| DIVIDEND INCOME |

The importance of dividends

They also provide investors with a way to assess a company as an investment

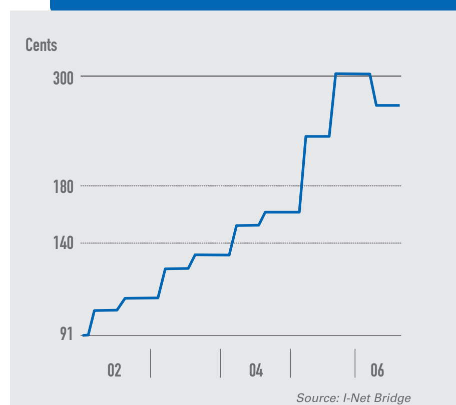
THERE ARE THREE STANDARD reasons for investing in shares: capital growth or income or both. Shares can generate an income stream through dividend payments. In essence, dividends are distributions of a portion of a company's earnings to its shareholders.

Richard Seddon, head of Online Share Trading at Standard Bank, says that dividends enable companies to distribute profits to shareholders. That's an income stream that can be compared to interest on a money market deposit, though it has higher risk, as the dividend isn't certain.

Companies don't have to pay dividends and may choose not to if management believes the cash can be better spent to expand the company or repay debt, although this policy is not often changed. The board is responsible for declaring the dividend and setting dividend policy.

A dividend policy is usually expressed as a dividend "covered" a certain number of times by earnings – say, three times. In other words: the earnings per share will be three times more than the dividend per share. In addition, companies can choose to pay dividends either in cash or in shares. For investors that's a chance to acquire more shares without paying brokerage fees.

STANDARD BANK DIVIDEND DISTRIBUTION



The dividend can be compared to an interest rate through the dividend yield. That's calculated by dividing the total annual dividends per share by the share price and is expressed as a percentage. All other things being equal, a share with a higher dividend yield is more attractive because you receive more income.

In SA dividends are tax-free in the hands of the recipient, so investors comparing a dividend yield investment opportunity with a fixed deposit should always remember to adjust for the tax on interest income.

For example, a fixed deposit with an interest rate of 7%/year only returns 4,2%/year after tax (assuming a marginal tax rate of 40%). In that scenario, any share with a dividend yield in excess of 4,2% would be more attractive as an income generator than the fixed deposit. However, it's important to remember that dividends are higher risk – or not as certain – as interest.

Dividends are important for more than income generation: they also provide a way for investors to assess a company as an investment prospect.

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First, investors can use dividends to value a company using the dividend discount model (DDM). A share price can be seen as the current value of all future cash flows. The DDM discounts the projected dividend stream for the next few years back to a current value. If the DDM value is higher than the prevailing share price, the investor will buy the share.

Second, the consistent payment of cash dividends gives investors an objective way of assessing that companies are cash generative, as it isn't possible to pay dividends over the long term if there's no cash in the bank.

Investors should always evaluate a company on a total return basis that includes both capital growth and dividend income. In recent years, companies have become more rigorous in managing their balance sheets to create value for shareholders.

Many companies with excess capital for their own investment requirements have returned capital to shareholders through either a share buyback or a special dividend. In a share buyback, a company will buy its own shares on the stock exchange. These can either be held as treasury stock (in reserve for acquisitions or share incentive scheme payments) or cancelled.

If shares are cancelled, the total number of issued shares reduces. That's positive for the value of the remaining shares, as the company's value and the total earnings base are now spread over a smaller number of shares.

There are a few key terms that investors should understand related to dividends: the date of declaration, the last date to trade, date of payment, cum dividend and ex dividend.

First, the date of declaration is the day on which the company declares the dividend. That announcement usually accompanies the half-year or annual results release. But there's a catch: only investors who actually own the shares on the last date to trade will receive the dividend payment.

Second, an investor may sell the shares after the last date to trade (LDT) and still receive the dividend. That's why shares trade cum dividend and ex dividend. Cum dividend can be literally translated as "with dividend". Up to the LDT, the share price will reflect the value of the dividend.

After the record date (five days after LDT) the share will trade ex dividend, or without the dividend entitlement and the share price will fall to adjust for that. Seddon advises shareholders to retain their shares until after the LDT so that they'll receive the dividend payment.

