share market index and a cash account in December 1982.
- The annual income received from both investments each year
- It assumes that each year the cash interest and the share dividends are spent
- The period is the 27 years from 1982 – 2008. This is close to the average length of a retirement
- This is an interesting time to look at this comparison, because initially cash provided a much better income return. Cash rates in the early 1980's were quite high. However, it only took 5 years until the \$10,000 share investment was providing a higher level of income than the \$10,000 cash return.
- None of the following three graphs include the benefits of franking credits for the Australian share income.

Growth of Dividends vs Cash Income; \$10,000 invested December 1982 - December 2008



The following two graphs show a comparison of the income from \$10,000 invested in either cash or shares, compared with inflation.

For inflation, we have started with \$500 worth of expenses and increased this by the rate of inflation each year. By 2008 the \$500 worth of expenses costs \$1,444 because of the impact of inflation.

It is interesting to note that the income from the \$10,000 cash investment comfortably covers the cost of the goods for a number of years, however soon becomes very inadequate when interest rates become lower during the 1990's.

The second graph, which looks at the income from a \$10,000 share investment, demonstrates how effective the share income is in providing an income stream that grows over time and negates the impact of inflation.

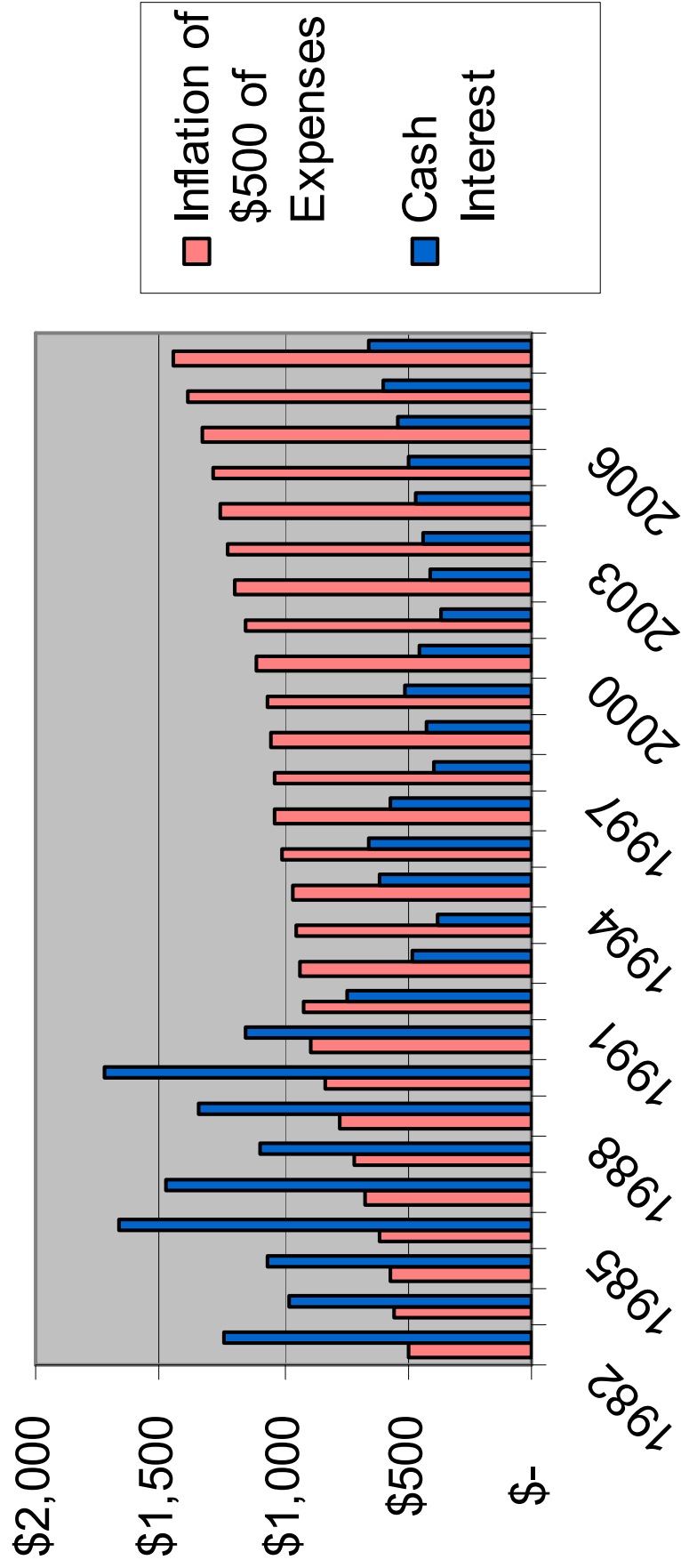
Conclusion

The focus for owning shares tends to be on whether they go up in value or not. And, over the long term we expect that shares will increase in value.

