



Morningstar Guide to Income Investing

Introduction

At Morningstar we are all about independence for the individual investor. Independence from conflicted advice, independence from excessive fees and independence from the presumption that it is somebody else's responsibility to give you the life you want.

Passive income is one of the pillars of independence. Which investor hasn't dreamt of earning income while sitting on a white-sand beach sipping a cocktail? That's nice but a Morningstar investor knows the difference between dream and reality. This dream isn't going to come true by itself. It takes research to uncover investment opportunities. It takes patience to let compounding do its magical work. It takes conviction to resist chasing the crowd. And it takes foresight to realise that earning money is only the first step on the journey to financial independence.

Income investing has played a crucial role in my own financial freedom. I started investing for income in university. This may not be the age at which most people gravitate towards income investing but I found the concept of passive income so compelling that I couldn't help myself. During my time as an income investor my approach has evolved. Initially, I used a dividend reinvestment program across my entire portfolio. This served me well, particularly when the global financial crisis hit. While certain stocks I owned cut their dividend, most did not, and my focus on sustainability worked well. The dividend reinvestment program allowed me to plough cash back into my holdings at what turned out to be extremely attractive valuations. As I get older my approach continues to evolve: I've set up a dedicated investment account that generates income, which I can use to spend on travelling. And this account brings with it a psychological inducement: the discipline to continue saving money while also generating some immediate gratification (yes, I know this is a trick; and no, I don't

care because it works for me). Eventually I hope to reach the point where the income I need to live will be generated by my portfolio—then I will have reached true financial independence.

But the life moment that really cemented my views on the merits of income investing came when my parents divorced. And with divorce comes solitude, which was understandably a great source of anxiety for my mother, especially since she was never one to pay attention to investing. With her retirement rapidly approaching she asked me to take over her portfolio, and before long concepts such as sustainability took on greater importance. Ten years later, my mother is retired and living off income generated by her portfolio. There will certainly be a time when she will have to start dipping into principal, but she is in a better situation than she may otherwise have been. And for me, being part of a real-world example of the type of financial freedom that income investing can provide is a source of relief and gratification.

The Morningstar Income Investing Guide is intended to help you become a better income investor whether you are just starting out or have been investing for years. The guide outlines basic income-investing concepts and points you towards Morningstar Premium features and tools that can help you navigate your own path to financial independence.

Best regards,





Mark LaMonica, CFA
Individual Investor
Product Manager

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Earning income from stocks

 Do you know the only thing that gives me pleasure? It's to see my dividends coming in.  John D. Rockefeller

Dividends: The truth about stocks

Let's start with the basics: What is a dividend? A dividend is a payment made by a corporation to its shareholders, with each share receiving an equal amount of value. Dividends can be paid in additional shares of stock (stock dividends or stock splits), or shares of another corporation (a process known as a spin-off). Some are one-time affairs known as special dividends. However, the vast majority of dividends are regular cash dividends, paid at predictable intervals—usually twice a year in Australia.

Dividends are everywhere: 90% of the companies in the ASX 200 Index make regular distributions of cash to shareholders, and many smaller companies also pay dividends. The yield of the ASX 200 is ~2.92%, which means that for every \$1000 invested \$29.20 of income will be generated. The yield increases to 3.58% if you exclude the 10% of the ASX 200 companies that pay no dividend. Australian companies tend to pay higher dividends than foreign companies and Australia has a higher yield than other global markets.

Common stocks derive their value from the same source that bonds do: cash that is paid by the security issuer directly to the investor. With a bond, the investor knows exactly what he is supposed to get. Interest payments are scheduled in advance, as is the return of principal when the bond matures. The only question directly related to these cash flows is

whether the issuer can pay on time and in full, and how much purchasing power these dollars will have when received. You could debate how much these cash flows are worth based on various scenarios for inflation, interest rates, credit spreads, economic conditions, and so on, but a bond that paid no interest and never matured would have a tough time finding buyers.

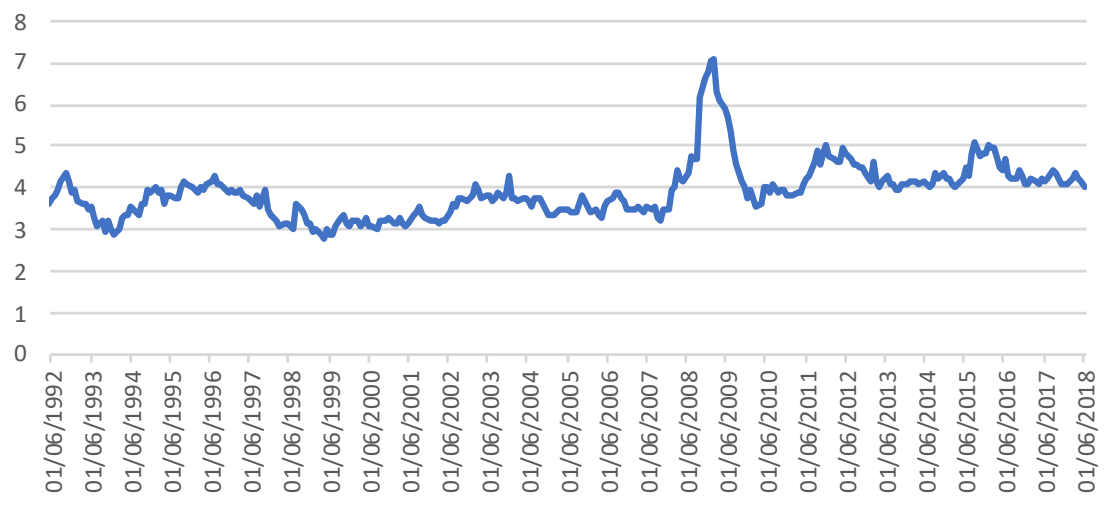
When one thinks beyond the “buy low, sell high” mentality that pervades the stock market, it turns out that common stocks are no different. Once you put some cash into a share of stock, there are only two ways you can recoup your cash. You could sell the stock on the open market, but then it has a new buyer, who would need another seller. Unless there is some other source of cash, this is the world's biggest game of hot potato. The other source of cash is from the issuing corporation itself. It might take the form of a liquidating distribution (these are very rare), a cash buyout offer, or a dividend. The most useful payments for some investors—and the only practical ones for the largest companies—take the form of regular cash dividends.

The critical importance of dividends, as well as dividend growth, is easily observed in historic stock market returns. Since 2000, the ASX 200 has returned an average of 5.12% annually. The proportion of total return that comes from dividends is 60%.

