Dividend imputation must be retained

Submission in response to the FSI from Fidelity Worldwide Investment

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Fidelity™ WORLDWIDE INVESTMENT

Our argument

While policy makers will view the dividend-imputation regime ("franking") through many lenses, from an investor's point of view franking's most important effect is how it promotes what can be called "**scrutinised reinvestment**" which in turn results in better management of corporate capital, hence better economy-wide outcomes.

- Franking creates a strong economic incentive for companies to pay out more of their earnings as dividends, which reduces the extent to which they can reinvest without seeking external investor funding.
- Because major reinvestment decisions must be mediated by external capital providers (equity and debt investors) – rather than internalised by management teams – the aggregate Australian investment dollar is allocated more effectively across the aggregate opportunity set.

This model of "scrutinised reinvestment" delivers profound benefits to an economy.

- Directing investment to only the most-promising opportunities company by company, year after year, means that projects with more dubious prospects are overlooked in favour of better opportunities. This **"high-grading" of reinvestment** results in better industry returns (i.e. profitability relative to assets invested) and a lower variance of returns.
- We speculate that it is this positive dynamic of "scrutinised reinvestment" that drives the surprising observations from research (Appendix 1) that companies with higher dividend payouts on average achieve stronger, not weaker, future earnings growth and that higher dividend-yielding stock markets deliver higher total returns. **Higher yield does not mean lower growth.**
- Since the local stock market is then populated by companies with higher payouts, higher yields, higher returns and better governance it retains a greater share of the retirement savings of local investors and draws in funding from international investors. This in turn lowers the cost of capital to local companies – which is an economy-wide benefit – and supports a vibrant financial services industry.

Since the introduction of franking, Australia's experience relative to other markets with different reinvestment policy settings (Appendix 2) has played out as this logic would suggest:

- Higher dividend payouts but with no significant decrease in asset growth or increase in debt funding
- Higher returns with lower variance of returns and higher persistence of high returns. **We estimate the value of this improvement to be approximately A$453.2 billion to date** though of course only a portion of this can be attributed to the franking regime.[1]
- Strong (and justified) "home-market bias", and low cost of capital.

Abandoning franking and reverting back to a policy setting of "internalised reinvestment" would, over time, unwind these benefits. Expected outcomes would include: lower company returns, greater economic volatility, a less resilient corporate tax base, less relative investment appeal to local and international investors, a higher cost of capital and a weaker financial services sector. We struggle to identify any set of benefits that could more than offset this significant cost.

Appendices

1. What the academic literature suggests

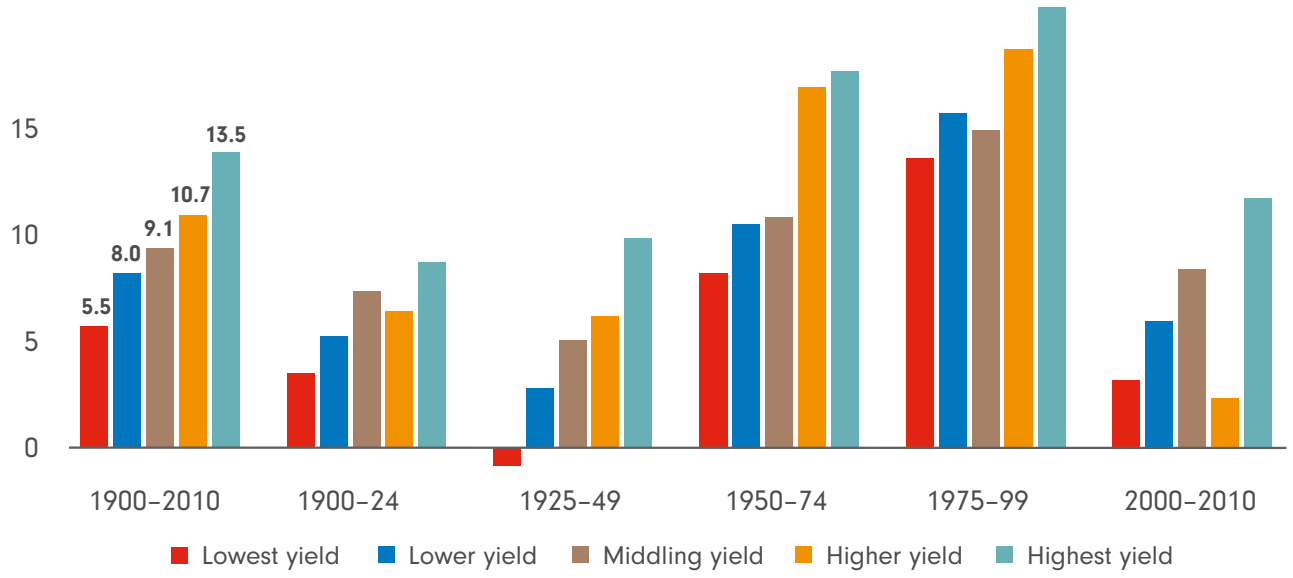
Conventional wisdom holds that companies retain more earnings when growth opportunities are ample and fruitful, therefore paying out larger dividends signals a paucity of good growth opportunities. However, academic analysis challenges this view. Arnott and Asness (2003)[2] used 130 years' worth of data to show that it is **high-payout firms which generate the best earnings growth over time**.

