CAPITAL GROWTH, COMPOUNDING RETURNS

The long-term case for shares

Don't be put off investing in the sharemarket by short-term volatility, **Mark Story** writes

Whether you're more interested in capital growth or income, it's critical that you aren't scared off buying listed shares because you are afraid of short-term volatility.

Even the most conservative investors, including retirees with little or no appetite for risk, would be better off with some exposure to shares to offset the times when bank rates struggle to outperform inflation and they end up losing money.

Listed shares, which provide investors with a financial stake in a company, offer investors greater flexibility and liquidity than other assets, especially property or bonds.

Equally important, the cost of buying shares is low and the capital requirement is minimal.

Investors can buy a parcel of shares with as little as $500, then turn their shares back into cash by selling them on the Australian Securities Exchange.

The single-best reason for investing in the sharemarket is the potential for your capital to grow, combined with the power of compounding returns.

An investment earning 10 per cent annually doubles every 7.2 years. Assuming an investor saves $50 a week and invests it in the sharemarket each time $1000 is accumulated and the shares earn 9 per cent, in 30 years that investor would have amassed $442,000 by investing $78,000.

And, yes it is true that long-term returns this century are unlikely to match those in the last.

However, assuming long-term annualised returns of a more modest 7 per cent, investors will still double their money every 10 years.

This explains why 55 per cent of adult Australians, eight million people, own listed shares, either directly or through managed funds and superannuation.

Despite the innately volatile nature of sharemarkets, research by Goldman Sachs reveals that they repeatedly outperform other key asset classes over the long-term.

For example, listed Australian shares delivered average returns of 10.93 per cent from 1995 to 2012. Cash and fixed interest delivered 5.63 per cent and 7.88 per cent, respectively.

Different asset classes perform better at different times, depending on market conditions and economic cycles.

However, the so-called average return reveals that listed Australian shares returned nearly double what cash did over the past 18 years.

Interestingly, the Goldman Sachs figures also show that cash has never been the top performing asset class over the same time frame.

There are shorter periods when cash and bonds have outperformed shares. But over the longer haul, history shows that shares have delivered better returns, especially when tax benefits are factored in.

Adding to an investor's after-tax position are dividend imputations, another tax benefit exclusive to shares.

Assuming a listed company has already paid tax on its profits, shareholders will receive a tax credit up to the corporate rate when these profits are distributed to shareholders.

However, there may be a shortfall if an investor's personal tax rate is higher.

Like all asset classes, investing in the sharemarket isn't without risks. According to the world's most successful investor, Warren Buffett, a company's share price should eventually reflect the intrinsic value of the underlying business.

That's fantastic when the fundamentals of the company are good, but when good businesses decline — because of market conditions, regulatory issues or poor management — a falling price can leave shareholders seriously out of the money.

Similarly, if a company fails owners of ordinary shares are usually last in line and chances of getting money back are remote.

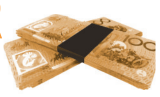
Because past performance is no guarantee of future returns, the Australian Investors Association urges investors to seek professional advice before buying.

Bank momentum may have maxed

AUSTRALIAN BANKS

	ANZ	CBA	NAB	WBC
Price $	32.30	78.13	34.38	33.02
Market capitalisation $m	88,623	125,725	80,532	102,485
Cash earnings FY13 $m	6498	7819	5936	7097
EPS cps FY13	239	486	253	229
DPS cps FY13	164	364	190	194
Payout ratio %	68.8	74.9	75.1	84.8
Net yield %	5.1	4.7	5.5	5.9
Franking %	100	100	100	100
Gross yield %	7.3	6.7	7.9	8.4

YIELD HUNTER



■ Greg Fraser

Now that the 2013 results of the four major retail banks are out and dividends declared, what should investors do, if anything?

Despite the well understood low credit-growth environment, the banks pulled other levers to generate excellent profit growth.

That, with strong capital, gave them scope to consider bigger dividends for shareholders.

And then, they paid them. Payout ratios were also tweaked up to accommodate optimal payments to shareholders.

Almost any bank shareholder would admit actual income stream and annual growth have been nothing short of terrific.

However, analysts are concerned this momentum must wane as the credit cycle turns.

High on the list of worries is the inevitable upturn in bad and doubtful debts that will inevitably weigh on future profit growth.

While the Reserve Bank has cut official interest rates to historically low levels, as economic activity becomes more robust rates must eventually lift.

