INTUITION

11 FEBRUARY 2022

Income: The Power behind Compounding

The Harvard House investment mantra underlines the importance of income when investing. Hardly a presentation goes by when this mantra is echoed that we are accosted shortly after by some investor eager to explain that they are not interested in income. Their objective is growth. Generally, the implication is that income is not important for growth clients. This could not be further from the truth. Numerous studies have demonstrated that a high percentage of long-term returns are generated by the compounding of dividends earned.

Robin Gibson

SPEED READ

- **An offshore portfolio started in 2012 has grown by 4.3% better than inflation in GBP terms yet of the absolute value of that portfolio today, nearly 20% is the total sum of all dividends re-invested over the period.**
- **The compounding of dividends is most significantly affected by investment costs, not by portfolio return. This is one of the reasons that Harvard House considers this a critical area to which clients should pay attention.**
- **R10,000 invested in the JSE All Share in 1960 would be worth R98 million at the end of 2021 assuming all dividends had been reinvested. If no dividends are reinvested the portfolio would only be worth R7.7 million.**

The power of compounding dividends is vastly understated. Growth investors have been lured by triple-digit returns from new era technology stocks in recent times. These stocks pay virtually no dividends (if they pay a dividend at all) yet investors are unfazed at the lack of their share of profits so long as the growth numbers look good. Well, that's fine until your favourite stock falls by 50% and then takes 5 years to recover - all the while not paying you anything for the privilege. Have investors missed a trick?

A very small investor gave us £14,946 at the end of February 2013 to run an offshore portfolio. We didn't hold any of the exciting stocks like Amazon, Tesla, Spotify or Netflix. We held boring old economy stocks that paid dividends - shares like Johnson & Johnson, Caterpillar, Disney, Rio Tinto, and Unilever - and we compounded those dividends. At January 2022, the portfolio is worth £28,069. Perhaps they would have done better in the S&P500, but their goal wasn't to pick the best performing market over the last 10 years. It was to grow their wealth against inflation. This they did, by 4.3% per annum, and comfortably within the 4% to 6% better than inflation range upon which we based the initial financial planning.

> "Without the dividends, the portfolio would have hardly exceeded inflation..."

Over the life of this portfolio the investor received £4,892 in dividends, almost 20% of the current market value. This money bought additional shares. It is impossible to establish what these additional purchases contributed to the final market value. After all the new purchases also experienced capital growth and earned dividends. Nearly a third of the market value is likely as a result of these dividends. Without the dividends, the portfolio would have hardly exceeded inflation and it certainly would not have achieved excess return above inflation of 4% to 6%.

The story of dividends is a frequently visited one. In 2021 an American fund manager, Hartford Funds, used Morningstar Data to evaluate the S&P 500 return including and excluding dividends. Without reinvesting dividends, a portfolio of $10,000 started in 1960 grew to $627,161 by the end of 2020. Over the same period, the compounding and reinvesting of dividends would have swelled this to $3,845,730 – 6 times better. Let's consider the data differently. The S&P 500 returned an annual 9.96% with dividends included. The S&P without dividends included (pure share price changes) produced 6.92% per annum. The reinvestment of dividends, therefore, contributed to an additional 44% annual return.

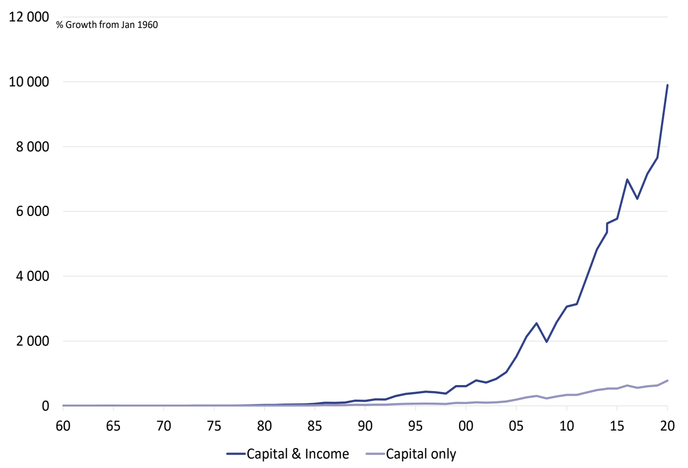
Now let's consider the impact of costs on this exercise. This is probably best illustrated with a table:

	No costs	1% annual cost	1.3% annual cost
S&P500 (dividends reinvested)	$ 3,845,730	$ 2,118,818	$ 1,772109
S&P500 (no dividends reinvested)	$ 627,161	$ 345,797	$ 289,082

What is probably most powerfully illustrated here is that even a 0.3% increase in the fee makes a big difference in the long term.

We have focused on foreign investments largely in this article, but it is not much different for the South African market. Consider the JSE All Share over the same period – 1960 to 2020. This is reflected in the chart below. An initial investment of R10,000 would have grown to R98 million with dividends, but only R7.78 million without.

JSE RETURNS WITH & WITHOUT DIVIDENDS



Compounding and reinvesting dividends has been referred to as the 8th wonder of the world, and for good reason. The difference in returns over time is startling. Investing early in life and letting the compounding process work for you is one of the best decisions you can make.

In conclusion, returns are important, but long-term returns are not just driven by the change in share prices. A fundamental building block of investment success is the compounding of dividends. Costs are incredibly important as well - even a small reduction can make a significant long-term difference. The Harvard House income-focused investment strategy is no less valid for growth investors. It has worked consistently for clients over the last 50 years and we are certain that the next fifty years will yield similar results.

Compounding may be dull in the beginning but, in time, it becomes downright exciting as money grows out of your interest or dividend contributions.

Our seminar schedule for 2022 will be published shortly
Watch this space

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Topic: **To be confirmed**

Natal Midlands	
Date:	TBC
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	TBC
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

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