The work of Zhou and Ruland (2006)[3] supported Arnott and Asness' conclusion. By using data over 50 years, their paper showed that high-dividend-payout companies tend to experience "strong, not weak, future earnings growth".

Conventional wisdom also assumes that high-dividend stocks offer low-growth potential. The perception is that companies that return much of their earnings to shareholders have less to invest than companies that retain their profits. But again this is not supported by the data: **over time high-yielding stock markets have offered the highest total shareholder returns**. Analysis by the London Business School shows that the highest-yielding stock markets returned 13.5% p.a. from 1900 to 2010 versus 5.5% p.a. from the lowest-yielding markets. As Chart 1 shows, the highest-yielding markets were the top performers over every consecutive quarter-century period last century and over the first decade of the 21st century.

Chart 1: Returns of highest- to lowest-yielding stock markets since 1900 (%)

Best returns from high dividend yield markets[4]



2. What the Australian experience to date suggests

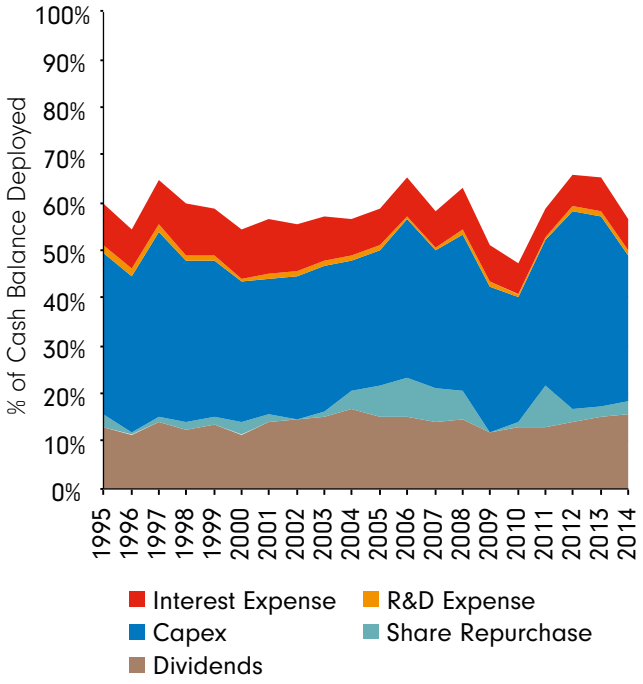
We commissioned Credit Suisse's HOLT team to review the data to see if experience to date supports our view. We chose Credit Suisse because its HOLT methodology is extremely rigorous and adjusts for most of the distortions that can arise due to differences in regional accounting practices. Fortunately, the HOLT dataset is also long term, geographically extensive and robust. Where relevant, we excluded the metals and mining and information-technology sectors as a simple way to insulate the data from the impacts of the recent commodity and "dot com" booms ("AUS Adj" and "US Adj").