That doesn't mean the dividend deluge is over but investors should be aware of a few developments. As the US economy drags itself off the floor and the Federal Reserve eventually tapers its unprecedented largesse, investors are likely to retreat from equities and perhaps financial stocks in particular.

For sturdier investors, it may be an opportunity to buy more Aussie bank shares at slightly better prices. In April, when US Fed chairman Ben Bernanke first mentioned tapering, Australian bank shares fell about 10 per cent in a month.

As the mining capital expenditure boom has passed its peak, some miners are beginning to generate enormous amounts of free cash flow that could be paid out as dividends.

Woodside Petroleum has significantly increased its payout ratio so that its gross dividend yield rivals that of the average bank stock at about 7 per cent.

Other resource companies could emulate this trend with Fortescue Metals Group and Santos potential sources of big dividends in the near future.

BHP Billiton and Rio Tinto are doggedly sticking to their progressive dividend policies, preferring to buy back large chunks of stock as an alternative means of delivering shareholder returns.

Investors will eventually have a wider pool from which to choose as more resource companies gain a reputation as income stocks.

It also gives investors an opportunity to selectively reduce exposure to bank stocks, which most analysts agree are fundamentally expensive.

Ultimately, any action depends on individual circumstances.

However, as long as the dividend flow from the four retail banks continues to gush almost $21 billion a year, investors will understandably clamp themselves to the fountain.

■ Greg Fraser is head of research at Kimber Capital

Check your past before you leap

DIY super

■ Monica Rule

With more than half a million self-managed superannuation funds in Australia, SMSFs have become the new must-have accessory.

It seems everyone wants to have one for the social recognition it brings to their financial status.

Fly-in, fly-out workers with large disposable incomes are becoming especially interested in exploring the benefits a SMSF may bring.

But perhaps we shouldn't get ahead of ourselves.

What people don't realise is they may not be able to set up a SMSF.

A SMSF can be established either under a corporate trustee structure or an individual trustees' structure.

Under a corporate trustee structure, a company needs to be established and appointed to act as the corporate trustee and all members of the SMSF must be directors of that company.

Under an individual trustees' structure, all members of the SMSF must be appointed as trustees of the SMSF.

Before establishing a SMSF, a person needs to first recall their past and honestly assess their current financial status to determine whether they can act as either an individual trustee or a director of a corporate trustee of their SMSF.

Any adult can be a trustee of a SMSF unless they are a "disqualified person".

Under the superannuation law, a person is a disqualified person if they have been convicted of an offence involving dishonesty or if they are an undischarged bankrupt.

A person is also a disqualified person if they have been convicted of an offence under the super law or have been disqualified as a trustee by the Australian Taxation Office.

If a person is a director of a company, then their company cannot act as a corporate trustee if the person is a disqualified person or if a receiver, an administrator or a provisional liquidator has been appointed to manage the company or action has started to wind up the company.

A friend recently approached me because she wanted to establish a SMSF with her husband.

But she had a problem. She was convicted of a minor stealing offence when she was 19, some 20 years ago. She wanted to know what she could do as she was pretty embarrassed by her past indiscretion and she didn't want her husband to know.

Luckily for her, there is a provision in the super law that allows her to apply to the tax office for a waiver of her disqualification status provided the offence that she was convicted of was not an offence involving serious dishonest conduct.

Under the super law an offence involves serious dishonest conduct if the penalty imposed by the court on conviction is at least two years imprisonment or a fine of at least $20,400.

If a person is an undischarged bankrupt, they cannot act as a trustee of their SMSF.

Also, if a person becomes bankrupt after establishing their SMSF and fails to notify the tax office of their disqualification and continues to act as a trustee, they could be fined up to $10,200 or face prison for up to two years.

If a person becomes a disqualified person, they need to remove themselves from their SMSF by rolling their super savings over to a retail super fund.

In some situations a person is allowed to appoint a legal personal representative to act on their behalf as trustee of their SMSF but a disqualified person cannot appoint a legal personal representative to act on their behalf as a trustee or a director of a corporate trustee.

It's best to check whether you have any skeletons in your closet before you set up a SMSF.

■ Monica Rule worked for the Australian Taxation Office for 28 years and is the author of The Self Managed Super Handbook — Superannuation Law for Self Managed Superannuation Funds in plain English. www.sunshinepress.com.au