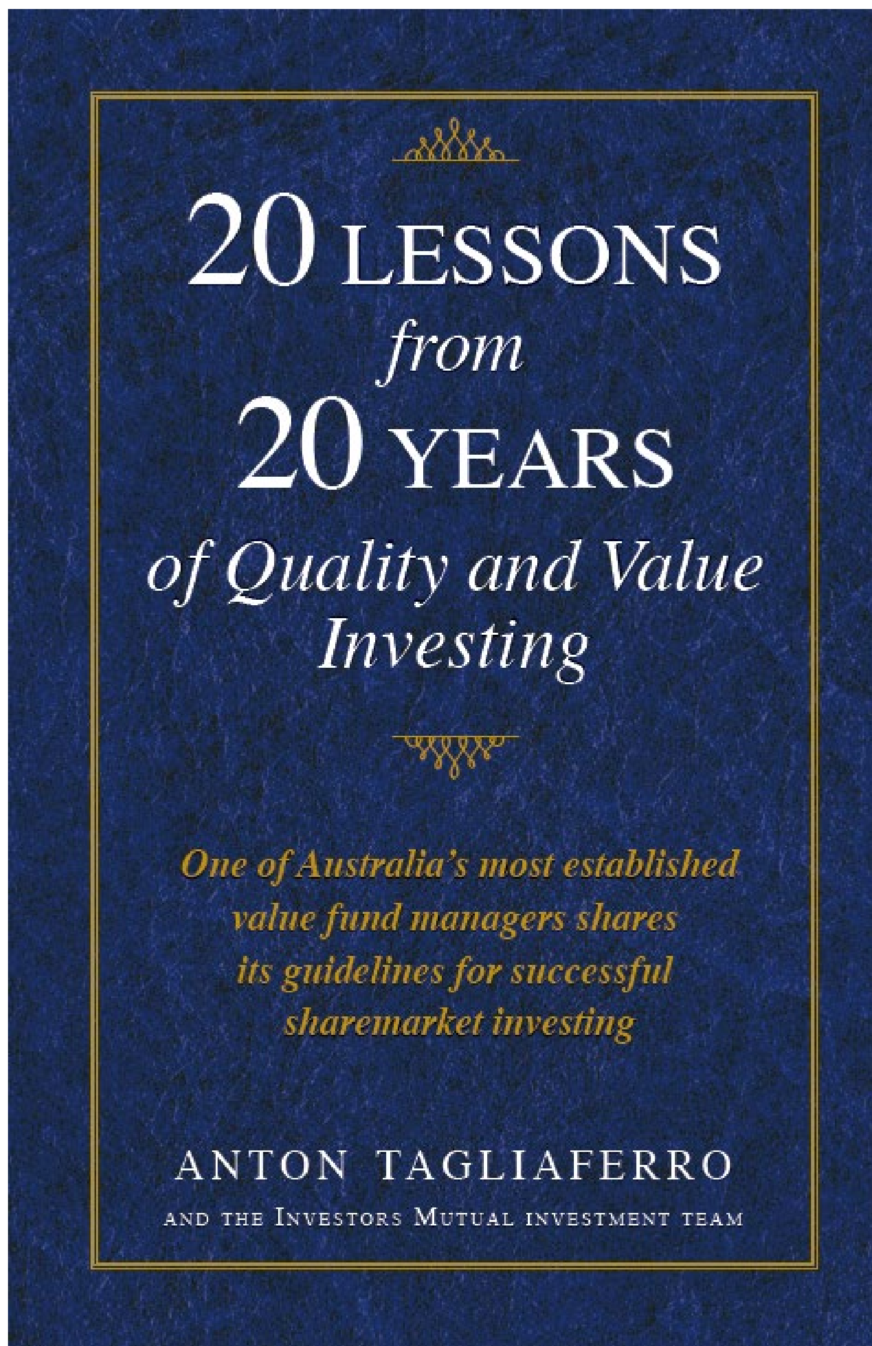


The following lesson is one of IML's '20 lessons for 20 years of quality and value investing', which were recently published by Anton Tagliaferro and the IML investment team to mark 20 years since IML was founded.

We chose this lesson for Lonsec Retire in particular as the first part shows how when companies reinvest back into their businesses, investors are rewarded with the benefits of increasing dividends and an appreciating share price over the long-term.