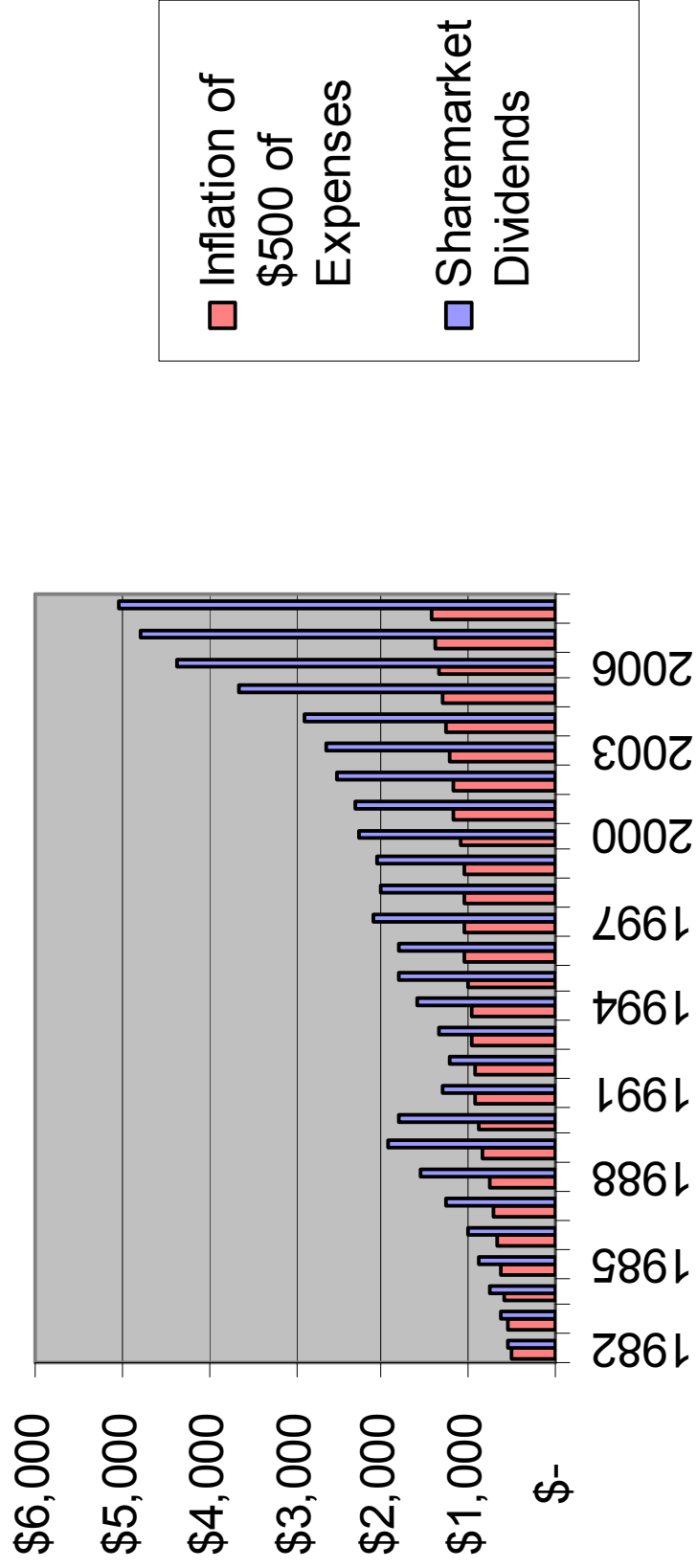
However, the key aim in owning shares is to build a strong and growing income stream – that also has the tax advantages of franking credits.

