IML INVESTORS MUTUAL LTD

Investor Series: Why earning income from shares has taken on extra significance…

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Looking back over 35 years of investing, I never thought that I would ever see the day in Australia where interest rates are as low as they are today.

Ninety-day bank bills are currently yielding 0.1%, with 180-day bills not much better at 0.13%. The yields on Australian Government bonds are also at record lows, with the three-year government bond currently yielding around 0.2%.

With interest rates this low in Australia, the challenges that have been confronting investors in other parts of the world, like Europe, since 2010 have now landed on our doorstep. The days when a retiree could earn four, five or six percent on an Australian term deposit are long gone.

Interest rates set the benchmark by which all assets, including shares, are priced. Keeping them too low for too long can contribute to asset bubbles, as ultra-low interest rates also encourage excessive speculation and risk-taking. At its most extreme, this can also create potential 'systemic risks', as we saw during the Global Financial Crisis.

So what is an Australian investor who has planned all their life to live off the income from their savings supposed to do, particularly when there is little prospect of interest rates and term deposit yields rising in the next few years? This is a very difficult question to answer, as we are living in unprecedented times. In many ways despite interest rates being so low, it is tempting for investors to keep a significant portion of their savings in cash, given the uncertainties and the dire predictions from certain commentators and in the media.

The truth is that no-one has the answers to this dilemma. What I do know from my 35 years in investment markets is that a diversified portfolio of quality industrial shares, able to pay reliable and consistent dividends, is still likely to provide the best long-term outcome for the majority of investors, including a reliable source of income.

The key question is what we mean by 'quality'. At IML, we believe it means companies that have a sustainable competitive advantage, such as a strong franchise; recurring earnings underpinned by a strong balance sheet; and are run by competent and experienced management. What we do not like are companies which are heavily reliant on strength in the economic cycle to grow earnings, or speculative companies which are often loss-making, as investors bet on a 'hockey stick'-style surge in profitability in the future. Stocks that come to mind and which seemingly have many investors infatuated are 'buy now pay later' stocks, technology companies which trade at huge valuations despite little or no earnings, or cryptocurrencies – the parade of so-called investment 'opportunities' is endless.

While the environment going forward remains highly uncertain, we still strongly believe that a carefully selected portfolio of well-managed, established companies with real earnings can generate reliable and consistent dividends and long-term capital growth for investors. It remains crucial to always pick well-established companies, especially given the highly uncertain economic environment, as we want to own companies that are able to "live to fight another day", almost irrespective of what the economy throws at them.

Thus at the moment we are accumulating more shares in **Orica**, a world leader in explosives with competitive advantage thanks to its scale, privileged plant location, and innovation pipeline. The company also has a strong balance sheet, a very capable management, and trades at a very attractive share price at current levels. Orica's operations have remained largely unaffected by the shutdowns in most parts of the world, and the firm is set to benefit from sustained earnings growth from new products such as wireless blasting, and from cost-outs.

Amcor, one of the world's largest packaging suppliers, has highly cash-generative operations which have produced steadily growing earnings and dividends thanks to a very resilient business. **Aurizon** has a strong balance sheet underpinned by its Queensland rail infrastructure business with regulatory-agreed returns and a haulage business with long-term contracts, generating sustainable cashflows which support the payment of a healthy dividend. **Brambles** is a global leader in the pallets industry and in the distribution of fast-moving consumer goods, and is a solid, defensive business which is reasonably valued, with a top-notch management team and proven track record of generating strong free cashflow. Despite a slowdown in the global economy, there will always be demand for the consumer staples goods which underpin Brambles' growing and recurring earnings stream. We also like supermarket operator **Coles**, which has a very strong balance sheet and is also improving its long-term margins through a billion-dollar cost-out program.

These are the companies that in future will reward investors through the payment of regular, healthy dividends as well as long-term capital growth. These companies' strong positions in their essential industries enable them to generate sustainable earnings from which they can pay good dividends to shareholders. We are also confident that these companies' experienced and capable management teams will invest retained cashflows wisely in the coming years, and that this investment will generate good long-term growth for their shareholders.

Judging by the recent share price performances of stocks such as **Afterpay** or **Zip**, it appears people buying these types of stocks are taking the view that the future prospects of these companies are fantastic, despite the fact that they are loss-making today. The truth is that nobody knows what the future holds for these companies. On the other hand, one can be pretty confident that the likes of Amcor, Aurizon, Brambles, Coles, and Orica will continue to produce steadily growing earnings and dividends over the long term that we can pass on to investors in our funds. This is why good quality industrial companies like these remain core holdings for IML. While many of these companies' share prices are not shooting the lights out in the same manner as **WiseTech** or **PointsBet**, they remain very attractively valued in our view.

Company	Ticker	Dividend Yield %
Amcor	AMC	4.4%
Aurizon	AZJ	6.0%
Brambles	BXB	3.1%
Coles	COL	3.5%
Orica	ORI	3.0%

Source: FactSet, dividend yields are FY21 consensus forecasts

With the economic backdrop uncertain, and interest rates looking set to remain low for a number of years, we remain confident that a carefully selected portfolio of well-managed industrial companies with repeatable earnings, attractive dividends, and company management who really know what they are doing will serve you well.

Remember our retiree we talked about at the start, facing the prospect of a return on their term deposit of next to nothing? They still need that income, and they are increasingly looking to the sharemarket to get it. And that is why we are committed to staying disciplined, avoiding froth, and putting all our efforts into picking stocks which pay reliable and consistent dividends, so that we can deliver the income and long-term capital growth our investors need to fund their lifestyle in the years ahead.