These lessons are available both in hard copy and e-book format. For your copy please visit www.iml.com.au/20-lessons or email iml@iml.com.au

#6 THE POWER AND BENEFITS OF COMPOUNDING OVER TIME IN EQUITY PORTFOLIOS

Most people are familiar with the concept of compound interest when it comes to term deposits, where one can earn interest on interest by continuing to roll over a term deposit. However, many investors do not relate the concept of compounding to their investments in the sharemarket.

Compounding occurs in the sharemarket when income from an investment is reinvested back into the business, and investors are rewarded with the benefits of increasing profits and appreciating share price growth over the long-term.

For investors in the sharemarket, there are two ways compounding can work in their favour to enhance their long-term returns.

1. THINK ABOUT STOCKS AS BUSINESSES

While every stock's share price tends to jump around on a day-to-day basis as the sharemarket oscillates, when you buy shares in a quality industrial company, you are purchasing and investing in a slice of that company's future earnings and dividends in perpetuity.

Good quality industrial companies generally pay an annual dividend from their annual profits. What many investors often don't appreciate is that most companies also retain a portion of their annual earnings as retained earnings. Management of these companies must then decide how to best utilise these retained earnings to grow the company. These retained earnings can be used to pay down debt or purchase new assets for the business, or management may decide that the best option to grow is to acquire other companies or, alternatively, to buy back shares.

Here is an example of how compounding works. XYZ Co. Ltd is a profitable Australian company that generates a sound recurring earnings stream in a steady sector such as packaging, supermarket retailing or healthcare services.

Looking at the table below, imagine that XYZ Co. Ltd starts Year 1 with $100 of assets and makes a profit after tax of $10 on these assets, i.e. a rate of return of 10%. The company's board adopts a 50% dividend payout ratio, meaning that the company pays its shareholders $5 in dividends, while holding onto the other $5 as retained earnings.

Year	Business assets	Profit (R.O.E)	Dividend	Retained earnings
1	100.00	10.0	5.00	5.00
2	105.00	10.5	5.25	5.25
3	110.25	11.0	5.50	5.50
4	115.75	11.6	5.80	5.80
5	121.55	12.2	6.10	6.10
6	127.65	12.8	6.40	6.40
7	134.05			

Source: IML and Peter Thornhill

As can be seen above, in Year 2 the company's assets have now grown to $105 in assets, and if one assumes another 10% return on this higher asset base and a 50% dividend payout ratio once again, the earnings of this company have grown in Year 2 to $10.50 and the dividend declared in Year 2 has grown to $5.25.

...

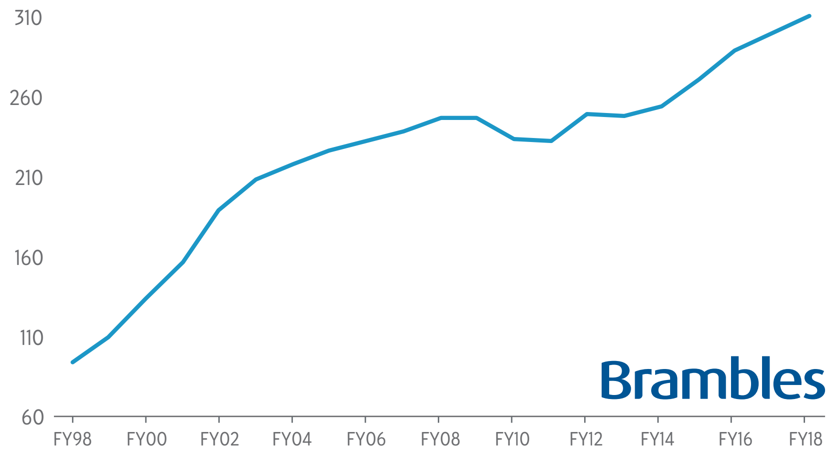
By this simple method of compounding, one can see how by Year 6, the earnings of the company have grown to $12.80 while the dividend has grown to $6.40 and the asset base ends at the end of Year 6 at $134.05.

By investing its retained earnings wisely every year, XYZ Co. Ltd has effectively been compounding its own earnings and managed to achieve growth in its earnings and dividends while growing the assets of the company over time.

Now imagine that XYZ Co. Ltd above is the giant packaging company *Amcor (AMC)*, the global pallet operator *Brambles (BXB)*, pathology company *Sonic Healthcare (SHL)* or supermarkets operator *Woolworths (WOW)*. Over the last 20 years, each one of these well-established, industrial companies has made a profit from operations and, through adopting a dividend payout ratio of 50% to 70%, has paid a portion of their earnings in dividends to shareholders. On top of this, all of these companies have also retained a portion of their earnings which has enabled them to reinvest each year into new packaging assets, pallets, pathology labs or supermarkets in order to increase value and grow its future earnings.

