

Roger Kinsky

Starting with SHARES

A BEGINNER'S GUIDE TO SHAREMARKET SUCCESS



WILEY

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Chapter 3
Profiting from shares

The most likely reason you're reading this book and wanting to get into shares is because you hope (or expect) to make a profit by investing in them. You probably realise that any spare cash you have isn't earning much in the bank so you want to bring your money back from the holiday it's having and put it to work for you. And a great way of doing this is to invest in shares.

Despite all the different types of shares you can invest in and all the ins and outs of share investing, there are really only two ways you can profit from shares: capital gains and dividends. In this chapter, I outline both methods. I also explain the tax implications involved with share investing. You probably aren't really interested in taxation but it's important you understand the basics because they can affect your share investing decisions. I've tried to make this part as pain-free as possible.

Making profit from capital gains

I imagine that the idea of making profit from capital gains is already familiar to you. It's based on the principle that you buy something for a certain price and resell it later on for more than you paid for it. The difference is called a *capital gain* and it's the profit you make on the deal.

Capital gain = net revenue – net cost

Net revenue is the amount of money you receive from the sale minus any selling expenses. For example, if you invest in real estate, your net revenue is the selling price minus the expenses the agent charges for negotiating the sale.

Net cost is the money you had to shell out in the first place to buy, including any purchase expenses. With real estate, your purchase expenses include stuff such as solicitor's fees, government charges (including stamp duty) and the cost of searches or any building and pest inspections you want.

When you trade shares, your purchasing and selling expenses are small because they're usually only the brokerage involved in the buy and sell transactions (see figure 3.1). In some cases, bank charges may be incurred for money transfers but they're usually small unless overseas transfers are involved.

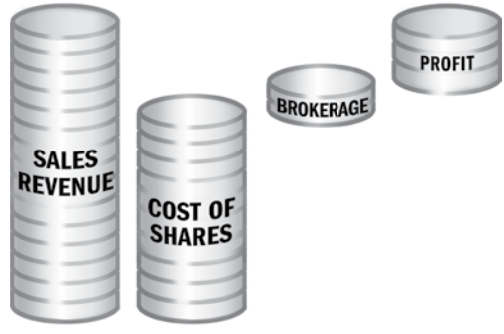


Figure 3.1: Brokerage is usually the only selling expense for shares

Capital gains profit with shares can be calculated using the following formula:

$$\text{Capital gain} = \text{N} \times \left(\text{SP} - \text{CP}\right) - \text{E}$$

Where

N = number of shares
SP = selling price of each share
CP = cost price of each share
E = expense involved with buying or selling (usually just the brokerage).

This formula will give you the correct answer for your capital gains profit unless the number of shares changes between the time you buy and the time you sell. If you buy and sell shares in different lots (or parcels), you need to calculate the capital gain with each parcel separately.

The formula I've just provided can look a bit intimidating if you're not mathematically inclined but it's really quite simple. All you're doing is calculating the profit on each share, and multiplying by the total number of shares to get your total profit. Then you're just subtracting your total expense.

Let's look at an example.

Say you buy 1500 shares for $4.20 and sell them later for $6.30. Brokerage is $15 on each transaction (the buy and the sell).

$$\begin{aligned}\text{Capital gain} &= 1500 \times \left(\$6.30 - \$4.20\right) - \$30 \\ &= 1500 \times \$2.10 - \$30 \\ &= \$3120\end{aligned}$$

That wasn't too hard was it?

Taxation and capital gains

Most people don't like to consider tax but unfortunately you may need to do so if you're required to submit a tax return. The tax rules applying to capital gains from share trading are basically the same as for any other commodity. Capital gains are considered income and need to be declared in the financial year of sale.

Here's the good bit: if you've held the shares for a year or more only half the capital gain counts as income. So in the preceding example, if you held

the shares for less than a year the full $3120 would be taxable income, but if you held them for more than a year only half the profit ($1560) is taxable income.

Tip

Even if an accountant prepares your tax return, you need to be aware of the capital gains tax rules because they can affect your share investing decisions. For example, if you hold some shares for, say, 10 months or so, and you're thinking of selling them at a profit, it may well be a good idea to keep them until 12 months is up before you sell, so you can take advantage of the 50% profit discount.

