

Colin Nicholson: free newsletter 115

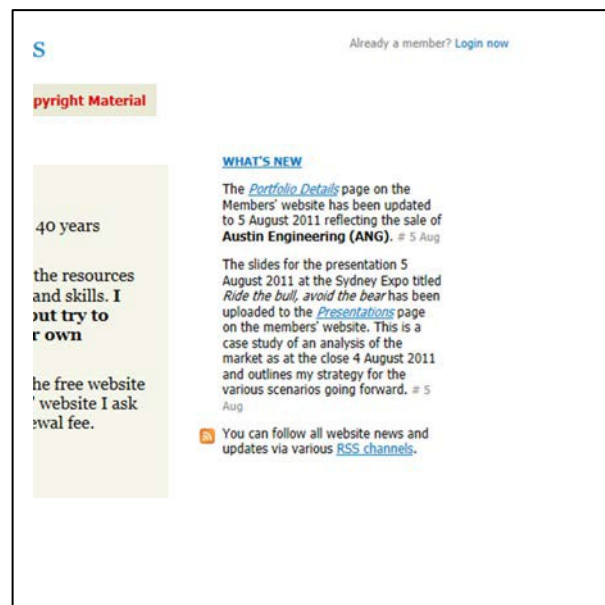
21 October 2011

What's New

At the request of readers, some time ago I created the What's New section at the top right of the home page on my website www.bwts.com.au

Every time I make any addition to the website - in the free section or in the members' section - I post an item on What's New. The last two additions are shown on the home page as pictured at the right. The heading of the What's New section is also a link to the What's New page, where all past additions to the website are listed.

At the bottom of the What's New section is a link for RSS channels. This contains instructions for how to set up an RSS feed so that you are notified every time I make a change to the website. I encourage you to use this facility to keep abreast of new material being posted.



The Importance of Dividend Policy in the Investment Process

By Michael Kemp

In 1938 John Burr Williams put his name on the investment map with the release of his classic book, "The Theory of Investment Value". Whilst not the first to conceptualise it Williams stated that share value is determined by the discounted value of anticipated future dividends. If true then why do we often see high valuations placed on low or non-dividend paying companies?

And if value is determined by dividends why has Warren Buffett, the CEO of Berkshire Hathaway, delivered only one dividend to shareholders during his 46-year stewardship of the American company? And this a period that has seen Berkshire's share price increase 6,000-fold. Alternatively why has the share price of Telstra, one of our best dividend-paying companies, fallen by 70% over the last 12 years?

Clearly there should be more to the sophisticated stock picker's armamentarium than simply chasing dividend yield. Some of the unappreciated issues surrounding dividend policy and its impact on wealth creation will be discussed in this article.

Where Do Returns Come From?

In order to resolve the dividend conundrum let's start by considering the factors which contribute to total stock returns. Most investors would appreciate that total returns are delivered from 2 sources - dividends and capital

gains. But there are interplays between the two that need to be understood in order to make better investment decisions.

Companies typically pay dividends as a partial distribution of company profits. Retained earnings are reflected in the Statement of Financial Position as an increase in shareholders' equity. Hence a lower payout ratio delivers a larger pool of capital for management to invest. If they put this new capital to good use then larger profits will be generated in the future leading to the potential to deliver larger future dividends. This sounds great in theory. But empirical studies have demonstrated that enhanced profit retention doesn't automatically lead to greater profits and dividends down the track.

By way of demonstration Arnott & Asness (*Financial Analyst's Journal* 59:1, 2003) observed a positive linear relationship between higher payout ratios and higher subsequent 10 year real earnings. A later study by Zhou & Ruland (*Financial Analyst's Journal* 62, 2006) came to a similar conclusion.

For higher earnings growth to follow higher rates of payout would seem to be counterintuitive. What might be going on?

Theory Vs Reality

The reality is that dividend policy is more commonly an instrument of wealth distribution than it is an instrument of wealth creation. This subtlety escapes most investors. And because dividend policy has the potential to be influenced by a number of conflicting factors the purist's claim that it should be undertaken in order to "maximize shareholder wealth" often gets pushed into the background. Consider the following:

1. Managements can at times be accused of "Empire Building" at the expense of the shareholders' best interests. Earnings are retained rather than distributed so that a war chest of capital is accumulated for the purpose of targeting potential acquisitions. Ben Graham referred to this as "Personal aggrandizement". But if acquisitions are made at excessive prices the resultant low returns on capital will see destruction of shareholder wealth.
2. Also influencing dividend policy is managements' aversion to reducing the dividend when profits are lower. Their fear is that a dividend reduction would send out a negative signal to the market in relation to the company's recent performance and future prospects. Therefore, in order to keep the dividend steady, there is a tendency to increase the payout ratio when profit is down. This typically happens at low points in the economic cycle. And as the economy recovers so too do company profits. Under this scenario profit growth follows a period when there has been a high payout, not low.
3. If management cannot invest retained earnings at a rate of return superior to what shareholders could likely achieve themselves then a full distribution of profits is in the shareholders' best interests. Thus a company paying a high dividend might not be indicative of a successful enterprise. Rather it might reflect a management faced with no suitable options for the investment of new capital.
4. There are times when it is in the shareholders' best interests for no dividend to be paid. If management has the capacity to invest new capital at rates of return higher than the investor's required rate of return then wealth will be created by retaining profits within the company. This is the principal reason why Buffett has chosen for Berkshire not to pay a dividend.

