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Banks' role in house price surge

The undemocratic four pillars policy should be unwound

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GLOBAL INVESTOR

The 1940s expression "that's the $64 question", which became synonymous with difficult or problematic challenges, evolved into the "$64,000" television shows and media references of the 50s and onwards up and until today.

This was largely because post Second World War real economic inflation became a celebrated reality, positively associated with actual economic progress and true prosperity.

But this acceptance of inflated numbers was perennially allowed to continue and most peculiarly, done so with some warped sense of pride.

This was peculiar because having the value of our "purchasing power" persistently debased — year after year — was somehow perceived as advantageous and not damaging.

But even for the most globally minded of Australian investors today, domestic asset inflation — played out very explicitly in our current Sydney and Melbourne residential real estate markets — must always remain on their radars because, no Australian "domiciled" investor should ever over-allocate their respective portfolios towards international investments.

All Australian investors should find a balance between domestic and global investment exposures and therefore, Australian domestic considerations always matter, to all of us.

Inflation itself is important and does represent much good throughout our economy but the substitute of inflation for genuine prosperity is unequivocally bad and allowing the "thin red line" between the two to continue to be blurred is where the Australian global investor must pay most attention.

Australian ultra high net worth investors do have the "upper-hand" and advantage over other Australian investment communities. This is because, broadly speaking, they hold a greater dispersion of "real assets" — a separate and distinct asset class from financial assets — than others as a proportion of their overall investment basket.

But like much in life, being aware of these issues does not make overcoming or avoiding them any easier.

This awareness does though allow all Australian investors to make shrewder investment decisions today that account for actual inflation and not government — in this case the RBA — advertised "normalisations".

And when it comes to Sydney real estate valuations, most pundits have spectacularly misunderstood the situation.

In short, the RBA has marginal influence; the big four Australian banks (ANZ, NAB, CBA and WBC), however, have very significant influence and culpability.

This distinction, however, matters greatly to Australian investors in particular, because the "warping" of what is technically referred to as the "smile of the yield curve", ultimately affects the entire domestic market across almost all important asset classes.

Very simply, asset inflation being seen across the entire price spectrum of residential Sydney real estate valuations has knock-on effects across all domestic investment markets — i.e. stockmarket, commodities, debt and credit, etc — and also affects all Australian investors, including the UHNW community.

We are witnessing this play out by "mum and dad" property buyers inflating this asset class, which, in turn, drives up higher-tier estates, such as those in Sydney making headlines.

Token "Chinese" may be easy to identify and heap blame on but they are not the problem and have become scapegoats. This obvious xenophobia is "groundhog day" for Australian commentators, who levelled identical accusations at the Japanese during the pre-1990 Australian real estate asset bubble.

The primary question that we, Australian investors, should be circling back to, is what are the "big four" — government-protected — Australian banks up to.

Twenty five years ago these banks held one third of their lending exposure to Australian real estate, today's proportion has roughly flipped to two thirds or more, measured either directly or indirectly.

Australian banks that have squeezed as much juice out of our current metaphorical lemon as possible have finally resorted to one last squeeze by (over) selling insurance solutions over the past five years, which, frankly, are just not required by any economy, anywhere in the developed world.

And therefore the obvious answer is rarely, if ever, simple. But in this instance it is: it is time to revoke the "four pillars" policy — an Australian government policy to maintain the separation of the four banks by rejecting any merger or acquisition between them.

There is no legitimate reason for maintaining the policy and it only serves to protect "oligopoly" markets, which drain enterprise value from the real economy, which should be redirected towards other parts of Australia's economy.

Such potential future newly allocated enterprise value would stoke genuine and broadly enjoyed prosperity.

We already know that prosperity drives productivity growth and this trajectory only enhances the integrity of our economy and in turn, our investable markets, such as the ASX 200 stockmarket.

Ironically as well, house price affordability will dissipate as an issue for community discussion.

The $64 question isn't why are house prices perennially rallying but who is lending the $62 of the $64 to the borrower who should not have been lent it in the first place?

Government is not to blame — the only input and impact government can and should have today is revoking the undemocratic four pillars banking policy.

By allowing liberal, freer and more democratic markets to breathe, Australia will only then find a new prosperity and liberate itself from its current self-incarcerated shackles.

Distortions will dissipate and all Australian investors can then rejoin the real game being played by international global investors, seeking out tomorrow's future investable opportunities, which are undervalued today.

When we allow competition to once again breathe, these issues will sort themselves out naturally.