So dividends are not just powerful in terms of delivering potential returns, they can also be practical in meeting investors' real-world objectives. Dividends help give investors the ability to use corporate earnings as they see fit: to fund portfolio withdrawals during retirement, to meet other personal financial obligations, to reinvest in the company that paid it, or to invest in other areas of the market.

Dividends may not be the contractual obligations that a bond's interest payments are, but once a dividend has been established, directors and managers have historically been reluctant to yank it away without good cause. An investor cannot take any dividend for granted, yet a dividend-paying company provides evidence, at least in part, that it has shareholders' interests in mind.

S&P/ASX 200 – DS Dividend Yield



Source: Morningstar

Dividends and compounding

Seeking a decent income from stocks is a good start, but it's not the final destination. It is critical for investors — even dividend-oriented investors — to think in terms of total return. Let's say you find a \$25 stock that pays annual dividends of \$1 a share. That's a 4% yield, which isn't too shabby. But if that dividend never grows, your income return is fixed at 4%, and there's probably no reason for the stock to go up over the long term, either. By contrast, an increasing stream of income is far more useful than a flat one in an inflationary world, and a growing dividend is also likely to result in capital appreciation over time.

Compounding is often compared to pushing a snowball down a hill. As it travels down the hill, the snowball gathers more snow. The bigger it gets the more snow it gains on each rotation. The "snowball effect" shows that small actions continued over the long term can have a big impact.

The same applies in investing. Compounding is simply the concept of earning a return on your previous returns. To illustrate the power of compounding, consider the scenario of buying shares in a company with a growing dividend. For instance, you buy 1000 shares in Transurban Group (TCL) on the first day of trading in 2009. It is a low point in the global financial crisis; Australia is experiencing the first negative quarterly GDP growth in 8 years; and it's a month before the introduction of the \$42 billion economic stimulus package by the Rudd government.

We have created a chart that shows two scenarios for your investment:

1. In the first scenario, your dividend payments are deposited into your account.
 - ▶ As Transurban continues to raise the dividend, your passive income increases. Each year the percent increase in the dividend compounds. As a result, your income is increasing faster than the sum of the annual totals.
 - ▶ In 2009, Transurban declares \$230 worth of dividends on your initial investment of \$5020. By 2017, Transurban declares \$545 a year in dividends. If you add up each annual increase in the dividend for the period in which you have owned the stock, there is a total increase of 91.49%. That sounds great but pales in comparison to the total increase in your income, which has increased by 136.96%. That difference of 45.47% in income growth represents the compounding of each increase building on the previous one.
 - ▶ The day after the last dividend declared in 2017 is paid on February 19, 2018, the value of your investment has increased from \$5020 to \$11,650 — an additional gain to the income you have earned.

2. In the second scenario, you have dividend payments automatically re-invested at the share price the day after the dividend payment date.

- ▶ A dividend reinvestment plan (“DRP”) simply requires you to complete a form and send it to the share registry*. The cash dividend will be converted to additional shares without incurring any brokerage, commission, stamp duty or other transaction costs for new shares. By using a DRP your income growth soars because you are getting the benefit of Transurban increasing the dividend and you are growing the number of shares you own.

- ▶ In 2009, you will be paid \$233.25 in dividends, which will grow to \$807.07 in 2017. The difference between the amount you earn in the first scenario and the second scenario is the compounding effect of continually increasing the amount of shares you own and therefore increasing the amount of income you are entitled to. The value of your initial investment has now increased from \$5,020 to \$17,861 on the day after your last 2017 declared dividend is paid on February 19, 2018. Your last declared dividend for 2017 is paid on February 19, 2018. The value of your initial investment has increased from \$5020 to \$17,861—a gain of \$12,841.

Transurban dividends				Taking dividends in cash		Dividend reinvestment			
Pay date	Stock price	Dividends	Annual dividend	Income	Income growth	New shares	Total shares	Total income	Income growth
29/08/2009	4.06	0.11	0.23	\$ 230.00	N/A	27	1,027	233.25	
26/02/2010	5.08	0.12				24	1,051		
27/08/2010	4.70	0.12	0.25	\$ 250.00	8.70%	27	1,078	266.33	14.18%
15/02/2011	5.13	0.13				27	1,106		
11/08/2011	4.83	0.14	0.285	\$ 285.00	14.00%	32	1,138	319.72	20.05%
14/02/2012	5.60	0.145				29	1,167		
14/08/2012	5.67	0.155	0.305	\$ 305.00	7.02%	32	1,199	360.73	12.83%
14/02/2013	5.98	0.15				30	1,229		
14/08/2013	6.76	0.155	0.325	\$ 325.00	6.56%	28	1,257	404.21	12.06%
14/02/2014	6.73	0.17				32	1,289		
14/08/2014	7.83	0.18	0.375	\$ 375.00	15.38%	30	1,319	489.13	21.01%
13/02/2015	9.29	0.195				28	1,346		
14/08/2015	9.69	0.205	0.43	\$ 430.00	14.67%	28	1,375	585.29	19.66%
12/02/2016	10.64	0.225				29	1,404		
12/08/2016	11.90	0.23	0.48	\$ 480.00	11.63%	27	1,431	680.60	16.28%
10/02/2017	10.94	0.25				33	1,464		
11/08/2017	11.56	0.265	0.545	\$ 545.00	13.54%	34	1,497	807.07	18.58%
16/02/2018	11.65	0.28				36	1,533		
				Total income	Total growth			Total income	Total growth
				\$ 3,225.00	136.96%			\$ 4,146.33	250.90%

Using dividends to evaluate stocks

Dividends can be remarkably useful. Not only do they deliver income and drive total return, they can provide a framework for analysing companies. Dividend investors seek stocks whose dividends (1) will not be cut, (2) will grow at an acceptable rate over the long term, and (3) will provide a good total return profile. That's why the analysis of a dividend paying stock can be thought of in terms of three questions, all of which are viewed from the standpoint of the dividend: Is the dividend safe? Will it grow? And what's the potential return?

This is a far more comprehensive approach than it might first appear. Everything relevant about a company—its operations, competitive position, financial health, growth potential, the attitude of management toward shareholders, the valuation of its stock, and more—is organised around these queries. But first, let's visit a concept that is central to Morningstar's approach to all stocks, including those that pay dividends: economic moats.

Economic Moats and Dividends: An economic moat—a term we borrowed from Warren Buffett—is a sustainable competitive advantage (or combination of advantages) that allows a company to earn excess returns on capital for a long period. We assign every company in our coverage universe an economic moat rating of wide, narrow, or none, depending on our assessment of its competitive strengths and

how long we expect these strengths to last. We say a company generates excess returns if its returns on capital (operating profits less taxes divided by the net assets used in the business) consistently exceed its cost of capital (the interest on its debt and the total returns required by shareholders, weighted by how a company's assets are funded). However, it's not enough to observe that a company earns excess returns; we also need to know why. Morningstar identifies five potential sources of an economic moat:

1. Intangible assets: These can include brands, patents, or government licences that explicitly keep competitors at bay. This can be seen in pharmaceutical companies with patent protection or with consumer brands that have long-standing and reputable profiles.