Incurring a capital loss

Despite all your good intentions and research, some of your share trades will inevitably result in a loss. If the trade is a losing one, when you calculate your capital gain using the formula I gave you, you'll get a negative answer because you've sold the shares for less than what you paid for them (see figure 3.2).



Figure 3.2: Selling shares for less than you paid for them, results in a loss

The good news is that if you make a loss, you can write it off against your profit when working out your taxable income. For example, if you bought some shares and spent a total of $5000 on them but later sold them and recouped only $3000, you've incurred a loss of $2000. Let's say you made a profit of $4000 on some other trades. You can write the $2000 loss off against the $4000 profit and you need to declare only $2000 as taxable income.

That's the good news; the bad news is that capital losses can be written off only against capital gains and not against other taxable income. So if you've had a bad year with your shares and finish up at the end of the year with a net loss on your share trades, you can't write that loss off against your other taxable income for that year. All you can do is carry the loss forward to next year. There's no time limit and capital losses can be carried forward indefinitely.

Tip

If at the time of your death you're carrying forward a capital loss, that loss can't be used by your dependants. So if you know when you're going to die, it's a good idea to sell some of your profitable shares and write the loss off against your profits — otherwise, the loss will die with you. The only problem with this strategy is that you usually don't know when you're going to die!

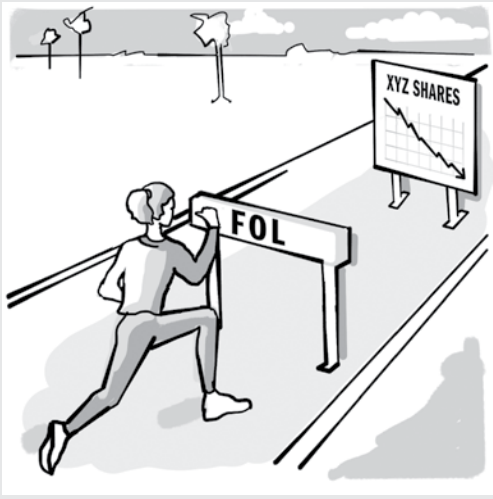
Paper versus realised capital gains or losses

You can work out capital gains or losses based on the current prices of the shares you own compared to their cost when you bought them. These capital gains or losses are 'paper' gains or losses and not actual or realised gains or losses (because you haven't actually sold the shares).

For example, say you buy some shares and spend a total of $4000 on them. When you check prices, you're pleased to discover that the share price has risen and the shares are now worth $5000. Therefore, you're making a paper capital gain of $1000 on them. You decide (wisely) to hang on to the shares and not sell them. At the end of the year, you don't have to declare the profit in your tax return. Your profit is paper profit and not real profit and won't become real profit until such time as you sell. If you never sell, you don't have to declare any capital gains profits as income.

Tip

Everyone likes making a profit and no-one likes taking a loss—that's just human nature. Because you don't actually make a loss until you sell, this can result in a fear of loss (FOL) bias (discussed in chapter 5), which makes you tend to hang on to losers for longer than you should. The problem is that if you hold on to losers for too long, you're likely to end up making a greater loss than if you'd swallowed the bitter pill sooner and not procrastinated.



'I really should sell my XYZ shares … but I have to overcome this hurdle.'

Tip

I discuss the important psychological factors that can affect your share trading decisions in later chapters.

Profiting from dividend income

The other way you can profit from shares is by receiving a dividend on them. If an Australian business makes a profit, it has to declare that profit and pay income tax according to Australian company taxation law. After the tax is paid the company can use the remaining profit in several ways:

- save it — that is, put the money into reserves and increase their capital pool
- reinvest it back into the business and upgrade machinery or equipment
- buy back their own shares that have previously been issued to reduce the number of shares in circulation
- buy (or take over) some other business
- reward executives and staff with salary increases or bonus payments
- reward shareholders by giving them a slice of the profit.

The way the after-tax profit pie will be divided up is decided by senior executives (board of directors) of the company. If they decide to pay a dividend, they also need to decide how much of the profit each share will receive. The amount allocated to each share is known as the *dividend per share* (DPS). If you're a shareholder, the total dividend payment you receive depends on how many shares you hold. Clearly, the greater the number of shares you hold, the greater your total dividend payment.

