Funds on Friday
By Glacier Research

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Dividend Income Funds
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It seems investors and advisers alike have forgotten the benefit of tax exempt returns on the lower side of the yield curve. Cash-type instruments are once again moving to the forefront and justifiably so, with market conditions that question the continual sustainability of weekly record highs within the All Share Index. Slow to almost recessionary economic growth, a struggling currency, rising inflation coupled with soaring unemployment and continuous threats by the Reserve Bank Governor of forced rate hikes, due to inflation being above the target range, all signal danger. But where to go in the vast world that is the conservative investment?

Current market conditions usually results in two different types of cash investors.

The first is the conservative investor who wants liquidity and capital security. He is usually closer to retirement or retired and he is more than willing to sacrifice return for peace of mind. These investors usually have little to no debt and love rising interest rates as their “safe investments” give greater returns.

The second type of cash investor in the current market conditions is the one who is looking for a short- to medium-term parking space. They usually have a longer outlook and the ability to handle short-term fluctuations. These investors tend to be in conservative investments for 6 – 18 months until they move their funds back to more aggressive strategies.

The options in the cash/conservative space are endless but for this article I’ve focused on four broad options that are easily available in the retail segment.

- Call accounts
- Income and Bond Funds
- Money Market funds
- Dividend Funds

Call accounts have the best liquidity but they also have the lowest yield and contrary to popular belief they have a higher risk than money market funds as they are exposed to only one issuer.

Income funds usually have a high bond exposure that makes the fund fluctuate more than a conservative investor might appreciate. The other problem with the bond exposure is that the bond market will probably struggle when equity markets struggle. Add this to our current Standard and Poor’s downgrades and one has to ask if income and high income funds can maintain their flamboyant balanced fund returns that investors have become used to. The simple answer is no, as most fund managers have warned advisers not to create unrealistic and unsustainable expectations when advising investors on income funds.

That leaves us with money market funds and dividend income funds. Both of these types of funds usually give 24 – 48 hour liquidity and both are linked to interest rates. Thus, when interest rates go up the yield in the fund will go up. The higher yield will obviously not appear immediately as with call accounts but will emerge as new underlying assets are bought and sold. The big difference, however, is the type of return. Money market fund returns comprise taxable interest and dividend fund returns are tax-exempt dividends. The graph below shows the enormous effect this has on a high net worth individual or any investor in a 40% tax bracket.

As seen in the table, a dividend fund yield equates to a pre-tax return of 8.3% (4.98% / 0.6). Compare this to a 6% money market yield and the investment choice for a conservative investor worried about security and liquidity should be an easy choice.

Saying this, one has to ensure that when choosing a divided fund you ensure that the underlying assets are all secure and approved by SARS and that the stated return is a dividend - not dividends and interest.

Annual effective seven-day rolling average	**Yields**
Total return	4.98%
Dividends	4.98%
Interest	0.00%
Net Quarterly income distribution	4.98%
Individual	
Total return after tax - 40%	4.98%
Pre-Tax Equivalent	**8.30%**
Company	
Total return after tax - 28%	4.98%
Total return after tax (Including STC benefit)	5.73%
Pre-Tax Equivalent	**7.95%**

The above table only tells half the story. As mentioned, with downgrades pouring on South Africa like a winter's day in the Cape of Storms, imminent interest rate hikes will only increase dividend fund yields. The after-tax effect with increased yield in the cash space will only widen the gap between after-tax returns on money market funds vs dividend funds as well as reduce the yields on already struggling income funds.

With current yields, the pre-tax yield pick-up on a dividend fund is 38% higher. If interest rates increase by say 1.5%, it is expected that both money market yields and dividend fund yields will increase by the same percentage, giving yields of 7.5% and 6.48%, respectively. If one now adjusts the dividend yield to a pre-tax return, the equivalent pre-tax return for the dividend fund may be as high as 10.8%. Thus, the result of a 1.5% interest rate hike increases the after-tax effect of dividend funds by a higher percentage, namely 44% compared to the previous 38%. But once again, I have to repeat myself to ensure I drive this point home. Make sure that the stated return on the dividend fund is actual dividends and not interest. Obviously the more interest the fund pays, the more yield pick-up relative to money market funds you will lose.

In a nutshell, dividend income funds are liquid, capital secure funds that provide an attractive after-tax yield when compared with money market funds. Secondly, dividend funds are a great alternative if you are looking for a parking space for cash or if you are a conservative investor by nature. Why pay tax on your returns if you could spoil yourself instead?

Glacier Research would like to thank Bennie Gerber for his contribution to this week's Funds on Friday.

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Bennie has seven years' investment experience within the financial services industry. He holds a degree in Financial Management as well as a degree in Industrial Psychology. He also completed his CFP in 2008. Through his career he has held positions as portfolio analyst and wealth advisor at PSG, Standard Bank and NMG actuaries and consultants.

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