



Market conditions and income distributions

While income distributions vary over time, this year will see many investment trust investors receive lower amounts than previous years. Market Watch spoke with MLC's Michelle Heinrich for the inside story.

MW: Michelle, let's start with the basics; what are income distributions and what are they made up of?

Michelle: Essentially a managed fund with a trust structure distributes the income they generate to investors.

Distributions are made up of income from the underlying investments held by the managed fund. These could be shares, property, bonds and/or cash. As such the distribution could include interest earned, franked and unfranked dividends, tax deferred income, and any realised capital gains made from selling investments.

So the distribution an investor receives can be as varied as the assets the managed fund invests in.

MW: Do individual investors have to pay tax on the income distribution?

Michelle: Yes. All income must be distributed from the managed fund in the financial year they are earned in order to maintain trust status. Whether an investor reinvests the distribution in the fund or has it paid out, they still have to pay tax at the end of the financial year. Just how much tax will depend on the components of the distribution and the investor's marginal tax rate.

MW: So why are income distributions lower this year?

Michelle: Distributions will be lower because they rely on the income generated by the securities the managed fund invests in. Over the last year or so, few assets have not been adversely affected by declining values and falling income, due to the impact of the global financial crisis and consequent economic downturn. For example not only has the value of the Australian sharemarket declined over the year to 30 June 2009, but the dividend yield has also declined.

MW: What were the specifics of the market impact and why?

Michelle: It's probably worthwhile addressing this question at the asset class level, so I will start with shares and listed property.

Many listed companies and property trusts have reduced the dividends they pay to shareholders. There are two main drivers of this decline in dividends:

Firstly, the credit crisis impacted the ability of companies to borrow money or refinance existing loans at competitive rates. This forced many companies to reduce dividend payout ratios.



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This problem is particularly painful in the Australian listed property sector which rode on the back of unsustainable payout ratios and high levels of gearing for many years. Retaining earnings and raising capital via equity issues is currently a cheaper way to improve balance sheet strength or to provide cash flow for many companies.

Secondly the global economic downturn meant many companies earned less, especially where they relied heavily on discretionary consumer spending. As dividends are primarily sourced from earnings, the impact of the downturn has been negative. For example, the dividend yield* on Australian shares fell 28% in the past two years; from 5% at 30 June 2007 to 3.6% at 30 April 2009. The dividend yield on Real Estate Investment Trusts (REITS) halved; from 7% to 3.5% over the same period.

The income paid by funds with bond investments also suffered from the market environment of the last year. Usually, a falling interest rate environment is good for bond investments, particularly those that have a longer time frame. That is, the longer the term to maturity, the greater the positive impact on current valuations when interest rates fall.

However, this positive environment was overwhelmed by a loss of confidence, particularly in the company or credit sector of the bond market, which saw bond values plummet.

*as measured by the S&P/ASX300 Index.

MW: What are the tax components of the distribution?

Michelle: This is where it gets a little complicated. Any realised capital gains are included in the distribution as they must be distributed under tax law.

So, when a fund manager sells a security and makes a capital gain, this gain is included in the distribution and therefore subject to capital gain tax.

If a manager regularly buys and sells investments in the fund and makes a profit on the sale, then they're likely to have larger distributions.

There are also portions of realised capital gains that are concessionally taxed. For our MLC portfolios, we provide a complete guide of the tax components in our investor tax statements to make it easier for them to fill out their tax return.

MW: This sounds like a lot of tax, how does MLC manage this?

Michelle: For our multi-manager funds, we prefer to hire managers who are tax aware. These managers tend to buy and hold shares in companies for the long term and thereby benefit from the concessional capital gains tax treatment of shares held for more than 12 months.

This means investors receive more of the return on the asset after all fees and taxes have been paid, compared to a higher turnover strategy, with holding periods of less than 12 months.



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MW: Why do distributions vary from quarter to quarter?

Michelle: There are two primary reasons why distributions vary.