2. Cost advantage: Firms that can provide goods and services at lower costs have big advantages over rivals as they can either undercut their rivals on price or sell at the same price and earn a higher profit margin. Generally, moats based on cost advantage are due to economies of scale—that is, saving costs by increasing production.



3. Switching costs: Switching costs refer to the inconveniences or expenses associated with a customer switching from one product to another. Banks can be good examples as it is time-consuming to switch bank accounts once you have set up direct deposits and payments.



4. Network effect: The network effect occurs when the value of a particular good or service increases as more people use the good or service. Social media sites are perhaps the best example as a low number of members provides less of a benefit to a user than a high number of members.



5. Efficient scale: Efficient scale applies to companies that serve limited markets where there are a small number of competitors. Potential competitors are discouraged from entering the market based on the small opportunity. An example can be a pharmaceutical company that produces drugs for diseases that only affect small patient populations.



What do economic moats have to do with dividends? Everything! If an investor can't rely on the profitability that funds dividends, they can't depend on the dividend. Economic moats also play a critical role in dividend growth. An economic moat doesn't just protect existing profitability; it also suggests that additional investments of retained earnings for expansion—however modest—should earn a good return that will be reflected through enlarged dividend-paying power. But if internal reinvestment fails to produce acceptable dividend growth, that provides evidence that a company's moat is shrinking or has possibly dried up.

Is the dividend under threat? It's hard to understate the importance of avoiding dividend cuts. Even flat dividends aren't too bad; an investor still has the potential to come out ahead. But, by the time it's obvious that a dividend is going to be slashed, shareholders will have usually endured a large drop in the stock price—they'll usually suffer a drop in income and a capital loss.

Sustainability: What factors can help create a reliable stream of dividends?

An economic moat. Economic moat ratings of narrow and wide are one place to look when evaluating future dividend payments potential. An economic moat does not guarantee dividend safety, of course, but no-moat companies are much more likely to cut their dividends during recessions than narrow- and wide-moat firms.

Strong finances. Dividends can be paid to common stockholders only if all other financial obligations are satisfied first—banks, bondholders, suppliers, employees, pensions, the ATO, and even hybrid holders. Being last in the pay line, an investor would typically want to see that this line is not too long.

Other financial factors that may warrant consideration can include tax problems, legal threats—pretty much any other potential claim on a company's cash. Liquidity can be an important factor, too—dividends may come indirectly from earnings, but they're paid in cash. Especially in seasonal or heavily cyclical fields, an investor should seek companies with cash reserves or suitably large lines of credit to smooth out shifts in cash flow. Finally, in situations involving large debt loads, it's important to be aware of any financial covenants with bankers or bondholders that can trigger defaults even before the firm runs out of resources. (If this seems beyond your grasp, simply avoid highly leveraged situations. Debt can be a plus if used in moderation, but there is always a point beyond which it's much more trouble than it's worth.)

Payout ratio. This may be the single most important statistic in evaluating a dividend's stability, but there's always a bit of tension. All else being equal, a higher payout ratio will generate a higher dividend yield, but lower payout ratios are less risky than high ones. What you should seek is balance—current yield versus stability, as well as current yield versus future growth.

The payout ratio itself is pretty simple: it's the proportion of earnings being paid out as dividends. If a company is earning \$2 a share annually and paying dividends at a \$1.20 rate, the payout ratio is 60% (\$1.20 divided by \$2.00). The inverse of the payout ratio—40% in this case—tells you how far earnings could drop before the dividend would no longer be covered by earnings.

One of the biggest responsibilities of the leadership of any company is making capital-allocation decisions. In other words, what you should do with cash that is generated from operating a company or accessing the capital markets (issuing stock or borrowing). The cash can be re-invested in the business (spending more on marketing, hiring people, research and development, etc.), debt can be paid back, acquisitions can be made, stock can be purchased through a buyback or dividends can be paid to investors. These decisions can be influenced by a number of factors and the wisdom of the path taken by management is critical to the future success of the company. The level of debt, the investment opportunities and the predictability of future cash flows are all critical to consider.

One more word about payout ratios: The optimal denominator (earnings) will be different in different circumstances. Among real estate investment trusts, funds from operations are a much better proxy for dividend-paying capacity than reported net income. In this case, payout ratios may approach 100% (or coverage may fall near 1.0 times) without necessarily indicating an unstable payout to investors. Most of these firms are set up to pay out a very large proportion of available resources while raising external capital (new stock and bond issues) to fund growth. If non-traditional statistics are needed to get a clear view of

the situation, you should find out what they are—and how they work.

Finally, all of the foregoing should be considered in the context of management: How devoted is the company's leadership to maintaining the dividend?

Consider past actions as well as anything they've recently said. Even a dividend cut that happened 10 or 20 years ago might tell you something interesting about the fundamentals of the business—and a more recent dividend cut should tell you quite a lot.



Here are some real-world examples of how different types of Australian companies approach dividend payouts based on their business models:

Mature companies in mature industries that have lower growth have smaller investment opportunities for capital. Therefore, it can often be prudent to have higher payout rates. The Big Four banks in Australia are a classic example—limited ability to gain market share domestically through organic growth and a level of industry concentration that makes it impossible to make an acquisition, a poor track record investing internationally and strong and stable cash flows. Consequently, the Big Four's high payout ratios compared to international banking peers seems justified (~65% to 80% payout ratio;

VS

Fast growing companies with ample investment opportunities often have a lower payout ratio as management prefers to re-invest capital to continue to grow the company. CSL is a good example of local company that has a lower payout ratio but has been growing quickly. While the payout ratio of ~46% and the ~1.5% dividend yield are low by Australian standards the growth of the dividend has been quite strong and averaged 19% growth per annum since June 2008. In this case income investors that choose to purchase shares in CSL at a 1.29% yield in 2008 would have a yield at cost of 5.67% today.

Will the dividend grow?

Dividend growth is a sign of health that reflects dividend stability. You can't require a dividend increase every year from every company, but most investors look for a decent average rate of dividend growth over three- to five-year periods.

A good place to start is with a stock's dividend record, preferably including at least 10 years of history, which preferably includes a time where the company has undergone earnings pressure. If nothing else, this will signal the willingness of management to reward shareholders. This doesn't mean candidates with shorter records should be dismissed out of hand, but additional scepticism should be applied.

