**Harnessing the power of dividend franking**

Vishal:

Welcome, my name is Vishal Teckchandani, and I'm Nabtrade's

content editor. This episode of Meet the Manager is going to be a treat

for dividend investors and retirees in particular because we're going to

be talking about the difference franking credits can make to the returns

in your portfolio. I'm very pleased to have Dr. Don Hamson with me to

discuss this topic. Don is the founder of funds management firm Plato.

Much like the namesake Greek philosopher, he loves to teach and we're

certainly going to be learning a lot from Don about this topic. Don,

welcome. It's great to have to you here.

Dr. Hamson:

Thank you. Glad to be here.

Vishal:

Don, let's start off with a basic question, franking credits.

Potentially a lot of investors underappreciated them, but you've got a

thesis that suggests they shouldn't.

Dr. Hamson:

Yes, most definitely. In Australia, we have a fairly unique

system where if a company pays company tax and then distributes

dividends out to clients then that company tax comes out as a franking

credit or a tax credit to the clients, for Australian clients anyway,

Australian investors. The size of that is quite large. For a $70

dividend, there'll actually be a $30 tax credit.

If we look at the last 10 years, these are numbers from end of March

2017, the Australian equity market in price terms has basically gone

nowhere, because we had that sort of lead up to the GFC and then it's

fall and it's rebound, but it's about back to where it was ten years ago

in price.

Vishal:

Right.

Dr. Hamson:

But if you look at the impact of dividends, you've got sort

of 4, 4.5% cash dividend per annum. If you actually accumulate the value

of that, it's worth about $5,000 on a $10,000 investment. Often people

forget the franking credits, but if you're a pensioner, the franking

credits will be worth almost $3,000 on top of that. That's a fairly

substantial sum.

Vishal:

If you started with a $10,000 investment in just the ASX200, in

2007, that, at the end of March 2017 would be worth $18,000 with

franking credits.

Dr. Hamson:

With franking credits if you got the full refund. If you're

a charity or a pension phase investor that gets that full refund then

you're getting nearly $18,000. The price of your shares is basically

still at $10,000, but the value of those accumulated dividends and

franking credits is quite substantial.

Vishal:

This is something that I think you've outlined in your work.

It's really important to keep in mind that the benefits of franking

credits are quite proportional to your tax bracket, so the lower the

bracket the greater the benefit, but even if you're on the highest

marginal tax rate it's still pretty good. Is that right?

Dr. Hamson:

It's better than most other forms of income.

Vishal:

Like unfranked dividends.

Dr. Hamson:

Like unfranked dividends, that's right. The biggest benefit

is say, for those on the very lowest tax rate, which is actually zero if

you're a pension or a charity, or indeed you're actually aren't earning

any other income, but you can earn about $18,000 before you hit the tax

free threshold. If aren't earning income but you have $100,000 invested

in the Australian Share Market, you'll probably get a full refund on the

franking credits. It's worth the most value there. As I said, basically

if you get $70 worth of dividends, you get a $30 tax credit, or if you

put in $1 terms, if you get a $1 full franked dividend, you actually get

another 43 cents on top of that. It's 43% more. That's actually fairly

significant.

If you're on the 15% tax rate, then the franking credit you have to pay

tax on it, but it still means a $1 dividend pre-tax is actually worth

$1.21 after tax, so it's a 21% uplift.

Vishal:

Let's say I invest in Woolworth's and I get a $1,000 check from

Woolworth's and I'm in the tax free threshold so I'm a pension phase

investor. That $1,000 is actually worth more to me at tax time, is that

right?

Dr. Hamson:

If you get $1,000 fully franked dividend, you put your tax

return in and the government will actually give you about $430 tax

credit on top of that.

Vishal:

Yeah, as cash. [crosstalk ]

Dr. Hamson:

As cash. You'll get a check from the government or probably

a direct credit from the government into your bank account worth $430.

That's the value of franking because what it's basically done is that

Woolworth's has paid corporate tax at 30% on that and you're getting a

full refund of it. That's what the dividend imputation system does. It

means there's no double taxation. If you're an untaxed investor saying

your pension faces [inaudible], you're going to get a full

refund of that corporate tax that Woolworth's paid.

Vishal:

Let's talk more about Plato. Looking at your history, you ran a

tax effective income strategy for Westpac in the 90s. You then moved

onto State Street I believe, and you managed quite a large pot of money

there and then you formed Plato in 2006. What was the reasons for

starting a boutique and what should investors know about the way you

invest.