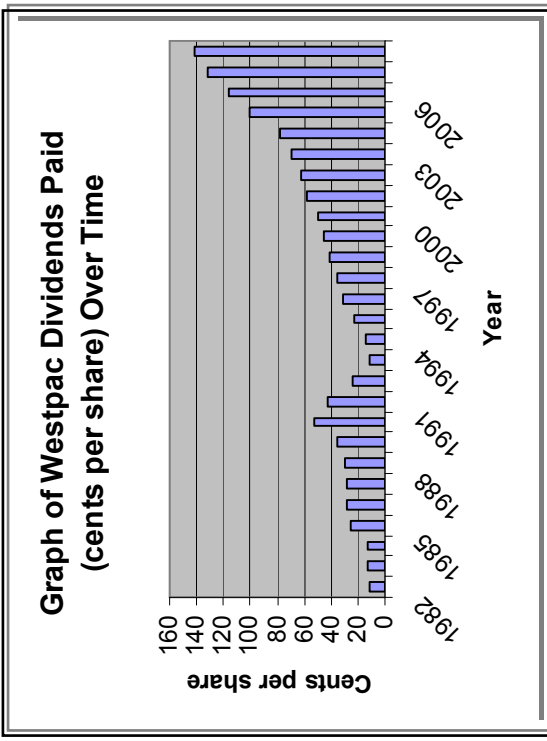
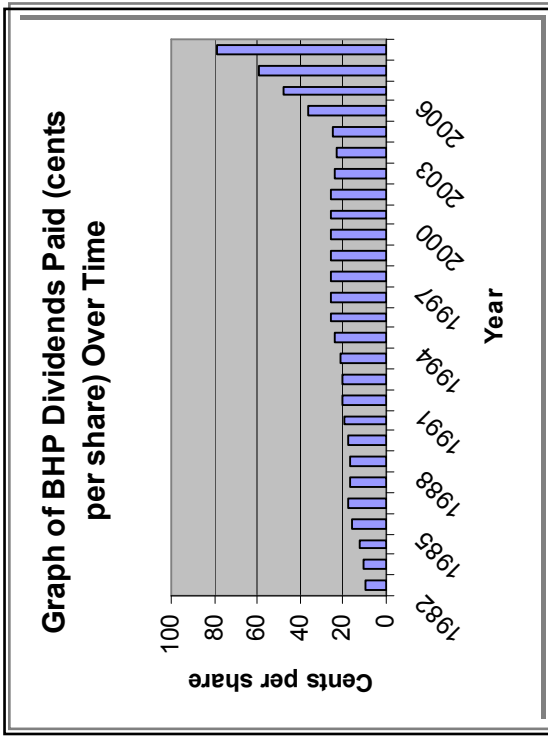
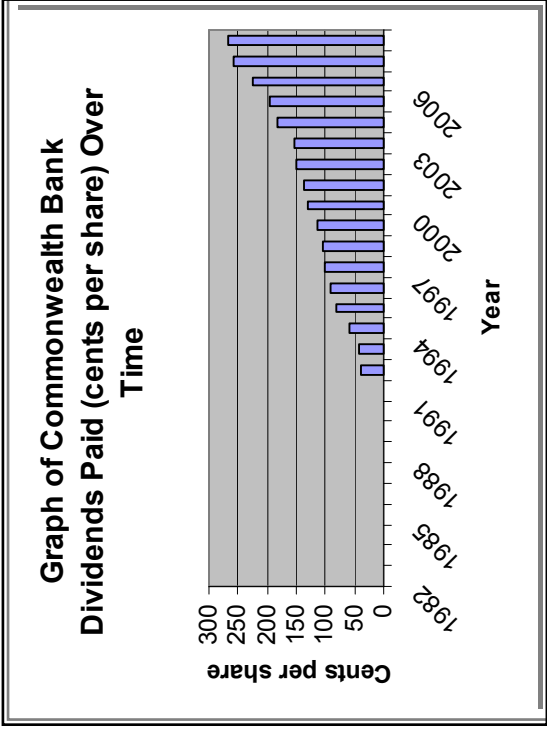
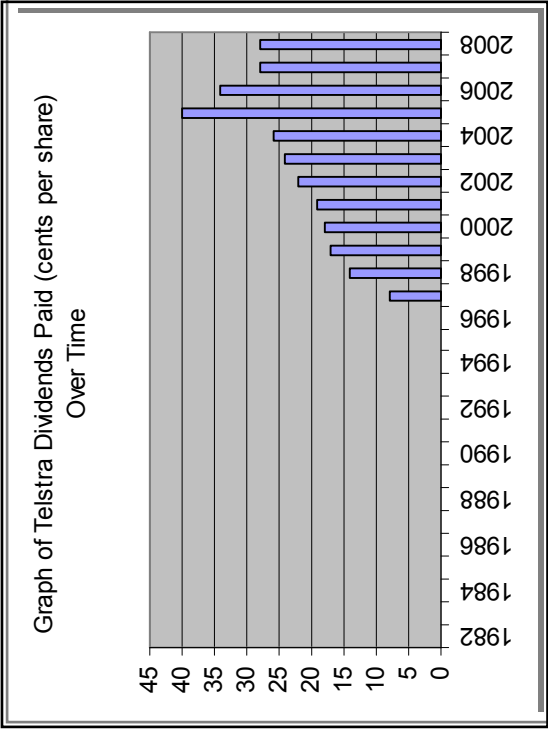
Appendix – We have put together the income history of the 10 biggest companies in the Australian market over time. We have substituted Wesfarmers for Westfield, as Westfield only has a few years of data in its current form. These biggest companies make up about 40% of the value of the index – and so are the biggest holding in an index fund.