Forecasting growth is much more than simply extending a recent trend, however. The look ahead starts by separating the dividend into per-share earnings and a payout ratio, both of which are variables. If an investor can presume a stable payout ratio over time, then estimating future dividend growth is no different than estimating earnings growth. But if the current payout ratio is abnormally high or low, an investor may have to make other adjustments to normalise the starting point. Assuming one can get a handle on a normalised level of earnings and dividends the future can be broken into three questions.

How fast can the earnings per share grow? Factors such as the drivers of revenue growth (inflation, real economic growth, market share changes, investment plans, and returns on capital) may be considered, as well as changes in profit margins, interest expense, or taxes.

If the payout ratio is forecast to remain the same, the estimate of the future dividend is calculated by simply multiplying the payout ratio by the future projected earnings. Forecasting changes in the payout ratio involves detailed assessments of the opportunities for future investment given changes in the company's operating approach or the business environment.

Estimating how fast a business grows and changes to the payout ratio are a key focus of the Morningstar equity research team. As an example, we can look at A2 Milk, which is covered by our equity analyst Adam Fleck. As part of his analysis, Adam forecasts both the future earnings and the payout ratio, which can be seen on the next page.

The a2 Milk Company Limited A2M

Morningstar Analyst Ratings

Morningstar Rating for Stocks ^(?)

★★★ 01 May 2019 | 02:20 PM



Note: marker indicates price with 20min delay

Fair Value ^(?) \$13.60 Uncertainty Rating ^(?) High Stewardship Rating ^(?) Standard

Economic Moat ^(?) Narrow Moat Sources ^(?)

- Cost Advantage
- Intangible Assets
- Switching Costs
- Efficient Scale
- Network Effect

Analyst Note Analyst Report Analyst Valuation/Risk

A2's Growth Engine Remains Solid, and Near-Term Profitability Pressure Not Concerning; FVE Unchanged



Adam Fleck
Morningstar
Analyst

Narrow-moat a2 Milk's rapid growth remains impressive, as highlighted by third-quarter fiscal 2019 results, and our long-term thesis continues to play out. We increase our fair value estimate to

NZD 14.50 (AUD 13.60) to account for time value of money since our last update, but following a strong run, the stock now

Share Price

Previous Close ^(?) \$14.58 52 Week Range ^(?) \$16.08 - \$8.14 Market Cap ^(?) \$10,715 M

Valuation

Consider Buying ^(?) \$8.16 Fair Value ^(?) \$13.60 Consider Selling ^(?) \$21.08 Price to Fair Value ^(?) 1.17

Earnings ^(?) Price sensitive numbers based on previous close

	06/17(a)	06/18(a)	06/19(e)	06/20(e)
NPAT (\$m) ^(?)	85.6	181.4	264.1	327.9
EPS (c) ^(?)	11.6	24.4	35.2	43.7
EPS Change (%) ^(?)	184.3	110.0	44.2	24.1
Div Payout Ratio % ^(?)	0.0	0.0	0.0	0.0
DPS (c) ^(?)	0.0	0.0	0.0	0.0
Franking (%) ^(?)	0.0	0.0	0.0	0.0
Grossed-Up DPS (c) ^(?)	0.0	0.0	0.0	0.0
Grossed-Up Yield % ^(?)	0.0	0.0	0.0	0.0
Dividend Yield % ^(?)	0.0	0.0	0.0	0.0
PE Ratio (x) ^(?)	20.1	33.3	41.4	33.4
Avg. Price/Price (\$) ^(?)	2.34	8.12	14.58	14.58

Source: Morningstar analysts

Within the [analyst note](#), [analyst report](#) and [analyst valuation/risk write-up](#), Adam goes into detail on the EPS growth he is projecting.

International income investing

There are several reasons why Australians don't invest overseas. Our own subscribers cite, for instance, a lack of knowledge about overseas markets, currency risk and uncertainty about how to access global investments. And when it comes to income investing, there are even more compelling reasons to stick with local equities. The dividend yield on Australian shares has consistently been among the highest in the world, not to mention the favourable tax treatment of franking credits. Together these two reasons alone leave many Australian investors wondering why they should look overseas for income.

On the surface this logic seems unassailable. If you are investing for income you should simply buy stocks with the highest dividend yield and the best tax treatment. For an Australian investor that means buying fully franked domestic shares. This assumes however—and it's an assumption that has been the downfall of many investors—that the future will match the past. This is of course not true. Future tax treatment of dividends is subject to government policy decisions. The implied forward dividend yield of a stock is based on company policies that are set by the board of directors and influenced by the company's performance and that of the economy at large. The argument for investing internationally for income is the same as all international investing.

By not diversifying your income streams you are making a very concentrated bet on the Australian market. Consider this: the Australian Stock Exchange makes up just 2% of global share markets. If your portfolio only includes Australian investments, you're depriving yourself of potential income from 98% of the world's share markets. And by sticking only to Australian shares you face other risks. A downturn in the Australian economy for instance could severely erode your income stream.



It's crucial to note too that within the ASX 60% of companies belong to the banking and resources sectors—a concentration that limits asset class diversification and exposure to different sources of income. Such a concentration also presents other risks. Falling commodity prices or changes in interest rates, for instance, can transform—for better or worse—the economic prospects and dividends of resource companies and banks. If you rely on the Australian market for an income stream to fund your retirement these risks deserve close consideration. The benefit of diversifying your income stream can outweigh a slight reduction in the current yield and the loss of franking credits.

When comparing international income investments to Australian shares it is important to look beyond yield

and tax benefits. Compare the payout rate, cash flow and balance sheet of different companies to assess the sustainability of the dividends. Explore how industry-specific and country-specific factors will influence prospects of the company and dividend. Diversification is critical when looking at your overall income stream, particularly if there's volatility in the income source or there are concerns over future income streams and capital gains.