We looked at outcomes both before and after franking, using the time periods of 1982-1987 and 1988-2014. On every parameter we examined, the outcomes were as expected. We do not claim that this analysis has the rigour of a proper econometric study – nevertheless the outcomes are highly suggestive.

First we looked at companies' **overall use of cash**. Despite higher payouts (and higher interest expense) Australian companies do not spend less on capex. There is no evidence that higher payouts have led to lower levels of investment.

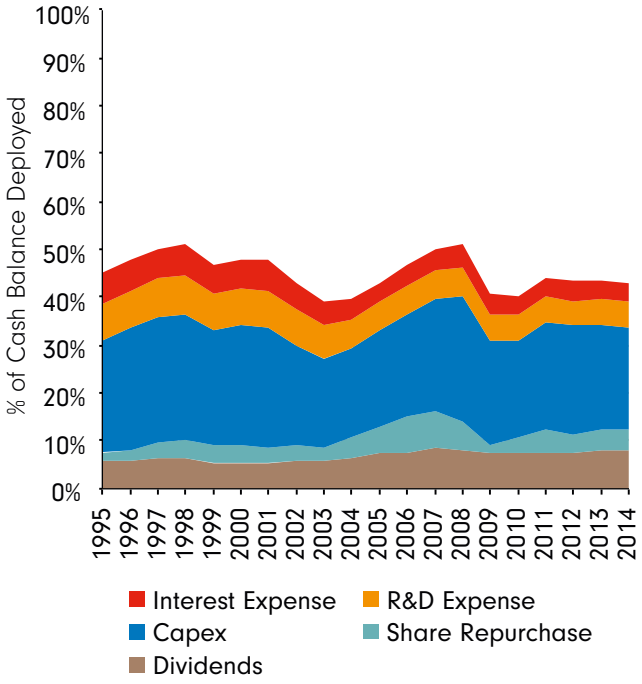
Australia[5]

Cash redeployed (% of balance sheet cash)