5. The potential for further distortion of dividend policy lies in the use of options as a form of management compensation. If management hold call options and/or have their compensation linked to an increase in the company's share price there will be an incentive for them to retain earnings rather than pay them out as dividends. This might run counter to the best interests of shareholders particularly if the retained profits are invested at low rates of return.

6. Net Profit after Tax, as reported in the financial accounts, is often not a true reflection of what shareholders earn over an accounting period. Despite this it is broadly used in both valuation formulae and value-based ratio analysis. Indeed most valuation articles and texts actively promote it as the figure to use. But a more appropriate measure of profit is that which remains after deducting the expenditures necessary to maintain the company's competitive position and its economic output. The accounts don't provide this figure hence the investor or analyst needs to calculate it. By way of example consider depreciation expense. Rather than reflecting the capital expenditure necessary to maintain the company's economic and competitive integrity it is a figure defined by accounting principles. The depreciation expense is calculated by applying a defined depreciation rate to capital equipment which is recorded at historical cost. This will usually understate the cost of its replacement hence accounting profit will overstate the real profit due to the owners. In an extreme example a company could be going backwards in an economic sense yet still report an accounting profit. To this end don't consider a dividend in terms of the reported net profit after tax. Rather consider it in terms of what the company can afford to pay whilst maintaining its economic and competitive integrity.

Tax Considerations

Fortunately the impost of double taxation on company earnings was removed in 1987 by the Hawke/Keating government. Dividend imputation is not enjoyed universally and this is one of the reasons why lower payout rates are observed in a number of other countries.

Australian retirees enjoy 2 additional benefits – both the reimbursement of tax paid at the company level and the exemption of Capital Gains Tax. It is interesting then to hear many retirees voice their preference for dividends as a source of income. But since neither earnings nor capital gains are taxed in their hands retirees should be indifferent, from a tax perspective, as to which they receive. If profits are retained and reinvested by a management capable of achieving high incremental rates of return on equity then the returns from capital gain potentially outweigh those from dividend distribution.

Countering this argument is that of market volatility. Retirees are loath to sell shares when equity markets are depressed. This might explain their preference for dividends as a source of income. But as long as a significant buffer of cash is maintained their preference for dividend income should be reduced since they now have greater discretion in the timing of sales.

Spotting High Yield Companies

Selecting a portfolio of shares based on dividend yield alone has been shown to be a useful "Scatter gun" approach to investing. One investment technique that uses this approach is "The Dogs of the Dow" (see ASX Update February 2011). These broad dividend strategies work because stock returns are based not on earnings growth alone but on growth relative to expectations. Investor pessimism results in a low market valuation which in turn results in a higher dividend yield. Thus investors are offered the potential for an enhanced capital gain as well as a high dividend payment during the time they hold the shares.

But the sophisticated stock picker should look beyond a selection process based solely on dividend yield. And in the search for companies capable of delivering a strong, reliable and growing dividend look for companies which demonstrate:

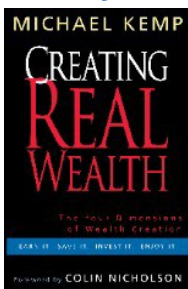
- Strong underlying business fundamentals.
- Low debt and good business prospects.
- Control over the price of the products and services they provide.
- A history of double digit earnings per share growth.
- Consistently high returns on equity (>15%)
- A dividend policy that is consistent with the company's underlying earnings.
- Growing book value.

And avoid companies which:

- Borrow to pay dividends.
- Have large and ongoing requirements for new capital simply to maintain their economic viability.

And remember there are many excellent companies which don't pay high dividends. But just make sure that management continues to invest retained earnings at high incremental rates of return.

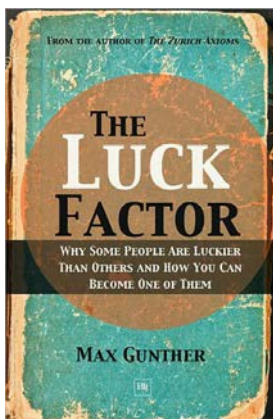
More of Michael Kemp



If you enjoy the insights that Michael Kemp brings to investing, I would recommend his book *Creating Real Wealth* that may be purchased from my website: [click here](#)

This hardback book is very easy to read. It is one of the best explanations of the role of investing in our lives that I have had the privilege of reading. I thought so highly of it that I wrote a foreword for it and have given it to all my own adult children and grandchildren.