1. For funds that have an allocation to Australian shares, a contributing factor is the dividend payout dates of many Australian companies. Many of the larger firms pay dividends in November and May which is then paid out in these quarters rather than the August and February quarters.
2. The final quarter distribution in the year is generally larger than other quarters as any capital gains the funds has made (realised capital gain) needs to be distributed in the last quarter of the financial year.

MW: Does the income distribution have any impact on the value of the fund?

Michelle: Yes. Once an income distribution has been paid from a managed fund, the unit price will drop. This is because the unit price reflects the accumulated income that is being paid from the fund.

MW: Does currency have an impact on the returns investors receive from funds that invest outside Australia?

Michelle: Yes. If you invest in funds that own non-Australian securities such as global shares, listed property and bonds, you'll be exposed to the impact of currency fluctuations on both your income and capital. This can impact the return you receive, both positively and negatively, depending on how you choose to manage your currency exposure.

MW: So what can be done to help manage the impact of currency fluctuations?

Michelle: Funds that have a currency hedging strategy help manage the impact of currency movements on your global exposures.

MW: How does this work in practice?

Michelle: Well, a fully \$AUD (Australian dollar) hedged position means the effect of currency is completely removed and returns from your global exposures are based on the performance of the underlying investment only. To implement this hedge strategy, a fund manager sells forward foreign exchange contracts at a set exchange rate to lock in the sale price at some point in the future. But this strategy does mean your hedged portfolio will underperform an unhedged strategy when the \$AUD declines¹.

Conversely, an unhedged position means the investment returns will also depend on movements in value of the \$AUD relative to the currencies in which the investments are held. Unhedged portfolios will underperform an equivalent hedged portfolio when the \$AUD rises².

¹ All other things being equal.

² All other things being equal.



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Alternatively you can hedge part of your global exposures and have the rest unhedged. This is the approach taken in the MLC Horizon portfolios where a strategic hedge ratio is set and maintained. Generally speaking, the greater your exposure to offshore assets, the higher the strategic hedge ratio.

MW: How does currency hedging impact income distributions?

Michelle: Currency hedging can help smooth the impact of foreign currency fluctuations on an investor's total return. However it can also result in foreign exchange gains or losses being realised and this impacts income distributions, because foreign exchange gains or losses are treated as income or losses and offset against other sources of income such as interest.

For example, if the Australian dollar rises, the value of unhedged global assets held by Australian investors fall, but the value of the sold \$AUD hedge contract rises. This increase in the hedge contract value compensates for the fall in the value of the unhedged non-Australian assets.

Any gains realised when the hedge contract expires are treated as income under Australian tax law and included in the trust's distribution. This may occur despite the total return of the fund declining.

This year, we saw a reverse of this occur, with the Australian dollar falling quite dramatically through the year against major currencies. The Australian dollar fell sharply from highs above 98c to lows around 60c against the US dollar between July and October 08, representing a decline in value of 40%. When the Australian dollar falls in value, the value of unhedged global assets owned by an Australian investor will increase in value. However this also results in a loss on the sold \$AUD hedge contract.

Any losses a fund realises when the hedging contract expires will be offset against other income. In some circumstances the hedge losses may exceed other income received, resulting in no net income distribution at all because the fund is in an overall loss position.

MW: Can currency hedging impact the funds' ability to pay future distributions?

Michelle: Yes. Unutilised realised currency losses can be carried forward from prior years and offset against other income until those currency losses are fully recovered³. But currency hedging isn't the only factor that impacts a fund's distributions. The distribution will also depend on a fund's other income, gains, losses and expenses.

MW: Will the income distributions be better next year?

Michelle: At this stage it doesn't look likely, at least for the next couple of quarters. However, if the market starts to recover and I believe over time it will, then the distributions should also improve.

If you're invested in MLC portfolios, you can find out more specific information on our [news and information](#) section of [mlc.com.au](#)

³ Subject to the trust maintaining the same owners



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