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Where to next for Dividend Income Fund unit holders?

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Background:
In December 2009, the FSB issued Circular No 11 to all unit trust management companies wherein it highlighted the concerns that it, as a body, together with the National Treasury and SARS have in relation to some of the Dividend Income Funds and the tax structures which they are entering into. Whilst Minister Gordhan made no specific mention of the issue in his budget speech the matter has been raised previously in this forum. The future of these funds remains in the balance and as per the FSB's circular, investors must be made aware of the potential risks.

The basic issue is as follows: Interest is a taxable form of income; in contrast dividends are tax exempt in terms of the Income Tax Act. Certain structures or schemes of arrangement which aim to convert or swap interest income for dividend income are frowned upon by the tax authorities. These structures often involve entities which are tax indifferent - such as pension funds or assessed loss companies – where the tax indifferent entity is happy to pay, say, 9c dividends in exchange for 10c interest, whilst the taxable entity would prefer the opposite. The structures inherently carry a degree of tax risk as their mechanics involve a level of interpretation of the tax legislation which has not always been tested in courts of law. In the case of the Dividend Income Funds, it is difficult to understand who carries this tax risk. It is most likely the unit holders.

So, Dividend Income Funds which cannot easily show the source of their dividends or distinctly point to money market instruments as the source of the dividend is deemed to be engaged in suspicious behaviour. These funds have been able to raise very large sums of money (> R50bn), which explains the defensive approach the management companies of these funds have taken towards the regulators efforts to gain clarity on the issue.

<u>So where does this leave investors looking for income, particularly dividend income?</u>

For now the Dividend Income Funds remain in operation. However, for investors who would prefer to stay clear of this debacle the question which now remains is where to next? The answer will of course differ depending on the individual investor's needs and risk profile.

Dividend Paying Options

Preference Share Investments
Preference shares are the traditional fixed income instrument available to investors looking for regular dividend income whilst maintaining a conservative view on capital. As an instrument they are perfectly legal but at times not very well understood. Preference shares are equity instruments and as such the yields paid on them are dividends. "Preference" relates to the preferential rights a preference share holder enjoys over other shareholders. This is usually the right to a fixed dividend yield and the right to capital repayment prior to the ordinary shareholders.

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Preference shares have been mentioned in the Dividend Income Fund investigation, however that does not mean that there is anything wrong with the asset class or instrument per se. The concern is how these preference shares are created and the objective behind their use.

The nature of the return can be brought into question if the issuing company has structured its tax affairs in a dubious or incorrect manner - this may taint the nature of the return to the holder. Suffice to say that investors should look to reputable issuing companies' for their preference share investments. One should also ensure that there are adequate tax warranties from the issuer.

There are two main categories of preference shares:

Redeemable Preference Shares
These are characterised by having a finite life and are normally redeemed at their par value or issue price. Thus the issuing company has guaranteed the capital at maturity. They pay either a fixed or variable % return. Many of the larger financial services groups do issue such instruments, but only into the wholesale capital markets. These instruments are still available in a more vanilla / direct format to investors via certain asset management companies and the issuers themselves.

Non Redeemable Preference Shares
These are normally listed on the JSE and are perpetual instruments i.e have an infinite life and can only be called at the election of the issuer. They generally pay a higher yield than the Redeemable Preference Shares. The capital values on these instruments are not guaranteed. Information on these instruments is publicly available and there are a handful of unit trusts and segregated Funds focused on this asset class such as the Grindrod Diversified Preference Share Fund, the BoE Preference Share Fund and the Coronation Preference Share Fund, to name but a handful.

In general, preference shares have a very valuable role to play as a conservative income generating asset class, and can be used very effectively in tax planning and portfolio construction.

Equity Markets
Ordinary shares do pay dividends albeit that their dividend yields are normally lower than preference shares. On the upside however, ordinary shares have the ability to achieve long term capital growth. In order to derive dividend income one could look to higher dividend yielding stocks such as the general retailers. As an example the SatrixDivi ETF is an index focused on higher dividend yielding securities. It should be remembered of course, that the general equity markets have a much higher risk profile than preference shares, bonds, cash and property.

Other, Taxable, Income Options
The other sources of income are all pretty well understood, but unlike the equity instruments listed above the yields are all taxable. They consist of Money Market Instruments, Listed Property Investments and Bonds. Of these three variations Grindrod Asset Management believes that the best value currently can be found in Listed Property Investments, where the current forward yield is 9.2% (before tax) and income growth is forecast to be in line with inflation over the next 3 years.

Conclusion
Given the hype around the Dividend Income Funds investors are encouraged to consider their position carefully. On a like for like basis redeemable preference share investments do achieve the same goals as the above Funds namely dividend yield and capital security – these instruments are however, not readily available to investors as supply from the issuers is not assured and they are normally only issued in the wholesale capital markets. Whilst more risky from a capital perspective, listed preference shares offer a viable alternative. Outside of preference shares one could look to higher dividend yielding equity investments or listed property for income. Ideally, investors should contemplate a mix of different asset classes to provide for their income requirements and preference shares should constitute a sizeable portion of that mix, particularly if the assets are held in the name of the individual and taxes are paid.

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For more information on Grindrod Asset Management, please visit www.grindrodbank.co.za.

Glacier Research would like to thank Grindrod Asset Managers for their contribution to this week's Funds on Friday.

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