For example, say you hold 2000 shares in a company that pays a dividend of 25¢ per share. The total dividend you'll receive is:

$$2000 \times \$0.25 = \$500$$

If you'd held 1000 shares, your dividend would have been $250.

Issues relevant to dividends

You need to be aware of a few issues relevant to dividends, discussed in the following sections.

Ex-dividend date

This is the cut-off date for receiving the current dividend. If you hold the shares before this date, you receive the current dividend (even if you sell the shares after this date). As you might expect, the share price invariably falls when the shares go ex-dividend and usually by the amount of the dividend per share, as shown in figure 3.3 (overleaf).

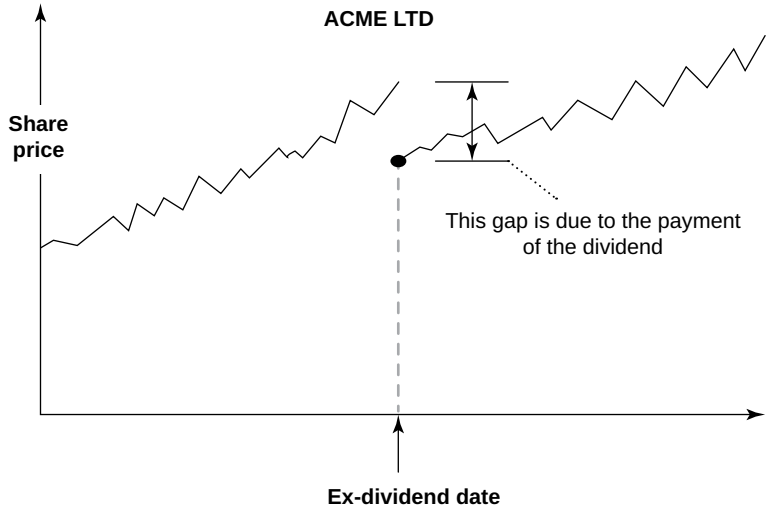


Figure 3.3: The share price usually falls on the ex-dividend date

Tip

You won't receive the dividend on the ex-dividend date but at a later date—known as the *payment date* (and also the *allotment date* or *allocation date*). This date is usually a month or so after the shares go ex-dividend (as shown in figure 3.4).

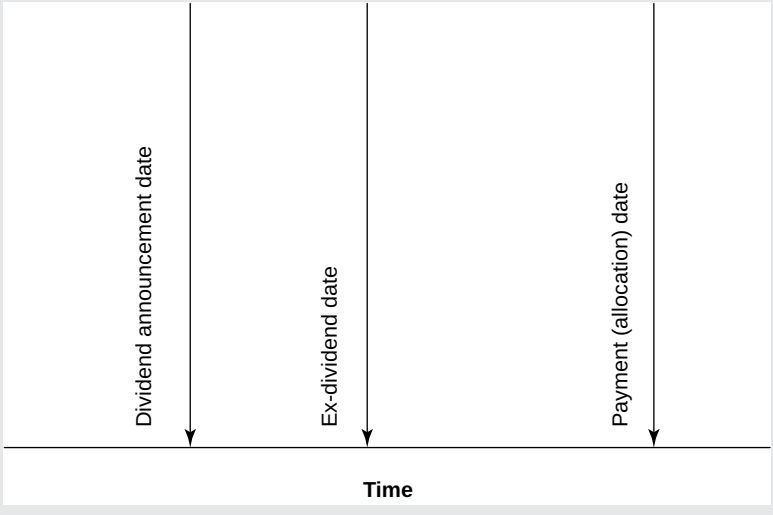


Figure 3.4: The time delay between the ex-dividend date and the payment date.

Final and interim dividend

For most Australian companies, the year is divided into two six-month periods, and dividends are paid twice a year. The dividend for the first six months is called the *interim dividend*, and for the second is known as the *final dividend*. Often the final dividend is higher than the interim dividend, but not always, and sometimes they're the same. The total dividend is the sum of the two and is the dividend amount always quoted in financial reports.

Tip

If you find a share price has dropped suddenly overnight—that is, the shares open the next day at a lower price than they closed yesterday—check whether this gap was due to the shares going ex-dividend.