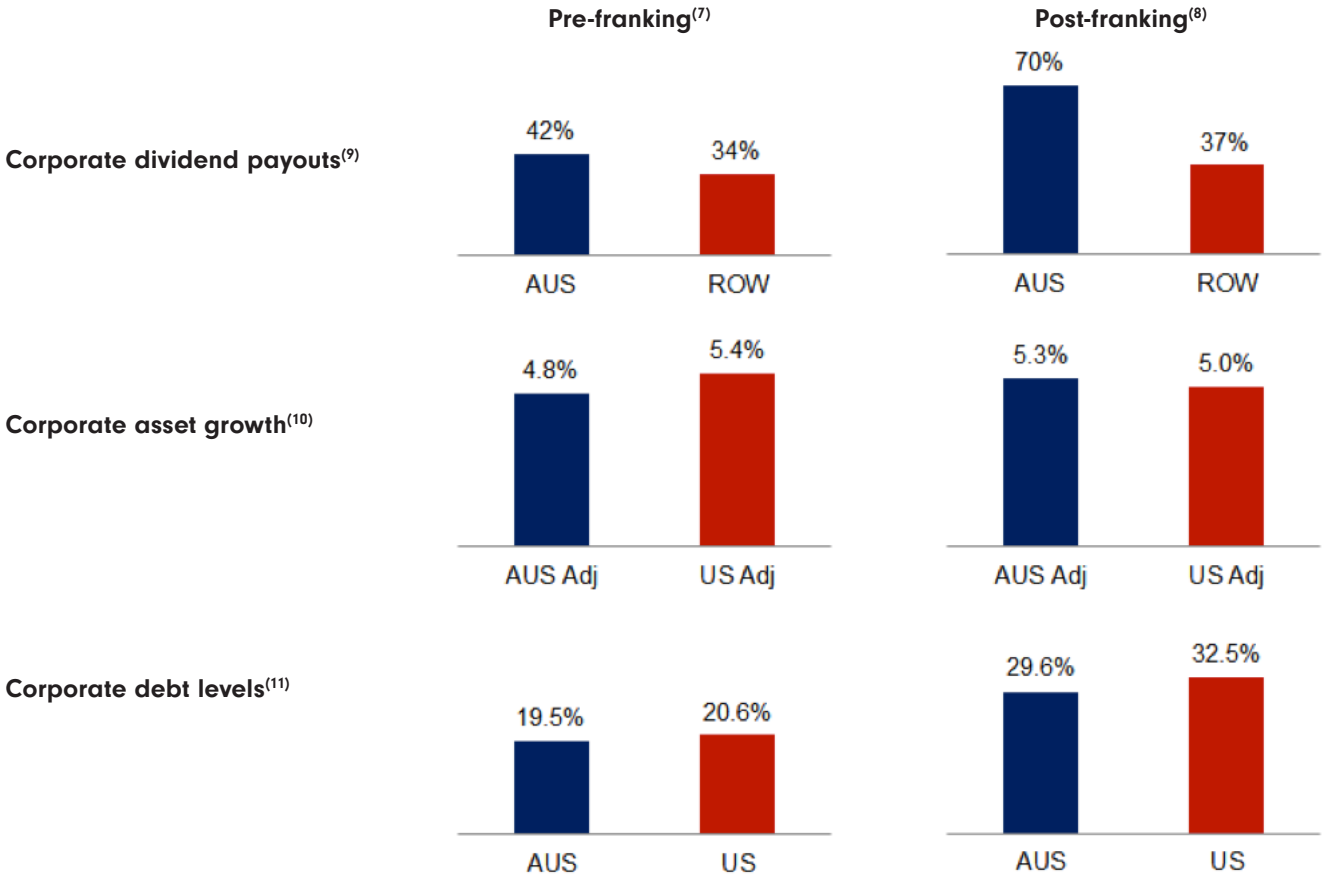


US[6]

