Djerriwarrh
AUSTRALIAN EQUITIES, ENHANCED YIELD

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Financial System Inquiry
GPO Box 89
Sydney
NSW 8001

via electronic submission

25 August 2014

Submission to the Financial System Inquiry Interim Report
RE: Dividend Imputation

Dear Sir/Madam

We are writing in response to an observation in the Financial System Inquiry Interim Report that "the case for retaining Dividend Imputation is less clear than it was in the past"

Djerriwarrh Investments Limited is a publicly listed investment company. Our investment aims are to provide shareholders with attractive total returns including capital growth over the medium to long term and to pay an enhanced level of dividends. Our shareholder base of nineteen thousand investors is comprised of predominantly retail shareholders and self-managed superannuation funds and a number of charitable and not-for-profit organisations. Because of the nature of our investment activities these shareholders have a deep interest and strong commitment to the continuation of the Dividend Imputation System. Any prospect that this system might be dropped or substantially changed is likely to be extremely detrimental to their interests. Accordingly, on their behalf we felt it was essential to respond to the observations about Dividend Imputation in the Financial System Inquiry Interim Report.

Company profits paid out as dividends are not taxed twice

The fundamental policy objective of the Dividend Imputation System is that shareholders receiving dividends from companies do not suffer double taxation on that income stream, that is once in the hands of the hands of the company and then a second time on the dividend received. This means that Australian Investors are taxed at their marginal rate on the underlying company income by being given a tax credit for the company tax already paid by the company. It means they do not suffer a tax disadvantage from investing in equities that pay dividends, as compared with bonds that provide interest income. Given that equities are generally more risky than fixed investment securities, it seemed particularly inappropriate that they were taxed disadvantageously prior to the introduction of Dividend Imputation.

Investor Behaviour under the Dividend Imputation System

The consequences of the Dividend System for Australian Capital Markets have been profound. It has stimulated retail investors to have an interest in equity investments both directly and through Superannuation. This is obvious from the very large shareholder bases of our largest companies such as the four major banks, Wesfarmers, Woolworths, BHP and Telstra. Equity investments are seen in the Australian community as not just an esoteric investment for the wealthy but an appropriate and sensible investment for most of the population, in particular, to prepare for their retirement. We believe that it would be an extremely retrograde step to make any policy changes that would reduce the appetite of the general investor for investing in equities.

It was very obvious during the global financial crisis that Australian investors supported the large and urgent capital raisings by major Australian companies including the banks to bolster their capital position and reduce their gearing. This was a very significant factor in the Australian economy weathering the shock of the global financial crisis with considerable resilience. It is our view that this investor support was greatly assisted by the fact that these companies, in normal times, pay attractive dividends which are fully franked under the Dividend Imputation System.

Corporate Behaviour under the Dividend Imputation System

It is evident to us as an investor in sixty major listed companies in Australia that the existence of the Dividend Imputation System has had an equally important positive effect on the behaviour of Australian companies.

We observe that companies are motivated to structure their operations in ways that are subject to company tax in Australia knowing that the company tax they pay will be imputed to shareholders when the shareholders receive dividends. It is our view that the Dividend Imputation System has contributed to the willingness of companies to pay Australian tax rather than look for creative ways to reduce it as much as possible (or to transfer that liability offshore).

The second change in behaviour we note is that the Boards of companies give more attention to the desire of shareholders to receive fully franked dividends.

We believe it is correct that the Dividend Imputation System has led to an increase in the level of dividend payout ratios for many Australian Companies. As a long term investor we regard this as a very desirable outcome. For a long term investor who is unwilling to sell their investment, the primary way of benefitting in the prosperity of a Company is by receipt of increasing dividends.

We see that fund managers with a shorter term investment horizon are much more willing to sell their shares to crystallize value for their investors rather than focus on dividends. Long term investment has entirely the opposite view namely, that the best value that companies can create is by increasing their flow of dividends. We think the Dividend Imputation System has been important in enabling companies to encourage their long term investors through attractive growing dividend streams.

It is sometimes argued that the Dividend Imputation system discourages companies from reinvesting their profit in the growth of the business. As investors we do not observe this. However, it has meant that companies are more disciplined in their use of retained profit. Companies should only retain profit if it can be deployed in a way that adds value for shareholders by earning an attractive rate of return as with any capital allocation decision. Otherwise, in our view, it should be returned to shareholders.

Companies that are in need of additional equity for new investment can promptly and readily tap their shareholder bases through Dividend Reinvestment Plans, Share Purchase Plans or Short Form Rights Issues. Our experience is that shareholders will strongly support companies that have a sound track record of performance.

The economic environment in Australia in recent years has been such that many companies have found it difficult to grow their businesses organically in a way that would provide attractive returns on additional equity. This may well be another factor behind recent decisions by companies to pay out a higher level of dividends rather than retain earnings.

Another line of argument about company behaviour under the Dividend Imputation System is that it discourages companies from investing offshore. In the case of the companies in which we invest we do not see evidence that supports this view. In fact, there are many listed Australian companies that have undertaken very significant investment in the growth and development of businesses offshore, examples would include AMCOR, ANZ Banking Group, ALS Limited, BHP Billiton, Brambles, Coca Cola Amatil, Computershare, CSL Limited, James Hardie Industries, Ramsay Health Care, Sonic Healthcare, Toll Holdings, and many more. We are not aware of instances where the Dividend Imputation System has substantially inhibited companies from investing offshore. However we can understand the reticence of some companies to do so. Investing offshore significantly increases the risk and complexity of operating and managing a business. Success usually takes much longer than is initially anticipated and the record of Australian companies in investing overseas has been patchy.

The attitude of Foreign Investors towards Australian Equity.

Another argument about the Dividend Imputation System is that it discourages foreign investors from investing in Australian Equity because they cannot participate in the Dividend Imputation System. We do not believe this is a significant issue.

The attitude of foreign investors towards Australia is a complex issue. It involves judgments by them about many general and specific issues. These include the state of the Australian economy, the level of the Australian dollar, the levels of interest rates and inflation expectations, fiscal and monetary policy settings and directions and the political situation. Then there are a whole host of issues that relate to particular companies and their management, risks and future prospects. While dividend yield will, of course, be one of the issues in their thinking, given all the factors involved we do not believe that the Dividend Imputation System looms as a significant issue for them. We should note in passing that they do benefit from the Dividend Imputation System, in that fully franked dividends are not subject to dividend withholding tax when paid to foreign shareholders.

Conclusion

We understand that one of the key issues of the Financial System Inquiry is to consider ways to maintain and enhance the stability and resilience of the Financial System. As one can infer from the points set out above, it is our view that the Dividend Imputation System has been one of the key policy settings that has supported both the health and robustness of the system in recent years. We believe that the case for retaining the Dividend Imputation System is now stronger and more important than it was in the past. Any move to eliminate or substantially weaken the Dividend Imputation System could have a significant negative effect on the willingness of Australian investors to put their capital at risk in the Australian Banks and Financial Services Companies. We would strongly urge the Financial System Inquiry to reconsider their view, and to recognize the significance of the Dividend Imputation System as a key plank in the strength of the Australian Financial System.

Yours sincerely / faithfully

John Paterson
Chairman
Djerriwarrh Investments Limited