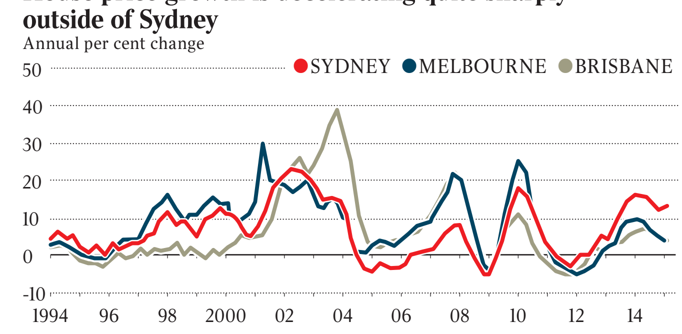
Australian UHNW investors may enjoy larger sums of capital to invest but they too face the identical same $64 conundrum.

And that problem may be easily solved by simply asking, why do four of the world's most profitable and scaled financial institutions, still require 1990 enacted government protections?

Larkin Group is a Wholesale Wealth Adviser focusing on high yielding global investments www.larkingroup.com.au

Sydney house prices have a knock-on effect across all markets

House price growth is decelerating quite sharply outside of Sydney



Source: Australian Bureau of Statistics, Goldman Sachs

Aviation's engine room maintains investor value

ROGER MONTGOMERY

Commercial airlines are notorious for destroying shareholder capital. But that doesn't mean the broader aviation industry should be off limits for prudent, long-term, global-minded investors.

In fact, despite the bad reputation that precedes some of the world's largest and best known airlines (regarding investment returns, service can be the topic of a follow-up column), there are some wonderful businesses around the globe that cater to the carriers, their passengers and savvy investors.

During the past three decades there have been dozens of bankruptcy filings made by US airlines. In fact, before being acquired by American Airlines in 2013, US Airways had actually gone bust on two separate occasions in the space of a few years.

As a group the US airlines have failed to achieve returns on their invested capital that exceed their cost of capital, according to a decade-long study by Aswath Damodaran at New York University's Stern School of Business.

Nonetheless, profitability in the sector has turned up in the past year as the oil price has declined, the US dollar has strengthened, and the number of competing airlines has declined through merger activity. Our leading listed aviation stock — Qantas — has revived. Across the international sector share prices are near record highs.

While the US market has experienced a wave of consolidation that has concentrated control of the domestic routes in the hands of a few big players — American, Delta, Southwest and United carry 80 per cent of passengers — the European market is much more competitive. In Europe, the big players account for just 50 per cent of the market. Low-cost carriers such as Ryanair have been gaining market share by offering passengers no-frills point-to-point travel options.

At the same time Emirates, Etihad and Qatar have expanded capacity in Europe by 17 per cent annually during the past decade when the traditional airlines have added seats at less than 3 per cent a year; indeed, senior management at Germany's Lufthansa recently complained in a letter to US government departments about this trend. Lufthansa's complaint is that the Gulf carriers have captured more and more traffic between Europe and Asia by offering high standards of service without regard to cost, funded by their respective states.

At the same time, traditional carriers have had to cut routes, delay new plane orders and fight with pilot and cabin crew unions to reduce costs just to stay in the game. This intense competitive environment has meant Lufthansa has invested more than €10 billion ($14.5bn) in its asset base since 2006, yet earnings are almost unchanged. Across a similar period Air France's return on capital is barely positive. After a rebound in both companies' share prices towards the end of last year, fundamental reality is taking hold and the stocks are down between 15 per cent and 20 per cent this year. The outlook for airlines and their share prices evidently is not for clear skies.

The plane manufacturers themselves are on a different flight path. The business of developing, manufacturing and selling large aircraft for use by commercial airlines is concentrated on two large players: US-based Boeing and French-listed Airbus. This has become even more apparent in the past few years as airlines seek to increase efficiency by streamlining their operations on to a select few platforms from a smaller number of providers. A duopolistic market structure has allowed Boeing and Airbus to earn very high returns on capital, typically exceeding 20 per cent, across long periods and this seems set to continue.

The two big aviation manufacturers are well placed to capture multi-decade secular tailwinds. Boeing projects that during the next two decades more than 38 thousand new planes will be ordered at a cost of $5.6 trillion, doubling the world's fleet of passenger planes.

All these new planes will cater to passenger traffic that is growing at almost 5 per cent annually, and will reach seven billion passengers by 2034, driven primarily by emerging countries in Asia-Pacific and Africa.

Boeing's stock price is also near a record high, and represents 17 times next year's earnings per share.