Dividend yield

The dividend yield (also known just as 'yield') is a very similar concept to interest on an account, because it's the percentage annual dividend return on the value of the shares. For example, if the yield is 4%, the dividend on those shares is providing a dividend return of 4% annually.

The yield is calculated by dividing the annual dividend per share in *cents* by the current share price in *dollars*.

Here's an example. Shares you own have an annual dividend of 45¢ per share and their share price is currently $9.62. Therefore, the yield on these shares is 45 ÷ 9.62 = 4.68%.

Effect of price changes

Even though the dividend paid usually changes only every six months, share prices change all the time, so the yield also changes with each change in share price. The yield moves opposite to the share price change, namely:

- If the share price rises, the yield falls.
- If the share price falls, the yield rises.

Tip

If you buy shares that pay a dividend, the yield would have been quoted at the time of purchase. Later on, as the share price changes, the yield also changes. You should always consider the current yield, not the yield at the time of purchase.

Dividend imputation and franking credits

Many investors find the dividend imputation and franking credits aspect of shares puzzling, but it's really not that hard. The best way to understand it is to go back in time before it existed. In those days, when some of the company's after-tax profit was used to pay shareholders a dividend, the total dividend received by each shareholder was regarded as income and taxed at the shareholder's income tax rate. This meant that the profit—which had already been taxed once—was taxed again. Of course, this was unfair, so the law was changed some time ago and nowadays when a shareholder receives a dividend, they're given credit for the tax already paid by the company. This credit is known as an *imputation credit* or *franking credit* and is paid to the shareholder by the ATO as a rebate on their taxable income. If the company pays full Australian tax on their profits, the dividend is fully franked (ff). In this case, if the shareholder is on a marginal tax rate of 30%, the dividend income they receive is effectively tax-free.

Now here's the really good part that applies to many retirees and people on pensions. If you don't pay income tax, you don't lose the imputation credits. The ATO still refunds the imputation credits as a nice, juicy cash payment! Sounds too good to be true? Well, it's true but has been a rather contentious issue. In the past, the Labor Party wanted to abolish dividend refund cash payments but this proved very unpopular with voters and was a major reason for their electoral defeat. But this change could be proposed again at some time in the future so you need to keep abreast of relevant developments.

If a company pays no Australian tax on their profits, the dividend is unfranked (uf) and a shareholder receives no imputation credits (or franking credits). In this case, the shareholder will need to pay full income tax on

the dividend they receive at their marginal rate. Unfranked dividends occur if the company doesn't pay Australian tax on their profits. This can be for various reasons, of which the most likely is that the company is based overseas and doesn't have to comply with Australian tax law.

Level of franking

Different levels of franking are possible between unfranked (zero franking) and fully franked (maximum franking). Fortunately, you don't have to worry about calculating franking credits because when you receive your dividend statement from the share registry, it will clearly state the dollar value of any franking credits you're entitled to.

Comparing dividends with different franking levels

Franking credits are of great benefit to you whether or not you pay income tax. But how do you compare dividends when different levels of franking apply? For example, are you better off with shares that pay a 4% unfranked dividend or those with a 3% fully franked dividend?

You can work this out by using what's called the *grossing-up factor*. I won't go into the maths here but have provided table 3.1, which is an abbreviated table of grossing-up factors.

Table 3.1: Grossing-up factors for dividends with different franking levels

Franking level	Grossing-up factor
100%	1.43
50%	1.18
0	1.00

Tip

You can estimate the grossing-up factor for levels of franking in between those shown in table 3.1, but if you want to be really accurate please refer to one of my other books (for example, *Teach Yourself about Shares*, 3rd edition), where a full table of grossing-up factors is included.

Working out the true value of a yield

To get the true value of a yield, you just multiply the yield by the grossing-up factor to obtain a grossed-up yield. For example, a yield of 4% unfranked is still worth only 4% to you because the factor is 1.00. However, a yield of 3% fully franked is worth 3 × 1.43 = 4.29%. Therefore, a 3% fully franked yield is better for you than a 4% unfranked one.

Another way of working this out is to apply your tax rate to the yield. For example, if your marginal tax rate is 30%, a 3% fully franked yield is still worth 3% after tax because with the franking credits the yield is effectively tax-free. But the 4% unfranked yield is worth only 4 × 0.7 for you after tax and so is only 2.8% net to you.