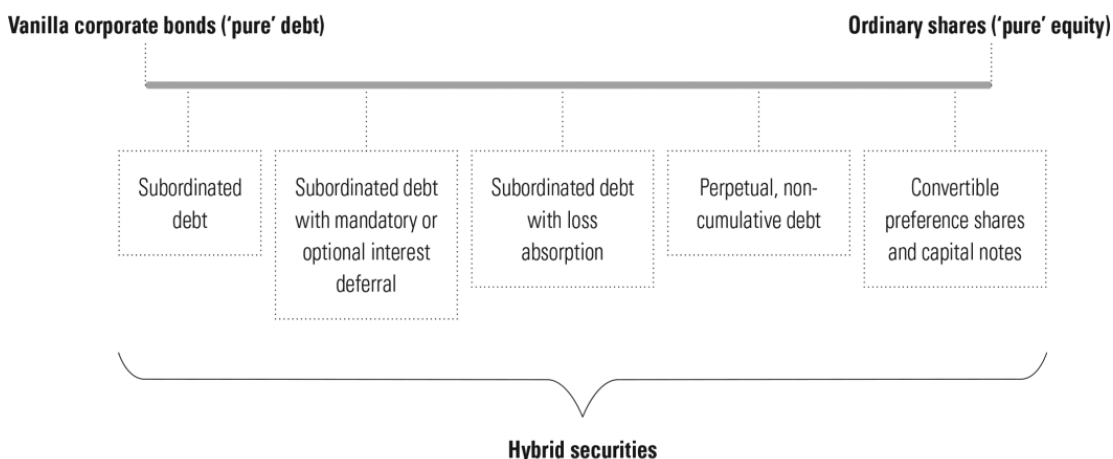
Earning income from hybrids

 A stock dividend is something tangible—it's not an earnings projection; it's something solid, in hand. A stock dividend is a true return on the investment. Everything else is hope and speculation.  **Richard Russell**

Introduction to hybrids

Another way to generate income from an investment portfolio is through hybrid securities. “Hybrids” are securities that contain both debt-like and equity-like characteristics. Within this category are subordinated debt, perpetual notes, convertible preference shares and capital notes.

ASIC's Hybrid Securities Spectrum



Source: ASIC, Morningstar.

Hybrid securities are a relatively new phenomenon in the Australian investment landscape. In 1991, ANZ Bank issued the first domestic Converting Preference Share (CPS), or hybrid security. The \$600 million issue was targeted at institutional investors, although a \$100 million allocation was set aside for retail investors. A coupon of 13.25% helped drive the issue to being nearly \$70 million oversubscribed, leaving ANZ Bank

management compelled to apologise for the shortfall to retail investors in their 1991 annual report for what they described as an “innovative issue”.

The success of ANZ Bank's inaugural CPS issue prompted other issuers to come to market and issue their own hybrid securities. These included household names across both financial and non-financial

industries such as Westpac Banking Corporation, Coles Myer and General Property Trust. Since then, hybrid security structures have evolved in line with economic, regulatory and industry body developments. The trend towards retail-based hybrid issuance accelerated over the years. The majority of new issuance now targets retail investors, predominantly self-managed superannuation funds, or SMSFs. There are still institutional-only hybrid issuances from Australian issuers, but these tend to be from issuers outside of the major banks seeking to raise a relatively low amount of funds. In this case, the relatively high fixed costs of launching a listed retail offer and the quicker execution make institutional issuance a convenient source of funding.

Hybrid security issuance by Australia's major banks has been particularly strong since 2012. This has been driven by:

- ▶ Regulatory capital requirements imposed on banks by the Australian Prudential Regulatory Authority, or APRA, as part of the revised international banking regulatory framework, developed by the Basel Committee on Bank Supervision.
- ▶ Issuer desire for funding source diversification
- ▶ Hybrids being generally cheaper than issuing equity and not dilutive to equity holders
- ▶ More flexible terms and conditions

In contrast to bank hybrids, non-financial hybrid issuance has been subdued in recent years. We attribute this to a range of factors, including:

- ▶ Rating agencies tightening the criteria to qualify as equity credit. This has resulted in corporate hybrid issues losing their 100% equity classification in place of 50% in many instances. The part-debt designation increases the amount of debt an issuer holds on the balance sheet, which can hurt their credit rating
- ▶ Cheaper alternative funding sources, particularly global debt markets
- ▶ Time and cost of execution being too high relative to alternate funding options

- ▶ Subordination in the capital structure. The capital structure is made up of the different securities that a company sells to finance their operations. At the top of the capital structure, debt investors get the first claim to the assets of a business in the event of a bankruptcy. Equity investors receive only the residual value after everyone else gets paid. Hybrids sit in between debt and equity within the capital structure.
- ▶ Distributions may be deferrable, either at the issuer's discretion (optional deferral) or in the event of covenant breaches (mandatory deferral), or both.
- ▶ The distribution may be either fixed, or as is the case for most Australian hybrids, floating. For floating rate hybrids, the distribution rate is tied to another interest rate.
- ▶ They are typically perpetual securities or have a long duration until maturity. Hybrids usually have one or more call options that give the issuer the right, but not the obligation, to redeem the security before the final maturity date. The investor does not have the right to request redemption before final maturity.
- ▶ Hybrid securities may have loss-absorption mechanisms, which require holders to absorb losses while the issuer is still a going concern. For example, capital notes issued by a bank that may qualify as regulatory capital may either convert into ordinary shares, possibly worth significantly less than the original investment, or be written off completely under certain conditions.

Comparing Hybrid Securities to Other Investments

	Shares	Capital Notes	Subordinated Notes	Corporate Bonds	Term Deposits
Income	Dividends. Non-cumulative. Discretionary.	Distributions. Non-cumulative. Discretionary. Subject to a dividend stopper.	Interest payments. May be deferred. May be cumulative.	Interest payments (fixed or floating).	Interest payments (fixed).
Investment Timeframe & Redemption	No maturity date. No redemption requirement.	Generally 7-10 years. Scheduled equity conversion or cash repayment at face value. No maturity date.	Up to 60 years. Issuer option for early redemption. Repaid in cash at maturity.	Fixed term. Generally 5-10 years. Cash repayment at maturity.	Fixed term. Generally between 1 month - 5 years. Cash repayment at maturity.
Early Repayment at Issuer's Discretion	No.	Yes. Generally, after a minimum of 5 years subject to terms & conditions or if trigger event occurs. May be issued with shares over cash.	Yes. On nominated dates usually after 5 years, or upon a trigger event.	Yes. In limited circumstances.	No.
Recovery in Event of Insolvency	Last in line.	Only senior to shareholders. In some instances, written off before shareholders.	Only senior to ordinary shareholders and deeply subordinated investors.	Only senior to shareholders, hybrid holders, subordinated note holders.	Deposits up to AUD 250,000 guaranteed by Government.

Source: ASIC, Morningstar.

While many investors may consider hybrids as purely an income-generating investment, there is the possibility for capital losses and price volatility. The more equity-like a hybrid, the more the security will tend to fluctuate in price during periods of market volatility.

