

What Are The *Sources* Of Profit?

By Wilfred Ling



Our contributor shows us how dividends can be more important than capital gain.

Although financial planners advocate buy and hold, in reality we all know that investors often look at the markets' performance and the value of their investment holdings regularly. Some people look at it once a month when they receive their statements while others tend to have a bad habit of looking at their holdings almost everyday. When they look at the value of the investment portfolios, what they hope to see is some price appreciation. Prices of unit trusts and stocks change everyday. So the impact of price movement is important. Yet, there is another component which we do not see. For equities, what is often ignored is the impact of dividends.

Frequently, I encounter people who say that they are not so keen in getting dividends. After all, what is so great about having a dividend yield of 3 per cent when the capital gain can be as large as 10

per cent or more? When I speak to some financial practitioners, I am surprised to learn that many advisers totally ignore the impact of taxes on dividends. They consider the tax to be immaterial because dividends are so little to begin with. In this article, I'll show you that dividends can be more important than capital gain.

There are three sources of profit for equity investments. These are: capital gain, dividends and reinvestment income. Reinvestment income is the result of reinvesting the dividends back to the same investment. Mathematically it is:

Total Profit = Capital Gains (or lost) + Dividends + Reinvestment Income.

For a portfolio, it may not be easy to track what is the exact amount of dividends because of the large number of securities in the portfolio. Fortunately common indices can tell us how much the total dividends and reinvestment income are available. Let's consider the MSCI World Index. This represents a globally diversified stock portfolio representing all of the developed countries.

The MSCI World Gross index represents the performance of the portfolio assuming all dividends are reinvested (at no cost and no tax). For the 30 years period from 28 September 1979 to 30 September 2009, \$1 invested in the MSCI World Gross yielded a total profit of \$17.39 or 10.19 per cent per annum. This is in US dollar.

On the other hand, the MSCI World Price index which represents purely capital gain had an absolute gain of \$7.34 or 7.33 per cent per annum.

Therefore, the difference of \$10.05 (\$17.39- \$7.34) is due to dividends being reinvested back to the index. If you look at the figure, \$10.05 out of the total profit of \$17.39 is 58 per cent! What this means is that dividends were more important than capital gains! To put it another way, by the fact that the return increased by 287 basis points from 7.33 per cent to 10.19 per cent per annum, you actually increase your profit by $\$17.39/\$7.34 - 1 = 137$ per cent! I will come back to this "287 basis points" again later. Just remember this figure first (refer to Table 1 & 2).

In order to have reinvestment income, it is assumed all dividends are reinvested. But this is not possible in real life because of the following:

1. Taxes. If the dividends are taxed, only the remaining balances are available for reinvestment. Some people have found that their dividends have been taxed unnecessarily. For example, if you invest in an ETF which underlying assets are in another country you could be taxed unnecessarily. If you assume that the ETF is listed on the US stock exchange and assuming you are a Singapore tax resident, you will find yourself being taxed at 30 per cent on the ETF dividends by the US government even if the underlying assets' dividends were already taxed. To avoid this, you can invest in a more tax efficient jurisdiction. The idea of investing in a more tax efficient jurisdiction is not to avoid tax payment but to ensure you do not pay more tax than you should.
2. Management fee of the fund manager. If you are investing into a fund, watch out for the management fee. Typically an active managed fund will cost from 1 per cent to 1.5 per cent in annual management fee. Coming back to that extra 287 basis

TABLE 1 - HOW \$1 INVESTED IN THE MSCI WORLD INDEX ON 28 SEPTEMBER 1979 GREW TO \$18.39 AFTER 30 YEARS. RETURNS IN US DOLLAR.

	Absolute dollar		Breakdown of profit
Original principal	\$1		
Capital gain	\$7.34	}	42%
Dividends + reinvestment income	\$10.05		58%
Total money	\$18.39		

TABLE 2 – PERFORMANCE OF MSCI WORLD INDEX OVER 30 YEARS AS AT 30 SEPTEMBER 2009. RETURNS IN US DOLLAR.