Book review: The Luck Factor by Max Gunther



One of the books that I learned a great deal from many years ago when I was first learning investment was a book called *The Zurich Axioms* by Max Gunther. I still reread this book from time to time to refresh myself with the insights into investing in this book. Interestingly, the copy that I own does not list any other books by Max Gunther and for years I assumed that was the only book that he had written. However, one day I made a search and found some of the other books that he had written. Among them was a book called *The Luck Factor*. As it happened, I was at that time reading a book called *Little Bets* which mentioned another book called *The Luck Factor* by Richard Wiseman. The latter is a recent book but Max Gunther's book had been written in 1970s and I thought it would be interesting to read it.

The Luck Factor is an easy to read book that is actually in four parts:

The first part is a general introduction to the book and gives a broad definition of luck: events that influence our

life and are seemingly beyond our control.

The second part deals with Speculations on the Nature of Luck: Some Scientific Tries, specifically The Randomness Theory, The Psychic Theories and The Synchronicity Theory.

The third part deals with Speculations on the Nature of Luck: Some Cult and Mystical Tries, specifically Numbers, Destiny and God, and Charms, Signs and Portents.

The second and third parts of the book make very interesting reading. Max Gunther explains each of the tries in a way that is sympathetic to its believers and each is illustrated with many personal anecdotes about people he has come in contact with over the years in his search to understand luck.

The fourth part is called the Luck Adjustment and deals primarily with what he calls the five components of the Luck Adjustment. This was by far the most interesting part of the book for me because, in it, Max Gunther distils everything he has learned about what makes some people lucky and other people unlucky under five headings:

- The Spiderweb Structure
- The Hunching Skill
- Audentes Fortuna Juvat
- The Ratchet Effect
- The Pessimism Paradox

I was surprised to find, as I read these last five chapters, just how applicable most of them are to investing and speculating (trading). Here is a brief description of the key ideas:

The Spiderweb Structure

The basic idea here is that the luckiest men and women tend to be those of us who, over our lifetime, have formed many friendly contacts with other people. At the time that we form a contact with other people we will generally have no idea where that will lead. However, if we did, it would of course not be luck when some good fortune emerged from that contact. Luck occurs when something good happens to us as a result of us having made many contacts over our lifetime and one of those contacts is the conduit through which luck finds its way to us.

The Hunching Skill

A hunch is a feeling that we have from time to time that might seem to us a bit like knowledge, but which we feel nevertheless is something that we should not trust as we would with a confirmed fact. What Max Gunther found was that lucky people have a tendency to trust their hunches whereas unlucky people rarely do so. However, it is not all that simple. Not any hunch will do. What lucky people seem to have is an ability to formulate accurate hunches. Even more important, they have great faith in their hunches and act on them, as more timid and unlucky people would not.

What I found even more interesting was Max Gunther's observation that the ability to generate sound hunches was a skill that can be learned. In order to do this there are three rules:

The first rule: Learn to assess the database. One of the key ideas about a hunch is that we don't really know what our feeling is based on. However, it will be based in some way upon the knowledge we have about the

general area covered by the hunch. What we can do is to ask ourselves whether we may have, at some time, collected those facts and whether they are likely to be reliable. However, there are two problems to be avoided which Max Gunther lists as corollaries:

Corollary one: never trust a hunch about someone we have just met.

Corollary two: never regard our hunch is a way of avoiding the hard work in researching the situation.

The second rule: Never confuse a hunch with hope This rule concerns a situation in which a hunch is something that you want very badly to believe to be true. These hunches should never be acted upon without further research.

The third rule: Make room for hunches to grow. The idea here is that we must learn to trust our hunch is by listening to our feelings, respecting them and considering them carefully. Max Gunther regards this as the most important of the three rules. This rule also has to corollaries:

Corollary one: Don't smother a hunch by over analysing it. Instead we must learn to focus on how we feel about the situation. As you think about your hunch ask more and more questions of yourself about how and why you feel the way you do rather than trying to analyse the situation only in a strictly logical way.

Corollary two: Collect soft facts along with hard. What Max Gunther means hereby soft facts are feelings or impressions that we have about the situation. Those of us who habitually confine our analysis to hard facts are at the opposite pole in dealing with hunches.