Tip

Get into the habit of considering the grossed-up yield of a share rather than the raw yield because the grossed-up yield is really the true value of the yield to you. Unfortunately, grossed-up yields aren't usually shown in the available statistics for shares so you need to work them out for yourself based on the level of franking.

Pitfalls of a high yield

Perhaps at first sight it seems that the higher the yield the better. Some shares may have a yield as high as 10%, which at first sight appears to be really great. But you need to consider that the yield may be high because the share price has fallen, and that's generally not a good sign. A high yield can also be an indication that the company is paying out too much of its profits and not re-investing enough back into the business. This makes it unlikely that the high dividend will continue in the future.

Tip

If a yield looks too good to be true, it probably is — and the shares could be shaky. This can be a trap you don't want to fall into so before you buy a high-yielding share, dig a little deeper and see if you can find the reason for the high yield. The best way of doing this is to look at the company's financial history. I show you how to do this in later chapters.

Considering dividend reinvestment plans

A dividend reinvestment plan (DRP) is a plan offered by some companies that allows you to take your dividend payment in additional shares rather than cash. Usually, the additional shares are offered at a discount price but this isn't always the case. When you become a shareholder in a company that has a DRP, you'll be given the choice of whether or not you want to join the plan. As far as the tax office is concerned, no difference is made between them and the same tax rules apply whether you take your dividend in cash or shares.

If you join the DRP, your dividend statement will show:

- the number of shares you held prior to the dividend
- the price of the shares allocated to you in lieu of cash
- the number of new shares you'll receive
- your total shareholding after you receive the new shares
- the value of the dividend in dollars
- the value of the imputation credits
- the allocation date for the new shares.

The allocation price multiplied by the number of shares is very unlikely to work out to be exactly the same as the dollar amount of the dividend, so you usually have some cash left over. This will be added to the amount of the next dividend and the carryover will be shown on your statement. If at some future time you sell all your shares, you'll receive the carryover amount in cash. In a few cases, the plan provides for rounding off the number of shares to the next highest number. In a few cases, the plan provides for rounding off the number of shares to the next lowest or highest number and no dollar carryover will be involved. If rounded down, you'll miss out on part of a share or if rounded up you'll receive it as an additional bonus.

Tip

You don't need to agonise whether or not to join a DRP when you first purchase a parcel of shares. You can change your mind at any time and you're not bound by your initial decision.

Let's look at a DRP example. Say the dividend on the number of shares you own is $536. The allocation price for the shares you receive under the plan is $8.20 per share. You also have $4.30 cash credit from the last dividend.

How many shares will you receive and what cash will be credited to you and carried over?

$$\begin{aligned}\text{Total cash available} &= \$536 + \$4.30 \\ &= \$540.30 \\ \text{Number of shares allocated} &= \$540.30 \div \$8.20 \\ &= 65.89 \text{ shares}\end{aligned}$$

So you'll receive 65 new shares and have the value of 0.89 of a share carried over.

The cash credited to your account and carried over to the next dividend will therefore be:

$$0.89 \times \$8.20 = \$7.30$$

Note: I've provided this example so you can understand how most DRPs work but you don't need to do any of the calculating provided here. It's all done for you and shown on your dividend statement.

Tip

If you don't need the dividend cash payment, I suggest you join the DRP. I explain why in chapter 12.

Comparing capital gains and dividends

The question of whether obtaining capital gains is better than getting dividends has been hotly debated for many years. Are you better off buying shares that offer the possibility of good capital gains or buying shares that have a reliable history of good dividend payments? At first sight, it might seem capital gains are the way to go. If the share price rises significantly you can sell the shares, cash in your profit and move on to the next trade. If you're able to do this several times a year, you'll end up with a handsome

profit. If you hold the shares for longer than a year, only half the capital gain is taxable and that's also a better proposition than the 30% or so tax concession for fully-franked shares. These are sound arguments in favour of capital gains but the issue isn't actually that clear-cut. For a start, capital gains tax concessions can be obtained only if you own the shares for a year or more and, further, they can be declared only once — when the shares are sold. On the other hand, if you hold shares over the long term, the dividend franking credits go on year after year.