The last important date is the date of payment, when shareholders will usually receive electronic transfers into their share or bank accounts (managed by Strate) or a cheque if the original share certificate is still held. ¤

| ONLINE TRADING |

Tax implications

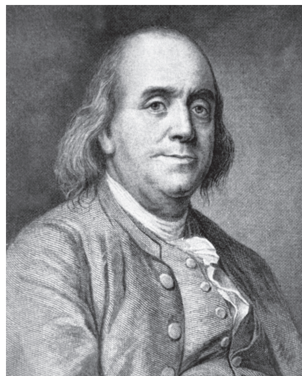
Investors must be aware of what Revenue will want

IT WAS BENJAMIN FRANKLIN who said that nothing is certain except death and taxes. And that applies just as much to investments as to other aspects of somebody's financial life. The good news is that shareholders don't have to pay tax on any dividends that they receive on ordinary shares, as in South Africa they're tax-free in the hands of the recipient. (That's not true in many other countries.) Instead, companies pay secondary tax on companies at 12,5% of the value of the cash dividend paid to shareholders.

Second, preference share dividends are also tax-free and have lower risk than ordinary dividends, as they're pegged at a certain level that is usually linked to the prime interest rate and behave more like bonds.

However, shareholders will be liable for tax on capital gains on shareholdings. A capital gain occurs when a share is sold at a price higher than its buying price.

First, novice investors need to be aware that the capital gains on share investments can potentially be taxed as income if the SA Revenue Service (Revenue) categorises the investor as a share trader. That simply means that if Revenue believes that you're making a living trading in shares you'll be taxed accordingly. Revenue tests that by evaluating the number of trades and their value.



Nothing is certain except death and taxes. **Benjamin Franklin**

Revenue looks at your intention when you bought a share – but a pattern of regular buying and selling will not help if you argue you bought a share for long-term capital gain.

However, most investors – particularly those who have a goal of accumulating wealth over the long term – won't find themselves in that situation. Instead, they'll be liable for capital gains tax. But CGT has an advantage over income tax, as the rate is lower. In SA, individual share investors pay their marginal tax rate on 25% of all capital gains. (If you're at a top marginal tax rate that equals a 10% CGT tax rate.) There's an annual exclusion of R10 000/person. Companies and trusts are taxed on 50% of any net capital gain.

That lower tax rate can play an important part in stimulating the development of the economy, particularly the small and medium enterprise sector, as the funds generated from company listings are ploughed into financing companies' growth plans. Government can encourage investment in listed companies through taxing capital gains at a lower rate than income. The only costs that can be considered in the CGT equation are trading costs.

Richard Seddon, head on Online Share Trading at Standard Bank, advises investors to consult a tax adviser. He cautions that tax concerns should never be the sole motivation for investment, though investors should understand their tax position. ¤

The golden rules of investing

Strategies that novice investors can use to help limit failures

THERE ARE NO sure-fire strategies or "magical" rules for successful investing. And even the world's greatest investors sometimes get it wrong. However, there are a number of strategies that even novice investors can – and should – use to boost their chances of success. The point is not to be right all the time but to make the most of your successes and limit your failures.

Richard Seddon, head of Online Share Trading at Standard Bank, says that there are five possible outcomes from buying shares: a big profit, a big loss, a small profit, a small loss and breakeven. He says the key is to avoid those big losses. Here are some pointers for doing exactly that.

First, Seddon discusses the capital that investors put into the market. He emphasises that you should never borrow money to invest or play with money that you can't afford to lose. Investors should know their own risk tolerance and work within that boundary.

Second, in terms of actual trading strategy he advises investors to always use stop losses for capital maintenance and never to be afraid to take a loss. In addition, however much it goes against the grain, always cut your losing shares before your winning shares.

Third, Seddon says that investors should always feel comfortable with their investments. If you don't, you should exit. He emphasises that all investors should do their own homework before committing their money to the stock market and only to take advice from investment professionals. He warns against investing on the basis of "hot tips" from friends around a braai, as that's often third-hand information.

Last, he warns investors to set realistic expectations. Though there will be years – such as 2005 – when the market booms and posts returns that are multiples of the inflation rate, that's the exception rather than the norm. Over time investing in shares should provide real returns that outstrip inflation.