Audentes Fortuna Juvat

This is a Latin aphorism meaning *fortune favours the bold*. What Max Gunther found in this area is that as a general rule lucky people tend to exhibit boldness. On the other hand the least lucky people tend to be the most timid ones. He offers some rules to how to develop the required degree of boldness:

The First Rule: Be always ready to examine and embrace lucky opportunities when we find them.

The Second Rule: Know when we are being bold and when we are simply acting rashly.

The Third Rule: Don't insist on having complete advance knowledge of any situation we are about to enter. It is rare that we can have all the facts. When all the facts are obvious it is usual that we have already missed the opportunity.

The Ratchet Effect

Max Gunther describes a ratchet is a device that preserves gains. What he means here is that it allows us to move forward boldly, but without slipping back so far that we are wiped out financially. Investors and speculators will recognise this is what they call money management or the disciplined exercise of stop losses. In other words we act on our hunches, but as soon as the situation seems to go wrong we quickly get out before the losses grow out of control. This implies a zigzag process where we undertake a series of risks quickly cutting our losses in those that do not work out while we wait for the few that we allow to build into huge successes. Max Gunther sees two obstacles that unlucky people never overcome, but which lucky people have moved beyond:

The first obstacle: It's too hard to say "I was wrong". In explaining this Max Gunther refers to the characteristic commonly exhibited by born losers: an overwhelming need to prove their own brilliance. The born losers will persist with a losing situation far beyond what is reasonable. Lucky people will have jumped out of the situation as soon as they perceived that it was not working out.

The second obstacle: It's too hard to abandon an investment. In this respect Max Gunther sees an investment as consisting of money, love, time, effort, commitment, or a combination of any of those. These investments become defined in our mind as being part of us and we tried desperately to protect them.

Max Gunther goes to some lengths here to emphasise to us that the ratchet effect does not imply that the lucky people are fickle or capricious. They do not seek to change for the sake of change itself or because they have become bored with the situation. As far as luck is concerned Max Gunther finds that only two useful reasons for making a change

A clearly defined piece of good luck has turned up and we see it boldly.

The situation has gone wrong or has met with bad luck.

The way the ratchet works is that lucky people enter attractive ventures that might have otherwise scared them away, but their potential losses are limited by their ability to cut and run when bad luck intervenes. At the same time their potential gains are unlimited.

The pessimism paradox

This is an intriguing idea. We are properly brought up to believe that lucky people are those who are optimistic. We attach pessimism as a label to those who are lucky and never see opportunities. However, Max Gunther puts it to us that the truly lucky people tend to be pessimists. As an example he evidences a commodity speculator whose mantra was: "Out of every four trades I'll lose money on three of them". He believes that the use of pessimism by lucky people is associated with two Cardinal Law's, which interlock rather than being exercised on their own:

Murphy's Law: "If something can go wrong it will." It is easy to see how this ties into the ratchet.

Mitchell's Law: "Life is slippery like a piece of soap. If you think you have a good grip on it, you are wrong."

Again, this is a fundamental way of thinking that ties back to Murphy's Law and the ratchet.

The way Max Gunther puts these together is "Murphy's Law counsels us not to depend too much on luck, for things are as likely to go wrong as right. Mitchell's law counsels us not to depend too much on our own control over events, for that control is less good than we sometimes like to think. Both laws say: never enter a situation without knowing what she will do when it goes wrong."

Interestingly Max Gunther sees these two pessimistic laws as having an optimistic corollary: "If something goes right don't argue, or to put it another way: when good luck pulls you sideways, let go."

Conclusion

I found *The Luck Factor* to be a valuable discussion of the idea of luck and how we can use it to better succeed in our lives. To fully understand Max Gunther's ideas the review above is no more than a sketch map. I would

recommend that readers who find this subject interesting may be well rewarded by reading the book in its entirety. To my knowledge it is available in Australia. I had no trouble finding it on Amazon.

Adobe Reader needs updating

Old versions of software that are no longer supported by the author are a security risk. Adobe Reader is free software used to read documents on my website and many other sources. It takes only a few minutes to upgrade. Go to www.adobe.com to find the latest version of Adobe Reader.

If you're still using Adobe Reader 8 (or even earlier versions), be forewarned that Adobe will no longer support these versions after November 3, 2011. Check the version you have and upgrade if it is not either Version 9 or Version 10 (also known as version X).

You may email this PDF file unaltered in any way to friends and invite them to join the list by going to the [Resources/Newsletter Archive](#) page on www.bwts.com.au and clicking on the relevant link. Please seek my permission to publish all or part of this PDF file in any other way. This document does not purport to be advice of any kind to any reader. It is intended as a tool for teaching investment through practical examples and using as a basis my investment plan as set out in *Building Wealth in the Stock Market*. This document has been prepared without knowledge of or regard to the financial plans of any other person. Readers should consult licensed financial, legal and taxation advisers before acting on anything in this document. I am not a licensed adviser.