Another problem with capital gains is that to make good profits from them, you need shares that are of the more volatile kind and so inherently more risky. In contrast, companies that have a history of good dividend payments over a number of years are likely to be far more stable. They seldom change their dividend policy (unless some severe event causes a large drop in profits, such as occurred during the COVID-19 pandemic). So the question really resolves itself according to the time frame of your investment. If you're into shares for the longer term — that is, you're an investor rather than a trader — good dividends are well worthwhile, especially if the dividend has a high level of franking. On the other hand, if you're more a trader than an investor and want fast profits in the short term, capital gains are the way to go.

Tip

The ideal situation is to get both benefits with your shares — that is, you receive a steady dividend over the years and the shares also rise in value. These are the types of quality shares I suggest you consider for your core portfolio. By all means, you can also have some speculative shares that offer the possibility of high capital gains as satellites to your core.

The importance of return on capital

Many people think that dollar profit is the most important consideration with any investment. For example, if a friend tells you that their profit from share investing was $10 000, what would your reaction be? Would you pat your friend on the back and say 'well done', or would you think it wasn't much good at all?



'I've been going okay with my shares. I'm making $10 000 in profit!'

The answer is that you can't actually tell how good the profit was because two vital pieces of info are missing. Can you think what they are?

The two vital bits of info missing are the amount of money your friend invested in shares and the time period over which the profit was made. This info allows you to work out the *return on capital invested*, and this figure is more significant than straight profit.

For example, if your friend invested $50 000 in shares and made a $10 000 profit in a one-year period, that would be great because their return on investment would be 20%. If the sum invested was $100 000, that would still be good but not as great because the return on investment is now 10%. If they invested $250 000 in shares, their return on investment wouldn't be much good at all because it's only 4%. The time period for the investment is also important. If the profit had been made on $250 000 over a two-year period, their profit would be rather paltry — only a 2% pa (per year) return on capital invested.

So you can see that the real measure of profitability is the return on capital invested expressed as a percentage pa. You can calculate it using the following formula:

$$\text{ROC} = \left(\text{yearly profit} / \text{capital invested}\right) \times 100$$

Note: You convert the decimal to a percentage by multiplying by 100.

If the time period isn't one year you can work out an equivalent return on capital for one year by multiplying by the following factor:

$$12 \div \text{number of months}$$

For example, if the time period is six months the factor is 2 (12 ÷ 6), but if the time period is two years the factor is 0.5 (12 ÷ 24).

Tip

The same principles apply to companies: knowing how much profit a company made in dollars is really quite meaningless. You need to know how much capital was invested in their business and the time period over which the profit was made. (For more discussion of this, see chapter 8.)

Key takeaways

- You can profit from shares in two ways—capital gains and dividends.
- You make a capital gain if you sell shares for more than what you paid for them.
- Dividends are very similar to interest on an account, and the more shares you hold, the greater your dividend payment.
- The statistic that tells you how much dividend bang you'll get for your investment buck is the yield. As with interest, yield is a percentage and is calculated by dividing the total annual dividend (in cents) by the share price (in dollars).
- Dividends can be fully franked (ff), partly franked (pf) or unfranked (uf). The higher the franking, the better—because the tax office refunds the franking credits you're entitled to.
- Payment of the next dividend has a cut-off date, known as the *ex-dividend date*. If you hold the shares (or buy them) before this date, you'll get the next dividend; if you sell them before this date, you lose out.
- On the ex-dividend date, the share price falls usually by the amount of the dividend.
- The yield rises and falls in the opposite way to the share price. That is, a rising share price results in a lower yield and a falling price results in a higher yield.

(*continued*)

- The true value of a dividend depends on the grossed-up yield. To obtain it, multiply the raw yield by the grossing-up factor, which varies with the level of franking.
- Some companies that pay a dividend give you the option of taking the dividend payment in shares by offering a dividend reinvestment plan (DRP). If you don't actually need the cash, I suggest you join the plan. I explain my reasoning in chapter 12.
- High capital gains are more likely with speculative shares. You don't want to hold on to these types of shares for too long but they can be satellites in your portfolio. If you're a longer term investor, the ideal situation is to make both capital gains and dividends from your core shares.