New property hot spots loom if Labor Party wins

Nobody really knows how the property market will react

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captionhere

The alarm bells are ringing again on negative gearing: what would its removal to do the market if the ALP win next Saturday?

For investors the questions are what would happen to property prices and who would win or lose should Labor leader Bill Shorten get his way with restricting negative gearing to new properties.

The ALP will also couple a negative gearing crackdown with a cut in the capital gains tax allowances in property investing.

Remarkably, despite the mountains of angst-ridden commentary on the subject throughout the last week, there is absolutely no firm consensus on what the ALP changes would mean for the wider economy. A very good example of this was a widely discussed report from the reputable SQM group, which said prices would fall by an accumulated 15 per cent out to 2018. I don't know about you, but any forecast that goes further than one year is fanciful in my book and I expect a lot of property investors would agree.

The issue that is undervalued in the debate — though not among investors — is that property investing for almost everyone offers three elements of value:

1. The potential for capital appreciation over a long period of time. A report a few days ago from Russell Investments showed residential property was the best investment by a big margin over the last decade in Australia, with an annual return of 8 per cent a year in the decade to December 2015.

2. The potential of income in the inner parts of metropolitan centres. This has waned considerably. Gross rental yields can be as little as 3 per cent or less. Still, with cash rates at 1.75 per cent, it remains a keen proposition.

3. The value of a tax write-off. For most salary earners negative gearing is the only significant tax break apart from superannuation. There are two million private property investors and a whopping 60 per cent of them claim losses (ie tax breaks) every year.

Under the ALP regime it has to be assumed that if a population of 25 million can boast two million property investors, then restricting negative gearing to new properties is going to create a major distortion in the market. How might it play out?

Cameron Kusher, senior research analyst at property group CoreLogic, points out that one of the first difficulties is the dearth of decent data on new properties: Kusher says CoreLogic has to assume "new" to be properties that have never been resold — so a house bought 10 years ago but not sold since would still classify as new ... there's an issue straight away. More pertinently, Kusher notes that the legion of investors currently invested in property — for income, capital and tax purposes — will review the landscape, looking for new properties that offer good opportunities if the ALP wins.

Kusher reveals some fascinating working in the accompanying table, which shows the premium investors will pay for new properties in each city. The premium is the percentage increase in price investors are willing to pay for a new property over an existing property of similar proportions in a similar location.

Note the wide disparity in the numbers explained by very different local factors: Brisbane's mighty 14 per cent premium is explained perhaps by the relatively new trend towards inner city density which has been tracking in Sydney and Melbourne for two decades.

-But why is Sydney's premium a multiple of Melbourne? "Every city has a different potential explanation," says Kusher. If we assume that investors swing towards new property — and the majority of them want property in the inner city, not the outer suburbs — we'd have to assume those premiums could only rise further.

Just consider this: if the driver of tax advantage is restricted to new properties then an investor in a new property can get tax relief on salary and maximum depreciation allowances combined.

But here's the rub: analysts believe the desire for a tax break coupled with the enduring appeal of property investment will initially lift activity in the inner city but analysts also warn the crucial issue will be resale value.

In other words, you might buy the property because you get negative gearing allowances on what is a "new property" but when you go to sell that property the next buyer is not allowed to negatively gear on that same property: one of the three prime values of investing in Australian property is removed. That's when even the smartest property investor is going to find themselves exposed to a new risk ... and nobody has done the numbers on that one.

Look for companies that can find extra profit without extra debt

ROGER MONTGOMERY

As a long-term investor I'll do just fine if I own shares in companies able to reinvest capital at high rates of return. If I auctioned a $100 million bank account earning an enduring 20 per cent interest rate, I would receive more for it than a bank account with $10 million earning the same 20 per cent. Therefore, in buying a business today with equity that subsequently rises tenfold while maintaining its return on equity, an investor will make a lot of money. And they don't need to worry about rolling crises such as Chinese growth rates or US Federal Reserve interest rate rises or indeed the worries we witnessed around Brexit.