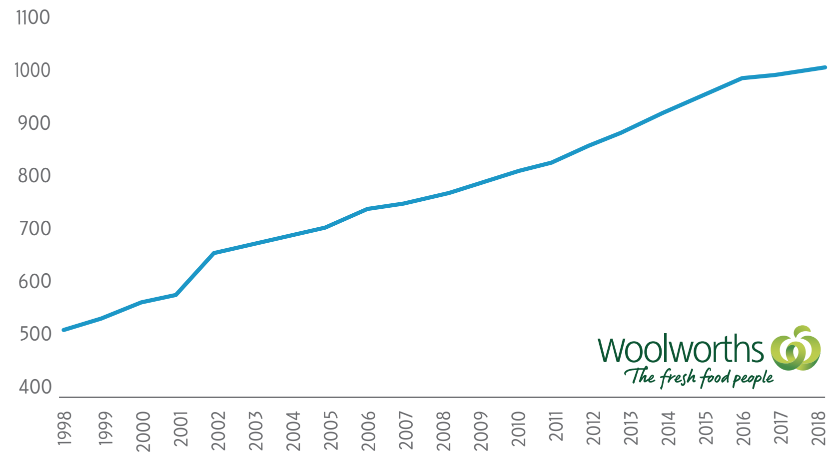
By reinvesting in its core business, *Woolworths* has grown its supermarket base from 500 supermarkets in 1998 to over 1,000 supermarkets today, *Brambles* has grown the number of pallets in its global pallet pool from 96 million in 1998 to 316 million today, while *Sonic Healthcare* has grown its pathology revenues from $146 million in 1998 to $4.6 billion for the year ended 30 June 2018.

BRAMBLES TOTAL PALLETS (M)



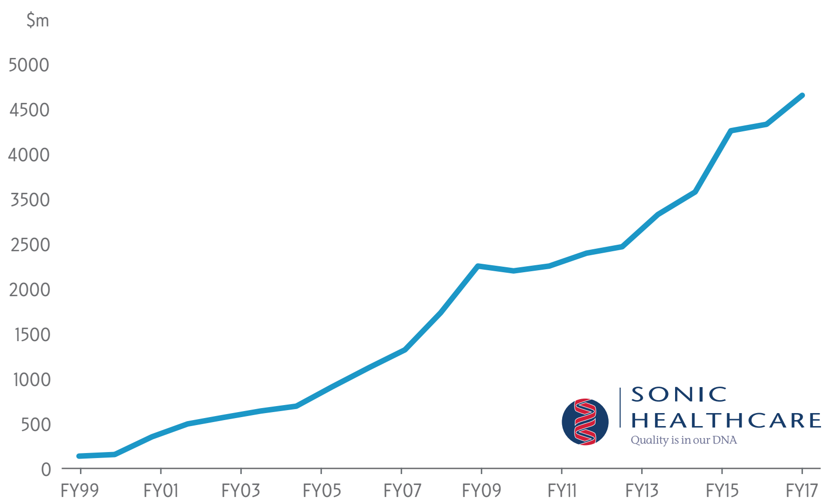
Source: Brambles; July 1998 to June 2018

WOOLWORTHS NUMBER OF STORES



Source: Woolworths; July 1998 to June 2018

SONIC HEALTHCARE PATHOLOGY REVENUE GROWTH



Source: Sonic Healthcare; July 1998 to June 2018. Sonic's acquisitions over this period have been funded by a combination of retained earnings, strong cash flow and the occasional capital raising.

Through wisely reinvesting their retained earnings, many good quality industrial companies have grown their assets over the long-term. This has benefitted shareholders as these assets have helped to increase the earnings per share (EPS) and dividend per share (DPS) of these companies over the long-term.

2. REINVESTING THE DIVIDEND INCOME RECEIVED BACK INTO THE SHAREMARKET

The second way that an investor can benefit from compounding in the sharemarket is by reinvesting the dividends received from his or her sharemarket investments back into the sharemarket.