In SA inflation has declined significantly. From the Eighties levels of more than 20%, investors now expect inflation to range between 3% and 6% due to Government's sound macroeconomic management.

However, lower inflation means lower nominal investment returns, though asset price growth should continue ahead of infla-

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2 « tion over a stock market cycle. Investors should set their expectations relative to where interest rates are, not on historic performance. In addition, Seddon says investors should set a time horizon and ignore small share price fluctuations in between. In a similar vein, SA Warrants MD Simon Pateman Brown also has some guidelines. First, he stresses that investors should buy quality – especially when they're investing for the long term and intend to "buy and hold". Second, he says that investors should understand what they're buying. That includes taking the time to thoroughly research each company in which they buy shares.

Third, understand an exit strategy – even before you buy any shares. If you know beforehand what should trigger a selling decision, you're less likely to let emotions get in the way of taking the correct action.

Last, Brown says that investors must understand the risk. He cites the case of Warren Buffett, who has refused to panic and enter a rising market because he can't find any buying opportunities that represent value.

Above all, let common sense guide you. As Buffett – the Sage of Omaha – said: "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful." The result has been the most successful investment portfolio the world has ever seen. ¤

Exchange-traded funds

ETFs provide investors with index-linked returns

ETFs will give investors a market return without the risk of underperforming the benchmark.
Mike Brown, Satrix manager

PERHAPS YOU'RE CONVINCED of the merits of direct investing but fear you don't have either the expertise or time to manage a portfolio yourself. If so, exchange-traded funds (ETFs) may be the solution to your dilemma.

ETFs are index-linked funds that trade on the JSE itself: investors can buy and sell units directly through their stockbroker. They provide investors with index-linked returns at relatively low cost. An index is a group of shares that track the movements of underlying share prices to estimate the actual changes in prices of the market or a sector. For example, the JSE Alsi 40 consists of the top 40 shares. The Satrix 40 ETF exactly tracks the JSE Alsi 40's movements.

ETFs have credibility, as South African-listed ETFs are registered as collective investment schemes and so fall under the regulatory auspices of the Financial Services Board (FSB).

There are currently seven different ETF products listed on the JSE: the JSE's three Satrix products, the Satrix 40, Satrix Fini and Satrix Indi; the Itrix FTSE 100 and Itrix DJ Stoxx 50; and Absa's NewRand and NewGold portfolios.

Satrix manager Mike Brown says these ETFs will give investors a market return without the risk of underperforming the benchmark. Brown highlights four key benefits of ETFs, such as Satrix versus other unit trust products, including index-tracking funds.

The first advantage of Satrix is that they're listed and trade all day on the JSE, whereas unit trusts are priced once daily. Second, Satrix investors get the index at all times. That may seem strange, but other index-tracking fund managers have to deal with "tracking error" or a deviation from the performance of the underlying index. Trading costs make it expensive to replicate an index exactly and so even an index fund can either outperform or underperform its benchmark.

Third, Satrix investors don't pay extra portfolio management fees if they buy their units directly through the market. (However, there will be the same brokerage and custodial costs as with buying any direct equity.) Brown says that Satrix covers its management costs with scrip lending and so effectively pays out all the dividends received from the underlying shares to Satrix investors. Last, the spread (difference) between buying and selling prices is smaller for Satrix than for unit trusts.

There are capital gains implications from investing in ETFs, as with any equity product: Satrix investors will be taxed on their capital gain when they sell their units. However, Satrix itself isn't liable for CGT when it sells shares if one of the underlying holdings falls out of the index. Standard Bank offers its clients two ways to buy ETFs: through an Online Share Trading account at just 0,7% brokerage or a minimum R89 fee excluding statutory costs and VAT, or through the Automated Share Investment scheme available to its Internet banking customers at a cost of R20 plus 1%. ¤

QUIZ

EACH WEEK we'll publish three questions related to the week's content. At the end of the 12 weeks Online Share Trading will give R10 000 worth of Satrix shares in an online account to the reader who has correctly answered each week's questions.

To take part in the draw just answer the following questions and submit your answers either online to SBquizz@finweek.co.za or by fax to (011) 884-0851.

1. What are the financial instruments called that track an index and are traded, like shares, on a stock exchange?
2. What income stream is tax-free in the hands of recipients?
3. Which investment guru is known as the "Sage of Omaha"?

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