Such fortunate investors can turn all of that noise off and indeed hope that the stockmarket collapses, enabling them to buy more of the shares in that excellent company at the inevitably cheaper prices.

Unfortunately, most investors aren't invested in these types of companies. They won't make a lot of money. I recently examined Australia's largest 10 companies and discovered that with the exception of CSL, each company is either mature, in structural decline, cyclically challenged or simply a mediocre business. And this is where most investors have their money.

Every investor should approach the stockmarket the same way and every investor needs growth. It is growth that ensures an investor can maintain their purchasing power and that is what commentators who advocate pursuing dividend yields or equally popular rental yields from investment properties, are missing.

A great yield today, if static, could prove to be an unattractive investment in the not-too-distant future.

Growth, however, is at a premium because it is very hard to come by. The low return environment I have previously described is symptomatic of very low rates of aggregate growth.

A company can grow its earnings one of four ways:

1. The first is that it can borrow money, however this increases balance sheet risk.

2. A publicly listed company can issue more shares and increase its equity. The problem with additional capital is that it dilutes existing shareholders who don't participate in the raising on a pro-rata basis — especially when they don't even get a look in because the company takes the cheaper institutional placement option.

3. A preferred option for a company that can generate high returns, is to retain profits to finance expansion.

4. The final option and for my money the first prize is a company that can simply increase profits without requiring any additional money. Raising product or service prices without a detrimental impact on unit sales volume is an example of how this can be achieved.

> Growth is at a premium because it is very hard to come by

My prediction of lower returns for baby boomer investors is due to their owning the wrong assets. I am almost certain returns will be poor from owning an "investment property" or our large cap but mediocre so-called blue chips.

Aggregate corporate debt is sufficiently high to dissuade companies from borrowing more even with rates at epochal lows. Continuing evidence that companies are not willing to expand their balance sheets any further suggests a long runway of credit-fuelled growth is off the cards.

When interest rates are high, as they were in 1981, for example, companies act very rationally and carefully when allocating capital. Restructuring was all the rage back then. The result was productivity gains, cost efficiencies and growing profits. Today restructuring only comes after companies go broke and the subsequent benefits, if they do transpire, accrue to the debt holders. The equity holders are often wiped out.

An examination of the use of debt since the GFC in the US reveals that an increasing and dominant proportion has been deployed on financial engineering rather than productive capital expenditure. Financial engineering includes share buybacks, mergers and acquisitions and dividends. And keep in mind, with the current level of price-to-earnings ratios in the US and in Australia those mergers and acquisitions have not been conducted at bargain prices. Remember the higher the price you pay, the lower your return. It doesn't matter if the buyer is an individual investor buying a few shares or one corporate buying another.

More concerning is that since 2010 cashflows, as measured by EBITDA have — in aggregate — been declining despite the increase in debt. I hate to consider what might happen to cashflows if interest rates actually rise!

In short, debt is not going to provide fuel for growth.

That leaves us with retained profits, which have been diminished by company boards acquiescing to shareholder demands for more dividends. Since 2010, Australian payout ratios have expanded from about 55 per cent of earnings to almost 80 per cent, according to FactSet. It's no surprise then that earnings per share have not grown at all since 2010.

If debt (too high) and retained earnings (too low) are not drivers of growth, that leaves only the possibility of additional share issues. I can construct a scenario where economic growth begins to emerge, interest rates go up — rendering debt more expensive — so companies issues shares to pay down the debt in order to grow. The problem with this scenario is that more shares on issue dilutes the earnings per share and the valuation of the company on a per share basis.

In such an environment every bit of extra return becomes much more valuable. Buying those carefully selected businesses that can grow through generating high returns on retained earnings, will not only ensure you maintain your purchasing power, but is the only path to ensuring you beat the market and indeed the only way to outperform the majority of investors who are trapped in the vice of low growth.

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

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Bank shares v bonds and more: getting the most out of a much-loved investment sector

ELIZABETH MORAN

Major Australian banks are much loved by investors, and rightly so. Over recent years they have delivered strong overall returns from growing dividends and rising share prices.