Examples of Hybrid Securities Across the Capital Structure

	Instrument Type	Issuer	ASX Ticker	Security Type	Interest Rate Payable	Franking	Maturity Date	Optional Interest Deferral	Non-Viability or Capital Trigger	Capital Structure Ranking
<p>Most Debt Like</p> <p>Least Debt Like</p>	Subordinated Debt	ANZ	ANZHA	Subordinated, unsecured	BBSW + 2.75%	No, distributions are interest payments	Jun 2022	No, unless ANZ is insolvent	Neither	Senior to Perpetual subordinated debt, preference shares and capital notes and ordinary shares
	Subordinated Debt with Mandatory or Optional Interest Deferral	Crown Resorts	CWNHA	Subordinated, unsecured, cumulative	BBSW + 5.00%	No, distributions are interest payments	Sep 2072	Yes	N/A	Ranking only in priority to Crown's ordinary shares, junior ranking obligations and subsidiary junior ranking obligations
	Subordinated Debt with Loss Absorption	Suncorp	SUNPD	Subordinated, unsecured, cumulative	BBSW + 2.85%	No, distributions are interest payments	Nov 2023	Yes, Dividend Stopper	Non-Viability Trigger	Senior to ordinary shares and Additional Tier 1 Capital, equal with other unsecured subordinated obligations, behind all unsubordinated creditors
	Perpetual Non-Cumulative Debt	NAB	NABHA	Unsecured, stapled, non-cumulative, perpetual	BBSW + 1.25%	No, distributions are interest payments	Perpetual	Yes, Dividend Stopper	Neither	Above ordinary shareholders, equal with preference shares and capital notes but behind all other debt holders
	Convertible Preference Shares	WBC	WBCPC	Subordinated, unsecured, non-cumulative, perpetual, redeemable	BBSW + 3.25%	Yes	Scheduled Conversion (Mar 2020)	Yes, Dividend Stopper	Capital Trigger	Above ordinary shareholders, equal with preference shares and capital notes but behind all other debt holders
	Capital Notes	CBA	CBAPD	Subordinated, unsecured, non-cumulative, perpetual, redeemable	BBSW + 2.80%	Yes	Scheduled Conversion (Dec 2024)	Yes, Dividend Stopper	Non-Viability and Capital Trigger	Above ordinary shareholders, equal with preference shares and capital notes but behind all other debt holders

Source: Morningstar. BBSW refers to the 3 Month Bank Bill Swap Rate.

Benefits of hybrids for investors

Higher rate of return: Hybrid securities generally offer a relatively higher rate of return compared to senior debt, reflecting their subordination on the issuer capital structure.

Liquidity benefits: Although hybrid securities are less liquid than the ordinary shares of the underlying issuer, their secondary market liquidity is supported by their ASX listing.

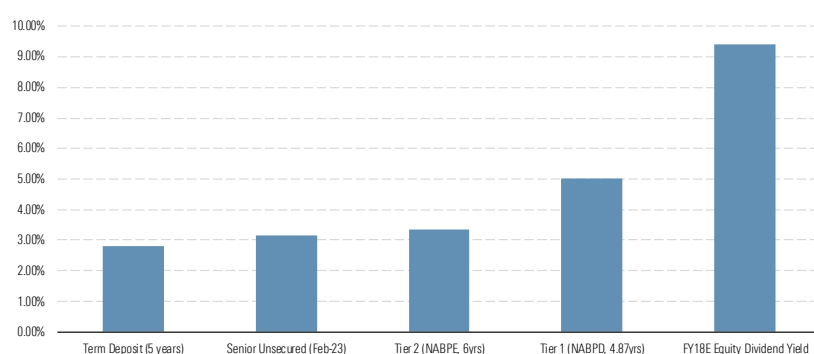
Income at a higher price volatility than fixed income, but lower price volatility than equity: Hybrid securities generally pay a regular distribution while displaying lower price volatility than the ordinary shares of the underlying issuer but a higher price volatility relative to the senior debt of the issuer. Nevertheless, the possibility that distributions can be suspended, or price volatility exceeds that of the underlying equity, remains.

Diversification benefits: Hybrid securities can diversify the overall risk of a portfolio while generating attractive returns, thereby improving overall risk-return profiles. However, we reiterate that hybrid securities should not be considered a like-for-like replacement for term deposits or pure debt. We believe they should be viewed as a separate asset class with their own asset allocation to fully benefit from diversification benefits.

For those wishing to learn more about hybrids please refer to [Morningstar's Hybrid Handbook](#)

To see how Morningstar's research on hybrids please refer to our [Credit Research Archive](#)

National Australia Bank Capital Structure by Returns



Source: Morningstar. Data as at 22 August 2017.

Model Income Equity Portfolio

Dividends may not be the only path for an individual investor's success, but if there's a better one, I have yet to find it. **Josh Peters**

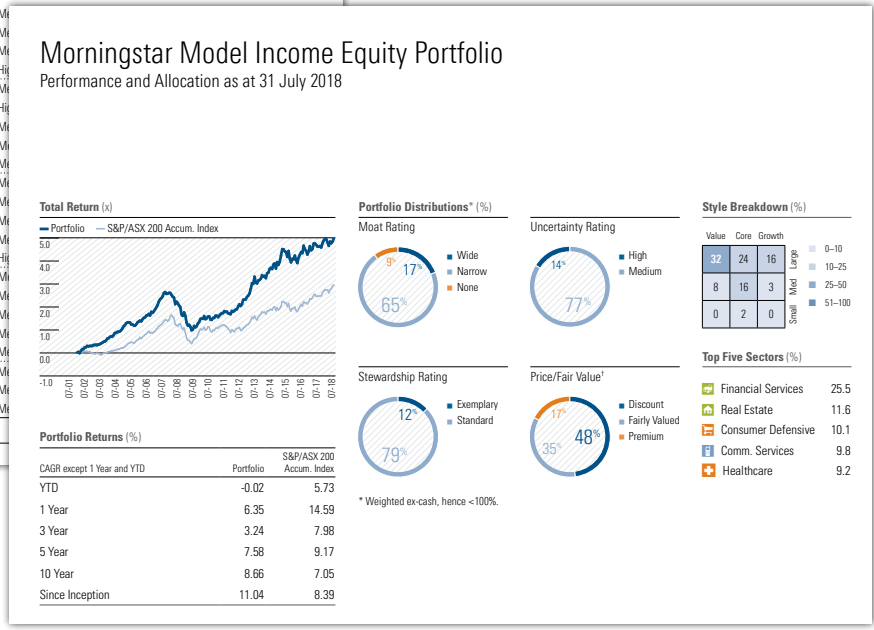
The Model Income Equity Portfolio aims to provide subscribers with a greater risk-adjusted returns and a higher sustainable franked dividend yield relative to the S&P/ASX 200 Accumulation Index in the long term.

The portfolio is actively managed and concentrated consisting of ASX-listed stocks covered by Morningstar's Equity Research team. Morningstar focuses portfolio exposure on companies with competitive advantages, a market price offering margin of safety, a sustainable dividend yield above the benchmark, and franking credits. This combination of

factors helps to preserve capital and reduce volatility in various market environments.