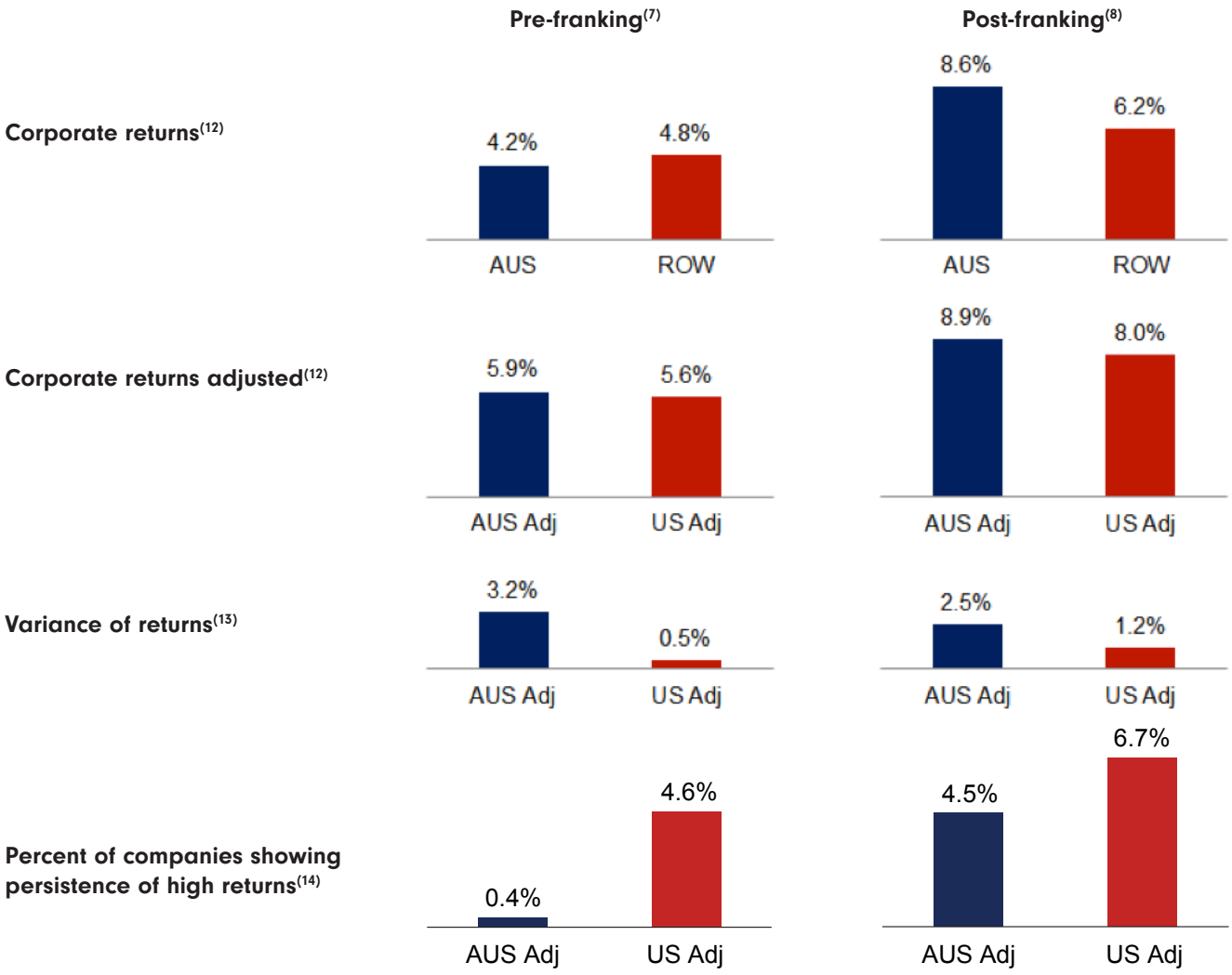
Cash redeployed (% of balance sheet cash)



We looked at changes to the **corporate incentive structure**. We found that payout levels have increased, but that this has not been at the expense of asset growth and has not necessitated significantly higher gearing levels relative to other economies:

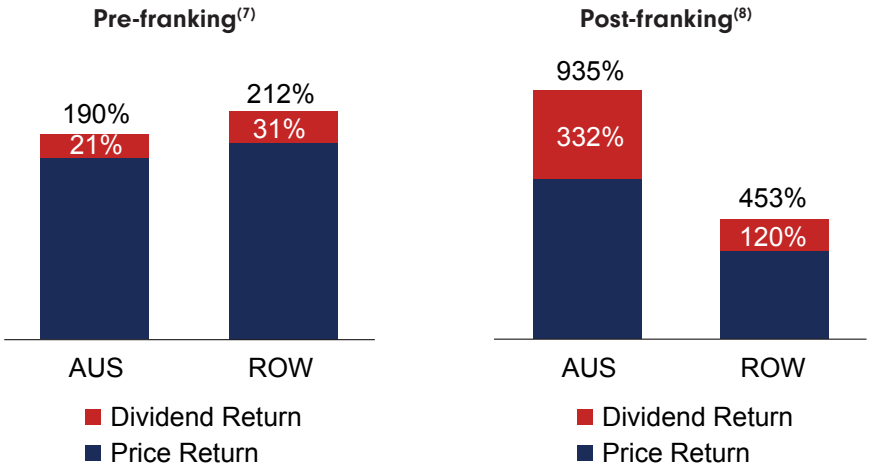


We examined **corporate financial outcomes** and found that returns in Australia have improved more than has been seen in the US, while the variance of returns has decreased, and the persistence of high returns has improved.