Manufacturing isn't the only industry catering to the airlines with much better economics than their carrier customers. Engines are a separate purchasing decision for airlines. However, the decision typically comes down to one of two choices, and some plane models have an exclusive engine provider. On larger wide body aircraft Rolls-Royce, headquartered in London, and Engine Alliance (a joint venture between US-listed GE and Pratt & Whitney, itself a subsidiary of US-listed United Technologies) are the options. Narrow body aircraft are fitted with engines from CFM (a joint effort between GE and France's Safran) or Pratt & Whitney. Rolls-Royce and Safran, the purest engine plays, often generate returns on capital above 20 per cent.

Certainly the airlines themselves have often found it difficult to offer equity investors a return of capital, let alone a return on capital.

However, investors who are able to look along the aviation supply chain and around the world just may be able to find some great opportunities to compound their wealth over a very long runway.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund.

Sensible steps to follow when compiling a retail bond portfolio

LIZ MORAN
SMART INCOME

Building your own bond portfolio puts all the choices in your hands. You choose the companies you want to invest in, the bonds with maturity dates that suit you, the risk you take and thus the returns you can expect.

One of the big attractions is that control, allowing you to diversify away from companies where you already own the shares. Not all bonds will suit all investors.

So, I'm going to suggest nine bonds but ask you to choose the five you think would suit you best — there are 126 combinations from this short list and no right or wrong answers. Included in the list of nine to consider are:

- Four fixed-rate bonds that will give you a defined income, and I think that's important to a lot of investors at the moment.
- Three floating-rate bonds, where interest income goes up and down depending on interest rates. If interest rates start to rise, these bonds will deliver higher income in the months ahead.
- Two inflation-linked bonds. While inflation is low at present and not expected to rise in the near term, this could be a good time to buy these bonds as it is always important to have inflation protection and to be prepared for the unexpected.

I would recommend new investors hold at least one of each kind of bond to help protect their portfolios from a range of economic conditions. If you decided to buy all nine the yield to maturity for the portfolio would be 5.07 per cent a year. Choosing the five with the lowest risk is 4.57 per cent while the highest risk and return would provide a yield to maturity of 5.69 per cent.

The lowest risk bond on the list is the Envestra inflation linked bond. Interestingly, it has a yield to maturity of 4.62 per cent a year, higher than National Wealth Management, which is also considered low risk. A large part of the reason the return is higher is because the bond has a longer term to maturity of about nine years as against an expected one year maturity for National Wealth Management.

A key assessment is the yield to maturity rate, which is the amount you can expect to earn a year if you hold the bond until it matures. National Wealth Management Holdings is a subsidiary of National Australia Bank.

It is expected to be repaid on its first call date in a year and its yield to first call is 3.58 per cent a year. It's higher risk than NAB one-year term deposits but pays a higher return.

The highest risk bonds are the two from Australian Securities Exchange-listed childcare provider G8 Education and the Qantas bond. G8 is a smaller company, as are the bond issues, so investors are paid more to compensate for the perceived higher risk.

The G8 fixed rate bond has a yield to first call of 5.49 per cent a year and even higher ongoing income — running yield at 7.28 per cent.

This would be an attractive bond for those investors looking to generate a high, known income stream.

All bonds are available in the over-the-counter market.

The fixed and floating rate bonds are available in $10,000 face value parcels, while the inflation linked bonds are around $12,500.

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A bond portfolio for beginners

Company	Maturity/ Call date	Bond type	Capital structure	Yield to maturity	Income (running yield)
Adani Abbot Point Terminal	May 29, 2020	Fixed	Senior Debt	5.45%	5.94%
Downer Group Finance	Nov 29, 2018	Fixed	Senior Debt	3.80%	5.41%
G8 Education	Aug 7, 2016#	Fixed	Senior Debt	5.49%	7.28%
Qantas Airways	June 11, 2021	Fixed	Senior Debt	5.48%	6.81%
DBCT Finance Pty (Dalrymple Bay)	June 9, 2021	Floating	Senior Debt	4.74%	2.66%
G8 Education	Mar 3, 2018	Floating	Senior Debt	5.45%	5.95%
National Wealth Management Holdings	June 16, 2016#	Floating	Lower Tier 2	3.58%	2.81%
Envestra	Aug 20, 2025	Inflation linked	Senior Debt	4.62%*	2.81%
Sydney Airport Finance	Nov 20, 2030	Inflation linked	Senior Debt	5.91%*	3.24%

Note: Prices accurate as at 24 June 2015 but subject to change # First call date/ expected maturity * Assumes inflation is 2.5% pa Source: FIIG Securities