Portfolio turnover is modest to minimise costs and further support after-tax performance. Morningstar Equity Research analysts' ratings, such as Fair Value Estimate, Economic Moat, and Valuation Uncertainty, are important inputs to the portfolio construction process. Total return will tend to be driven more by income than capital appreciation, although both are of course desirable.

Portfolio Holdings	Morningstar Ratings	Legend: Shares Added, Shares Sold, New Holding, Under Review				
Stock Name	% of Portfolio	Morningstar Analyst Rating	Morningstar Style Box	Uncertainty Rating	Moat Rating	Stewardship Rating
Cash	9.12					
Telstra Corp	7.28	★★★★★				
Medibank Private	5.87	★★★★				
Wesfarmers	5.78	★★★				
OBE Insurance Group	5.59	★★★★				
Sydney Airport	5.56	★★★★				
Crown Resorts	5.47	★★★★				
Vicinity Centres	5.18	★★★★				
National Australia Bank	4.74	★★★★				
Commonwealth Bank	4.71	★★★★				
Westpac Banking Corp	4.63	★★★★				
Scentre Group	4.39	★★★				
Coca-Cola Amatil	4.33	★★★★				
Sonic Healthcare	4.20	★★★★				
Woodside Petroleum	3.29	★★★★				
Healthscope	3.28	★★★★				
Brambles	3.12	★★★★				
AGL Energy	3.02	★★★★				
Spark New Zealand	2.67	★★★★				
Carsales.com	2.36	★★★★				
Unibail-Rodamco-Westfield ADR	2.17	★★★				
Ramsay Health Care	1.63	★★★★★				
MYOB Group	1.61	★★★★				
Grand Total						



Glossary

Dividend (or dividend rate): We express most of our dividend data for individual stocks as an annualized amount based on the most recently declared amount per share multiplied by the frequency of dividends during a year. For example, CleanUp, Inc. declared an interim dividend of \$0.78 a share in February 2016 and final dividend of \$1 in September 2016, so its annualized dividend rate is \$1.78 a share. Dividends in Australia are typically paid twice a year. To find historical dividend figures of ASX shares, please enter a ticker and review the Dividend History section.

Dividend growth rate: This figure reflects the compound annual growth rate in the company's annual dividend payments over the preceding ten, five and one-year period. We also make forward-looking projections for dividend growth—typically over the upcoming 2-year period—which are also expressed as a CAGR. To find historical dividend growth and projections of ASX shares, please enter a ticker and review the Key Measures section.

Growth Rates	10yr	5yr	1yr	2yr Fcst
Sales	4.3%	0.2%	-9.5%	--
Cash Flow	-5.1%	-31.1%	235.4%	--
Earnings	7.2%	3.9%	2.2%	0.4%
Dividends	7.4%	3.5%	0.5%	1.1%
Book Value	--	--	--	--

Dividend yield (or current yield): A stock's yield is the annual dividend rate divided by the stock's current price. If CleanUp, Inc. trades at \$95, and the dividend rate is \$3.12 a share, the yield is 3.3%. While dividends are not contractual obligations the way a bond's interest payments are, dividend yield provides a reference for the income potential of a given stock versus other stocks and other income-generating securities. To find the dividend yield and comparisons to the overall market yield and sector yield, enter a ticker and review the Key Measures section.

Income	Company	Market	Sector
Dividend Yield	5.7%	4.0%	6.2%
Franking	100.0%	--	--
Tax Adjusted Dividend Yield	4.5%	2.7%	4.9%
Dividend Stability	99.5%	91.6%	97.7%

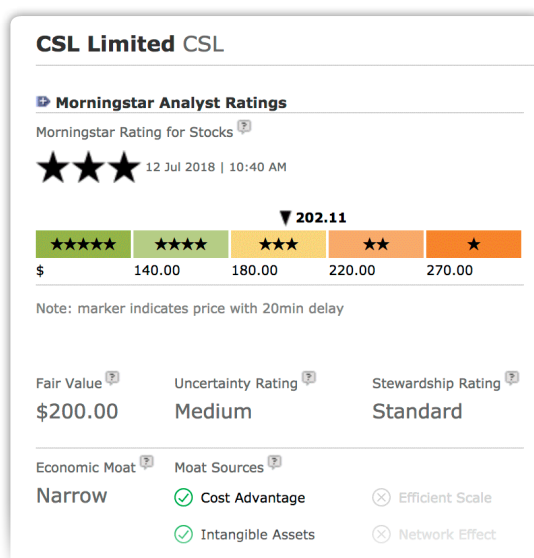
Commonwealth Bank of Australia CBA

Dividend History to Date ^(?)

Type	Cents per Share	Currency	Franked % ^(?)	Ex Dividend Date ^(?)	Books Close Date ^(?)	Dividend Pay Date ^(?)
Final	231.00	AUD	100	15 Aug, 18	16 Aug, 18	28 Sep, 18
Interim	200.00	AUD	100	14 Feb, 18	15 Feb, 18	28 Mar, 18
Final	230.00	AUD	100	16 Aug, 17	17 Aug, 17	29 Sep, 17
Interim	199.00	AUD	100	22 Feb, 17	23 Feb, 17	04 Apr, 17
Final	222.00	AUD	100	17 Aug, 16	18 Aug, 16	29 Sep, 16
Interim	198.00	AUD	100	16 Feb, 16	18 Feb, 16	31 Mar, 16
Final	222.00	AUD	100	18 Aug, 15	20 Aug, 15	01 Oct, 15
Interim	198.00	AUD	100	17 Feb, 15	19 Feb, 15	02 Apr, 15
Final	218.00	AUD	100	19 Aug, 14	21 Aug, 14	02 Oct, 14
Interim	183.00	AUD	100	17 Feb, 14	21 Feb, 14	03 Apr, 14
Final	200.00	AUD	100	19 Aug, 13	23 Aug, 13	03 Oct, 13
Interim	164.00	AUD	100	18 Feb, 13	22 Feb, 13	05 Apr, 13
Final	197.00	AUD	100	20 Aug, 12	24 Aug, 12	05 Oct, 12
Interim	137.00	AUD	100	20 Feb, 12	24 Feb, 12	05 Apr, 12
Final	188.00	AUD	100	15 Aug, 11	19 Aug, 11	06 Oct, 11
Interim	132.00	AUD	100	14 Feb, 11	18 Feb, 11	01 Apr, 11
Final	170.00	AUD	100	16 Aug, 10	20 Aug, 10	01 Oct, 10
Interim	120.00	AUD	100	15 Feb, 10	19 Feb, 10	01 Apr, 10

Economic moat Morningstar's moat ratings reflect our assessment of a company's competitive standing, with ratings of wide, narrow, or none. We expect the structural competitive advantages furnished by a wide moat to encourage excess returns on capital (defined as returns on capital less a company's cost of capital) for at least 20 years. Narrow moats reflect an expectation of shorter-lived advantages and/or smaller excess returns. Wide and narrow moats help protect a company's ability to pay and increase its dividend, so we strongly prefer stocks with Morningstar economic moat ratings of wide or narrow. To find out if a company has an economic moat and the source of the moat, enter the ticker and review the Current Research View section.