Dr. Hamson:

The reason we started a boutique was, I suppose, a lot of

people want to work for themselves. I'd worked for institutions like

Westpac and State Street for a number of years and I wanted to be more

my own boss and I suppose have more control over what we were doing,

because I was a bit frustrated.

Vishal:

That's one of the key attractions of running a small boutique,

isn't it. Yeah.

Dr. Hamson:

That's right.

We've developed a strategy which is quite unique and quite tailored for

really specifically for pension phase investors. We actually have dual

objectives. We think it's not all about income, it's about total return

and income.

Vishal:

Franking credits are an important part of that, of course.

Dr. Hamson:

Yes. We always fully value franking credits because we're

managing from a pension perspective. We are trying to meet these dual

objectives, which is we want to have a good return, a total return

that's higher than the market, but we want to deliver more income along

the way. We're happy to say, we've actually since inception we've been

able to satisfy both those objectives.

Vishal:

For customers of Nabtrade, they can access your strategy in two

different ways. There's the Australian Shares Income M Fund and if I'm

not mistaken, the list investment company also follows the same

philosophy. What are the considerations of investing in either vehicle?

Dr. Hamson:

The recent LIC that we launched, Plato Income Maximizer,

actually invests in the same pot of money as the M fund, actually

invests into that fund.

Vishal:

Okay.

Dr. Hamson:

It is exactly the same strategy.

Vishal:

That provides more accessibility, doesn't it?

Dr. Hamson:

Yeah, the thing about M fund is it's actually a managed fund

and it's settled on shares, but actually it doesn't trade during the

day. You get the closing price. The listed company trades all day so you

can invest in the morning or you can invest in the afternoon. It might

change if the market goes up, et cetera. It has one unique feature,

which we don't have in the underlying fund or the M fund, is being a

listed company it can actually bank up, it can build up some income,

which it will do for the first few months, and then it's aiming to

distribute or pay out monthly dividends. Regular monthly dividends over

time once we start paying dividends ...

Vishal:

Is there a certain yield you target to provide investors?

Dr. Hamson:

Our long-term aim is to pay essentially the same yield out

whether they invest in the fund or they invest in the company. In the

company's case, it would be aiming to build up sort of a kitty of

profits and then distribute that out equally each month.

Vishal:

Don, I'd like to finish off the final question by reciting a

quote from Plato and asking you answer it in investing context. Plato

once said that 'The first and best victory is to conquer self'.

Dr. Hamson:

I think there's one important thing about income investing

is, don't get sucked into buying necessarily the highest yielding stock

or what might appear to be the highest yielding stock. Yes, you want to

buy stocks with good sustainably high dividends, but if a stock is

trading on a ridiculously high historic yield, 10% cash ...

Vishal:

For example, as Metcash, 17% years ago.

Dr. Hamson:

Yeah, Metcash was trading on a grossed up for franking

yield, about 17% two years ago. You're looking at it saying, 'This is

fantastic, or is it too good to be true.' As it turned out it was too

good to be true because a couple of weeks after that, the company

announced what its dividends were going to be and its earnings result.

It was a very poor earnings result. They actually announced they weren't

going to pay a dividend for at least 18 months. A, you got zero income

out of that stock because dividends aren't guaranteed, but secondly the

market reaction to no dividends for 18 months was a 30% decline in stock

price. We've got to follow both of our objectives if we do that. We've

got zero income, so we follow the income objective and our total return

objective, where we've just lost 30%, if you have one or two of those

disasters in a portfolio, particularly if it's like a five or stock

portfolio, then you're probably going to write off all your performance.

One of the ways we get around that is we have well diversified

portfolio, but we also actively try and avoid what we call dividend

traps which are the stocks that are, historic yield is probably too good

to be true.

Vishal:

Don, thank you so much for taking the time to come in today.

Dr. Hamson:

Thank you.

Vishal:

We hope you enjoyed that video. I will be filming another piece

with Don on a practical investment strategy called 'Dividend Rotation'.

Look out for that on Nabtrade. Hope you learned a lot from this video.

As always, please do your research before considering any investment and

please consider seeking financial advice if you don't have the

confidence or if you're unsure. I'm Vishal Teckchandani, see you next

time.