But can we count on them to continue delivering, or is it time to look at other forms of exposure to the sector?

In terms of companies listed on the ASX, Commonwealth Bank, to my mind, is the lowest risk. The other three majors, Westpac, NAB and ANZ, are also low-risk propositions for a number of reasons: they are tightly regulated by the Australian Prudential Regulation Authority, which elevates them above other corporations on the risk scale; the government guarantees deposits of up to $250,000 per entity without charge, meaning in the worst-case scenario many creditors are protected; they operate in an oligopoly; and they are critical to the financial health of the country .... too big to fail.

So what are the risks of investing in bank shares? Like any equity investment, bank returns are generated from a combination of dividends and share price.

The question for investors is whether they can continue to grow their franchises in a low interest rate environment awash with cash where there is fierce competition for new business.

Percentage income returns from bank bonds and shares

	ANZ	CBA	NAB	Westpac
Dividend yield	7.22	5.59	7.71	6.33
Senior bond (5-year term)	3	3	3	3
Subordinated bond (5-year term)	4.4	4.4	4.4	4.4

Source: FIIG Securities

While the greatest risk is that a bank can't pay its debts and goes into a wind-up, that risk in the Australian context is remote.

The more likely threat to earnings is the potential for rising bad and doubtful debts in a slowing economy that could see a decline in dividends and a share price rerating.

If we consider a worst-case scenario, we can use the global financial crisis as a possible predictor. It's worth recalling that in CBA's case, the value of its shares fell roughly 60 per cent during the GFC.

Over the past year, CBA shares have fallen about 13 per cent, from about $86 each to $75 now.

The loss is reduced if you add back dividends and franking to your accumulated return.

The other three majors are also down on a share price basis, with ANZ and NAB down about 25 per cent.

This sort of performance indicates growing concern over future earnings.

Bank bonds are lower risk

Another way to invest in banks is to examine the options in bank bonds. All the major banks issue a wide range of bonds in domestic markets, as well as in foreign currencies.

The drivers for investment differ from shares in that bonds are a legal obligation — the bank can't cut or forgo interest and it has to pay the face value of the bonds, usually $100, back at maturity.

Bond investors are less concerned with growth; their main concern is that the company can make the payments when due.

The main factor to consider when investing in bonds is the "survivability" of the bank or company. It's easy to say all four major banks will survive in the long term — just like the shares, the bonds have the same benefits. But they have the added protection of shareholders that must absorb losses before they lose any money. While bonds are lower risk they should have lower returns, but this isn't always the case, as the past year demonstrates.

Investing in a senior or subordinated bank bond will earn you between 3.0 and 4.4 per cent a year, which is the rate of interest on offer. Like shares, bonds are tradeable — you can sell them before maturity — and the price moves up and down, so you can achieve higher than expected returns if the price of the bond rises.

If the price of the bond drops, then because a bond will pay $100 face value at maturity, you have that as a back-up, and if you do nothing a bond will naturally mature. An investment in an Australian bank or corporate bond will earn a positive return if held to maturity.

XTBs: a new opportunity

While bonds are lower risk, they don't offer franking, a major benefit of shares. But it's easy to get caught up in franking — tax considerations should not be the main determinant for any investment.

Shares are also more accessible, as they are available on the ASX.

Most bonds are traded in the over-the-counter market and you must find a dealer/broker to trade.

One exception to this is the newly created "fractional bond units", known as XTBs, listed on the ASX. The two banks that now offer retail investors access to their bonds through this structure are Bank of Queensland and NAB. You can find more on this sector at xtbs.com.au. This is an interesting development for retail investors accessible at modest prices, but just now it is minuscule in terms of the overall market.

Most of the big banks offer direct bond investment, but they require high minimum amounts and only make them available to wholesale investors — the minimum is often $500,000.

Still, there's a time to own shares and a time to own bonds.

Ongoing volatility will provide opportunities in both shares and bonds, but if you are seeking long-term capital and income certainty, bank bonds products offer an alternative to the serious investor in the present economic climate.

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