Payout ratio: This is the percentage of earnings being paid out as dividends by a corporation. For example, a company earning \$2.00 a share on an annual basis and paying dividends at the rate of \$1.20 a share annually has a payout ratio of 60%. Both the numerator (dividends) and the denominator (earnings) may reflect timing issues, adjustments for unusual dividend payments, and/or factors influencing reported earnings. To find the current and previous year's payout ratio as well as projections for the next two years, enter the ticker and review the Current Research View section.



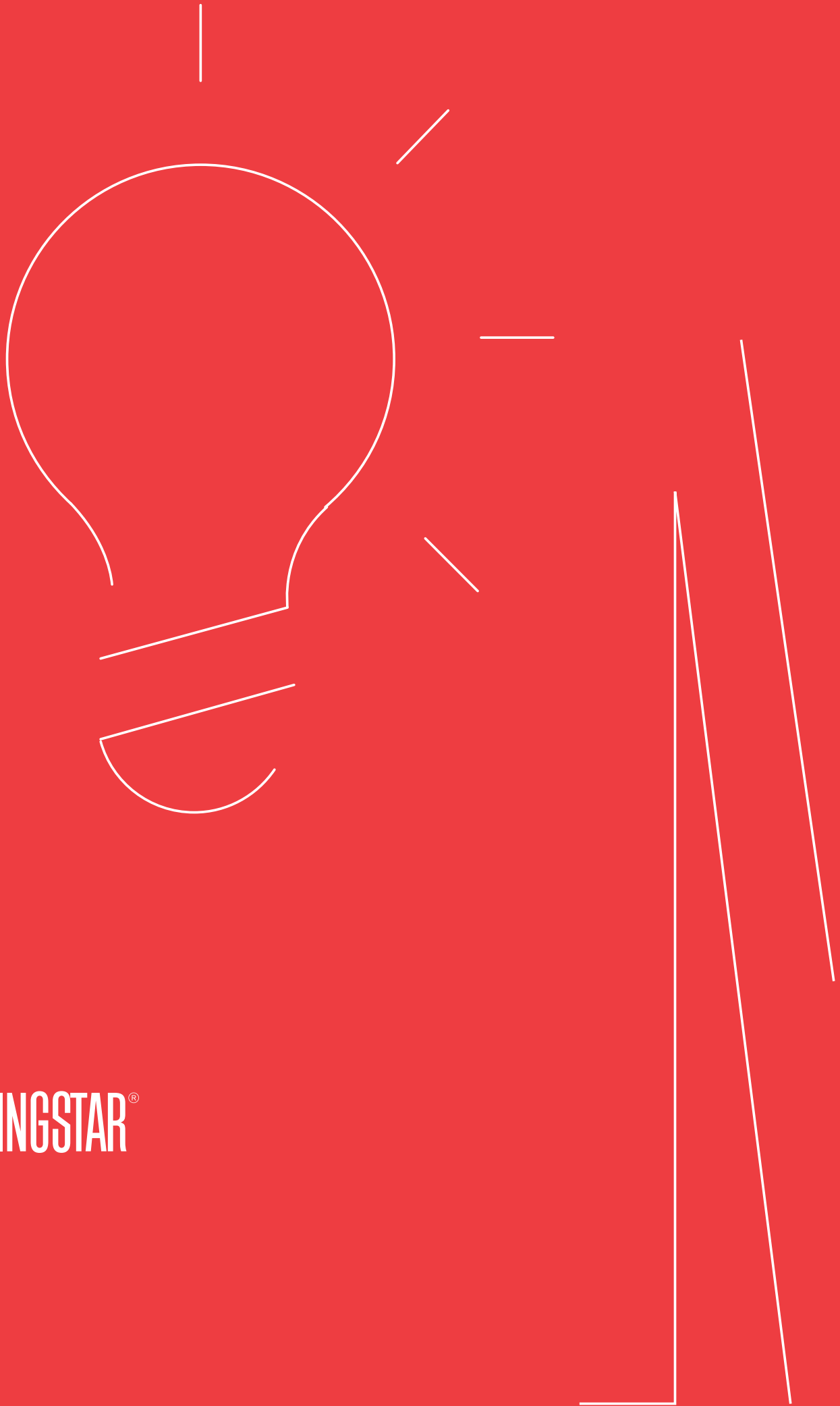
Earnings ^(?) Price sensitive numbers based on previous close

	06/16(a)	06/17(a)	06/18(e)	06/19(e)
NPAT (\$m) ^(?)	1,680.0	1,745.7	2,273.7	2,736.5
EPS (c) ^(?)	363.6	383.4	501.8	604.1
EPS Change (%) ^(?)	-3.8	5.4	30.9	20.4
Div Payout Ratio % ^(?)	46.9	46.3	46.0	46.0
DPS (c) ^(?)	170.4	177.5	230.8	277.8
Franking (%) ^(?)	0.0	0.0	0.0	0.0
Grossed-Up DPS (c) ^(?)	170.4	177.5	230.8	277.8
Grossed-Up Yield % ^(?)	1.7	1.5	1.2	1.4
Dividend Yield % ^(?)	1.7	1.5	1.2	1.4
PE Ratio (x) ^(?)	27.5	29.9	40.0	33.2
Avg. Price/Price (\$) ^(?)	99.96	114.63	200.61	200.61

Source: Morningstar analysts

Dividend Stability: This calculation is designed to assess the probability of a future cut in dividends based on the company's 10- year track record. It is based on two factors: (1) The number of times in the last 10 years (or less, if data is not available), in which the annual dividend has been cut. This percentage is then multiplied by the average percentage size of the cut. The higher the percentage, the more stable the dividend. A dividend stability of 100 percent indicates no dividend cuts have been recorded. To find the current and previous year's payout ratio as well as projections for the next two years, enter the ticker and review the Key Measures section.

Income	Company	Market	Sector
Dividend Yield	5.7%	4.0%	6.2%
Franking	100.0%	--	--
Tax Adjusted Dividend Yield	4.5%	2.7%	4.9%
Dividend Stability	99.5%	91.6%	97.7%



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