	Annualized Return
MSCI World Gross Index (capital gain + dividends reinvested without tax)	10.19% per annum
MSCI World Index (capital gain only)	7.33% per annum
Difference	2.87% or 287 basis points

points I asked you to remember? Well, if the management fee is going to take away 150 basis points, you have lost $150/287 = 52$ per cent of your “extras”! To avoid paying for this hefty fee, you can consider passive managed funds that will charge from 0.5 per cent to 0.75 per cent.

3. Brokerage fee of the brokerage house. I am not referring to the fee which your broker charges you. I am referring to the brokerage fee which is charged to the fund manager of your unit trust whenever a trade is done on the fund level. If you look at the annual report of a typical unit trust, you will find a “turnover ratio” which is typically in the range of 100 per cent to 200 per cent. A 100 per cent turnover, means that in theory the fund manager sold the entire fund and repurchased again. This means there are two sets of transaction – a buy and a sell. A turnover of 200 per cent means that on average the entire fund is being sold and repurchased twice in a year. Assuming a brokerage fee of 0.2 per cent per trade, a 200 per cent turnover translates to approximately $200 \text{ per cent} \times 2 \times 0.2 \text{ per cent} = 0.8 \text{ per cent}$ or 80 basis points of cost being deducted from the fund. To reduce this cost, you may want to consider a low turnover fund such as passive fund or an ETF.
4. Impact cost due to buying and purchasing in an illiquid market. Whenever a fund manager buys in a large volume from the stock exchange, it will “move” the market price up if the security concerned is not liquid. By moving the market, it has a negative impact on the fund. Similarly if a large SELL occurs in an illiquid market, the market price tends to move down. Assuming the movement is 1 per cent and if the turnover of the fund is 200 per cent, the impact to the fund is $1 \text{ per cent} \times 2 \times 200 \text{ per cent} = 4 \text{ per cent}$ or 400 basis points being deducted.
5. Similar to the lack of liquidity and in the absence of a reliable market maker, you will notice that the bid and offer price of a security is never the same. This spread is called the bid-offer spread. The bid-ask spread adds up to the cost of frequent buying and selling of the security. If a bid-ask spread is 1 per cent, we assume the mid-point spread is around half which is 0.5 per cent. So for a turnover of 200 per cent, the impact to the fund is $0.5 \text{ per cent} \times 2 \times 200 \text{ per cent} = 2 \text{ per cent}$ or 200 basis points.

From the above illustration, the management fee, brokerage, impact and bid-ask spread can easily add up to 830 basis points not including the effect of taxes and commissions to your financial adviser (and his advisory management fee) and brokerage fees. In the light of the above, many people would do the following:

1. Invest on their own in stocks to save on fees. However, this

may not solve the problem because brokerage fee, impact cost and bid-ask spread are also the same problems faced by private investors. Moreover, it is well known that many private investors are speculators and face similar high turnover rate. The problem is made worst through margin trading such as the use of contract for difference (CFD) because costs are amplified through leverage. In addition, the time spent in analyzing individual companies will not be insignificant. As the saying goes – time is money.

2. If dividends are so important, does it make sense to invest in high dividend yield securities? If a company gives out high dividends payout, it implies it does not need to retain its earnings because it does not have any good project to invest in. This implies that the company is either a “mature” company or that it has no growth potential. To put it another way, if you are receiving very high dividends from a company, do not expect much capital appreciation. Therefore, high dividend yield play may turn out worst especially if you end up spending it away!

Perhaps at the end of the day the simplest way is to just have a diversified portfolio of passive funds and hold on for a very long term. In this way, you do not suffer from high management fee, high turnover, high impact cost and large bid-offer spread problem. Most importantly there is no fear of a single company collapsing since diversification would have reduced the impact of a single company collapsing. Before anyone jumps on the bandwagon to invest in ETFs, please note that many ETFs issued in recent times have significant counterparty risks. The diversification benefit does not apply to these ETFs as you need to monitor the financial standing of these counterparties closely as what you would do if you are putting all your money into a single company. If in doubt, consult your financial adviser. ■

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