20 YEARS OF INVESTING IN THE ASX AND REINVESTING DIVIDENDS DELIVERED THE INVESTOR OVER $150,000 MORE THAN IF THEY HADN'T REINVESTED

Source: Morningstar Direct; 1 July 1998 to 30 June 2018

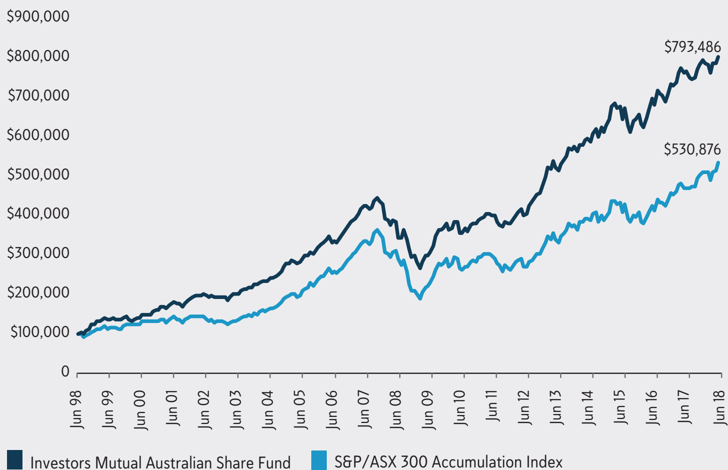
In the chart above, the light blue line shows what happened to $100,000 invested on 1 July 1998 into an ASX 300 index fund, where the investor has used the dividends received from this portfolio to live on. As can be seen above, at 30 June 2018, the initial $100,000 would have been worth $230,563. In addition, the investor would have received $148,546 in dividends over that period. Simplistically, this means that the original $100,000 invested returned $379,109 in total capital growth and dividends received over the 20-year period.

If, however, same investor had decided to reinvest all dividends received over that 20-year period back into the ASX 300, as shown above, the initial $100,000 would have been worth $530,876 at 30 June 2018. …

This is $151,767 more than if the investor had spent all his dividends instead of reinvesting them. The difference comes from the impact of the dividends having been reinvested and compounded over the last 20-years, clearly demonstrating the benefits of compounding to the investor as the sharemarket rose over this period.

Interestingly, had the investor opted to invest his $100,000 into the IML Australian Share Fund (IMAS) on 1 July 1998 instead of an index fund that replicated the ASX 300 Accumulation index, and then reinvested all distributions received back into IMAS, the original $100,000 would have been worth $793,486 at 30 June 2018.

20 YEARS OF INVESTING IN THE IML AUSTRALIAN SHARE FUND VS THE INDEX



Source: Morningstar Direct and IML; July 1998 to June 2018. Past performance is not a reliable indicator of future performance. Returns can be volatile, reflecting rises and falls in the value of underlying investments.

Highly respected market strategist and economist Don Stammer describes the concept of compounding as “magic”, particularly for investors who make an early start and are patient. Stammer notes that by reinvesting one’s returns and dividends back into the sharemarket, the compounding growth in returns gets amplified over time.

IMPORTANT INFORMATION

While the information contained in this publication has been prepared with all reasonable care, Investors Mutual Limited accepts no responsi-bility or liability for any errors or omissions or misstatements however caused. This is general financial product advice only and is not intended to constitute a securities recommendation. This information does not account for your investment objectives, particular needs or financial situation. Statements of opinion are those of IML unless otherwise attributed. Except where specifically attributed to another source, all figures are based on IML research and analysis. The prospective P/E ratios and earnings forecasts referred to in this presentation constitute estimates which have been calculated by IML's investment team based on IML's investment processes and research.

Investors should be aware that past performance is not a reliable indicator of future performance. Returns can be volatile, reflecting rises and falls in the value of underlying investments. Prospective investors should seek independent advice as to the suitability of the Fund to their investment needs. The fact that shares in a particular company may have been mentioned should not be interpreted as a recommendation to either buy, sell or hold that stock. Any commentary about specific securities is within the context of the investment strategy for the given portfolio. All data, examples and case studies were prepared during the period from May 2018 – September 2019 and should be considered within this context.

Investors Mutual Limited (AFSL 229988) is the issuer of the IML Funds. Applications can only be made on the current application form. Prospective investors should consider the current Product Disclosure Statement for the relevant fund, or through IDPS products that include these Funds. The Product Disclosure Statements can be obtained by contacting Investors Mutual or at www.iml.com.au. Prospective investors should consider the relevant Product Disclosure Statement, and Investment Guide where applicable, before deciding to invest or continue to invest in the Funds. Investors Mutual Limited is also the investment manager of QV Equities Limited ACN 169 154 858 (QVE).

© 2019 Investors Mutual Limited, all rights reserved.