Graph of Inflation vs Cash Income Annually - 1982 to 2008

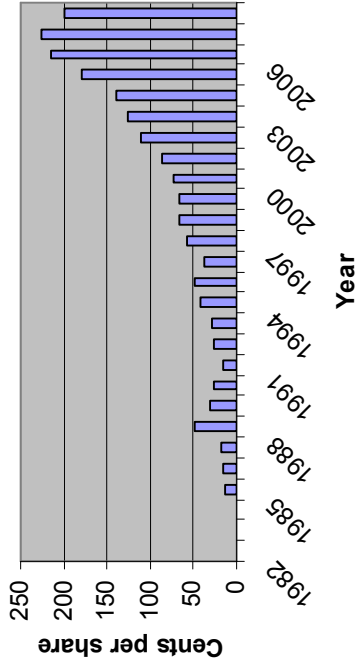


Graph of Inflation vs Share Dividends Annually - 1982 to 2008

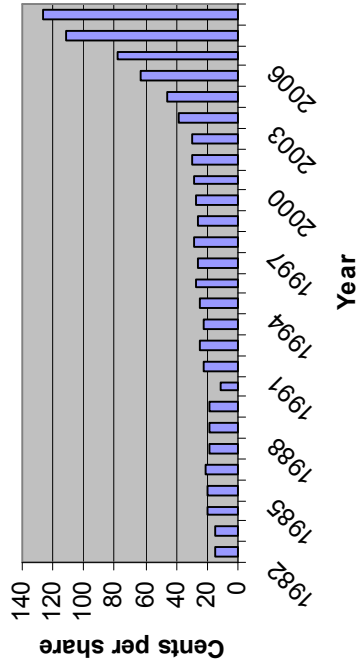




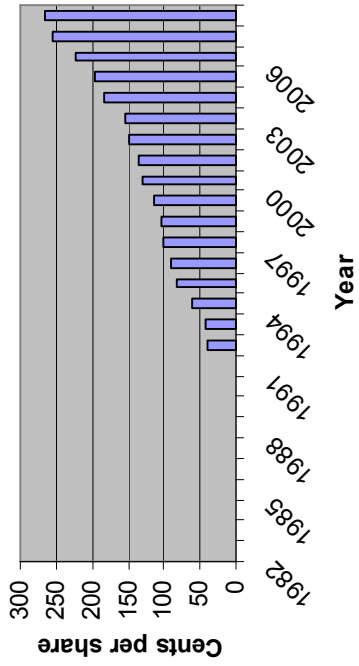
**Graph of Wesfarmers Dividends Paid
(cents per share) Over Time**



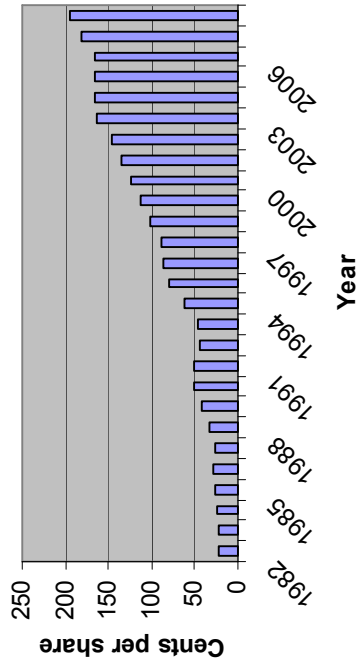
**Graph of QBE Insurance Dividends
Paid (cents per share) Over Time**



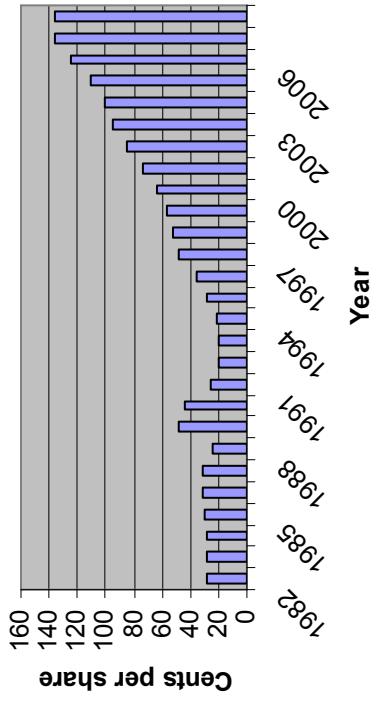
**Graph of Woolworth Dividends Paid
(cents per share) Over Time**



**Graph of National Bank Dividends
Paid (cents per share) Over Time**



Graph of ANZ Dividends Paid (cents per share) Over Time



Graph of CSL Dividends Paid (cents per share) Over Time