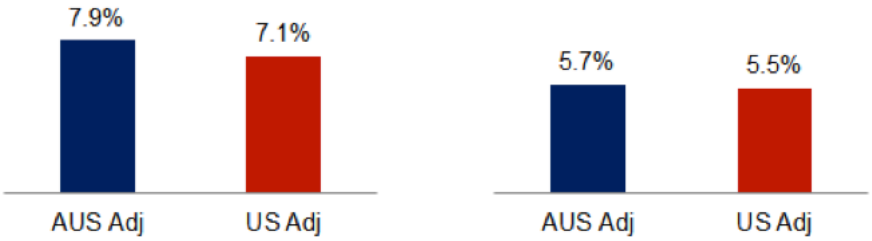


In terms of **share market outcomes** we again saw our expectations confirmed in that Australia's higher dividend return has not been at the expense of price return. Since the introduction of franking, the cost of capital of Australian companies has improved more than for similar companies in the US.

Shareholder returns[15]



Cost of capital[16]



3. Notes and sources

1	Value added	Cumulative economic profit generated over the stated time period. Economic profit is calculated as the economic return ("CFROI®") less the real cost of capital multiplied by Australia's aggregate gross investment (listed asset base).	CS HOLT
2	Robert D. Arnott and Clifford S. Asness "Surprise! Higher dividends = higher earnings growth." Financial Analysts Journal, Volume 59, Number 1. 2003		
3	Ping Zhou, CFA, and William Ruland. "Dividend payout and future earnings growth." Financial Analysts Journal. Volume 62. Number 3. 2006.		
4	Elroy Dimson, Paul Marsh and Mike Staunton, London Business School, 2011		
5	Cash deployed	Calculated as each Australian outflow item (e.g., interest expense, capex, dividend) divided by total Australian cash available for reinvestment (cash and investments) Universe – Australian Top 250 Industrial Firms	CS HOLT
6	Cash deployed	Calculated as each US outflow item (e.g., interest expense, capex, dividend) divided by total US cash available for reinvestment (cash and investments) Universe – US Top 1500 Industrial Firms	CS HOLT
7	Pre-franking	1982-1987	
8	Post-franking	1988-2014	
9	Corporate dividend payouts	Aggregate dividends paid divided by aggregate net income for each country/region	CS HOLT
10	Corporate asset growth	Calculated as the average annual growth in each country/regions inflation adjusted gross investments (i.e., HOLT assets which includes inflation adjusted book assets plus capitalised assets such as operating leases and R&D)	CS HOLT
11	Corporate debt funding	Calculated as HOLT Debt (book debt plus HOLT capitalised debt items such as lease liabilities) divided by inflation adjusted gross investments.	CS HOLT
12	Corporate returns	CFROI (Cash Flow Return on Investment) is an estimate of the average real internal rate of return, earned by a firm on the portfolio of projects that constitute its operating assets. A firm's CFROI can be directly compared against its real cost of capital (the investors' real discount rate) to establish whether a firm is creating (or destroying) economic wealth. Importantly, CFROI values are also directly comparable across time, industries and countries. Key adjustments in the CFROI calculation include capitalising off balance sheet items (e.g., operating leases, pensions); capitalising research and development, adding back all non-cash items; accounting for inflation and determining a company asset life (which assists with determining how much cash flow will be earned over a realistic time period).	CS HOLT
13	Variance of returns	Median CFROI variance over the stated period.	CS HOLT

14	Persistence of high positive returns	HOLT's "eCAP" measure stands for "Empirical Competitive Advantage Period" and is for firms that display unusually persistent CFROI. Competition tends to push CFROI towards the long-term average, which HOLT has empirically shown is 6.0%, but some firms display above-average CFROI persistence and are awarded eCAP status. With a greater level of stability in CFROI, HOLT projects a "fade" in these eCAP firms at a slower rate than non eCAP firms.	CS HOLT
15	Shareholder returns	Price returns are the index returns when available, prior to index existence market cap weighted returns of initial constituent returns are used. Dividend yields are weighted by market capitalisation. Universe used are the ASX 200 and the MSCI World Ex Australia.	Jefferies
16	Cost of capital	HOLT's market derived discount rate which is a weighted average cost of capital. This cost of capital is a function of market observed equity and debt values and projected cash flows.	CS HOLT

For further information

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