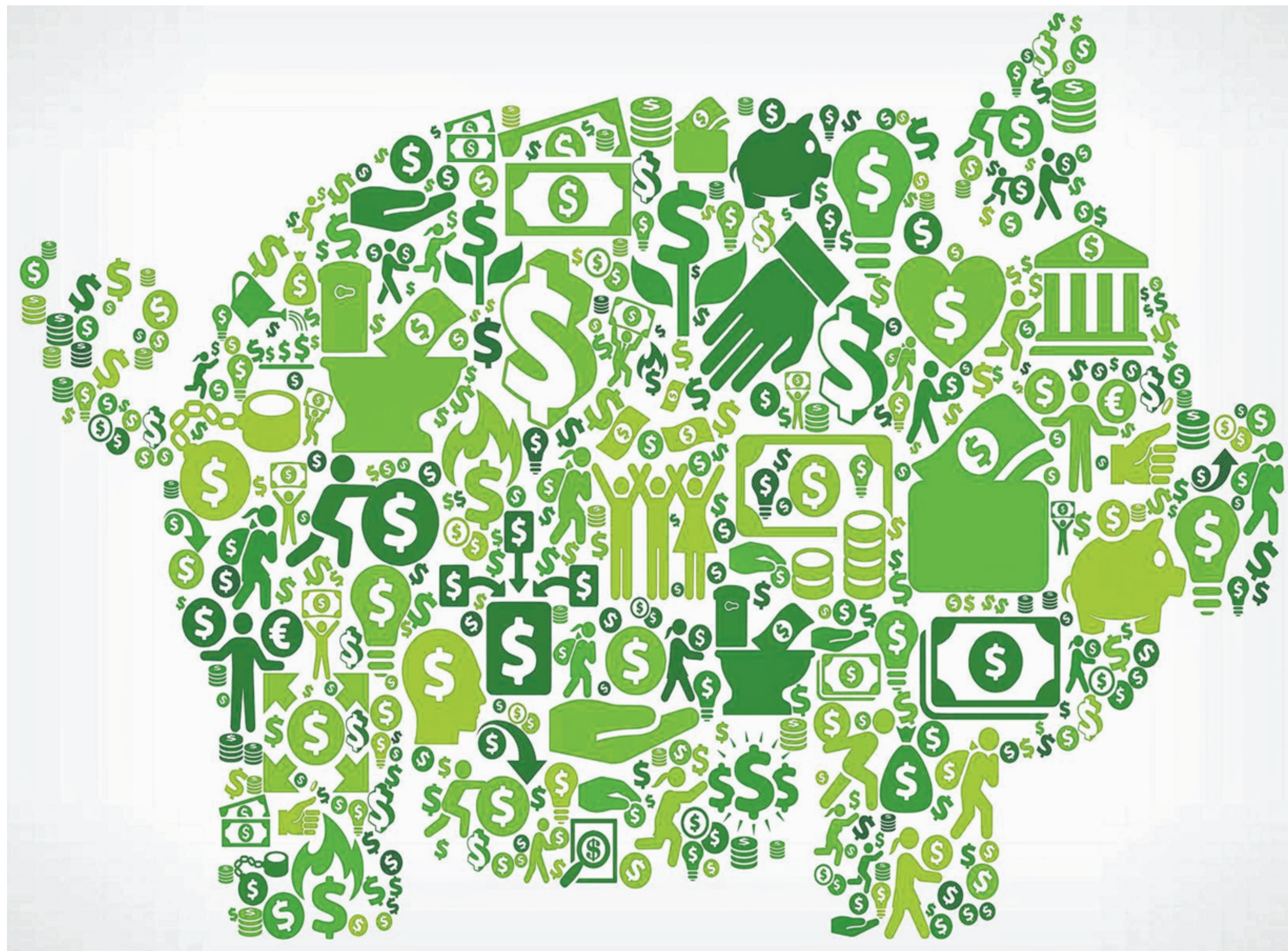
Cash will be king once again ... and soon

The old stalwart is looking good on a risk-adjusted basis

ROGER MONTGOMERY



Cash, they say, is a horrible investment option offering punitive returns. And indeed it was those punitive returns that caused the mass exodus out of cash in recent times: where once cash was king, it has now come to represent a liability to those holding it.

Of course, that money flowing out of cash accounts had to find a home somewhere. And at first it flowed into property and shares.

Unsurprisingly, and assisted by some foreign investment, property prices in countries such as New Zealand, Australia and Canada smashed all time records and building activity boomed.

The record $26.25 million paid for the Besen family home in Melbourne's Toorak, as well as the rumoured $20m for their Mornington Peninsula weekender, is reflective of the tidal wave of funds flowing away from cash holdings.

And now the stockmarket is having its day in the sun. The Cape/Shiller PE ratio, a key measure of stock price value, is trading at 30 times earnings — a level only reached or exceeded twice since 1880: once prior to the tech wreck and once before the Great Depression!

The US stockmarket has been in a bull run for almost eight years and currently, the 12-month trailing price-earnings ratio of the S&P 500 is 21.1 times, which is materially higher than the historical average of 16.6 since 1970.

While I might be more cautious than my peers, I could also be a touch early. In the final stages of a boom, extreme overvaluation is often justified on the grounds that growth is improving.

The surge in share prices this year has been bolstered by strength in corporate profits. S&P 500 companies reported 12.6 per cent growth in second-quarter profits from a year ago, and relative to GDP, profits are much higher than they have been on average since WWII.

Great Expectations

Meanwhile, we are seeing a concentration of money flowing into shrinking group of listed beneficiaries.

Back in the 1960s and 1970s those beneficiaries were the Nifty Fifty stocks, a group of 50 companies listed on the New York Stock Exchange that were considered buy-and-hold blue chips that could do no wrong. And while Disney, McDonald's and General Electric were on the list, so were former champions Xerox, Polaroid and Kodak.

By mid-May of this year almost 50 per cent of the S&P 500's gain could be attributed to just 10 stocks and fully one-third had been generated by just five companies — Apple, Facebook, Amazon, Google and Microsoft.

How this all ends is no mystery — only its date remains to be determined

Today, companies such as Uber, Twitter and Tesla command price premiums that belie the fact they make no money.

Here in Australia the P/E ratio is at 18 times, which is 7 per cent above the level reached before the GFC. Importantly, in the past five years only 19 per cent of the rise in the P/E can be attributed to growth in forecast earnings, the other 81 per cent simply reflects investors' willingness to pay more for the same dollar of earnings.

When risky investments become preferred to low-risk alternatives such as cash, record prices aren't unusual. And when cash earns a punitive return, the fear of missing out replaces the fear of losing money.

Towards the end of a boom, collectibles prices reach new highs, risk premiums plumb new lows and markets become risky. As Jeremy Grantham at GMO noted: "The market, however, appears not to care at all about the past or to learn much from it."

The inverse of record high asset prices today is record low prospective returns. In fact Grantham estimated prospective real returns, for various asset classes, for the next seven years, and the very best is offered by emerging market equities, with an estimated return of just 3.8 per cent. The worst was large US equities offering minus 3.8 per cent.

The problem is this: in many cases alternative assets are offering prospective returns that are as low, or even lower, than cash. But cash has no prospect of capital loss. So, cash now offers the same prospective return as these other assets but it provides much lower risk. Cash is starting to look attractive again on a risk-adjusted basis.

How this all ends is no mystery — only its date remains to be determined — so at Montgomery we are becoming a little more cautious and circumspect, preparing ourselves, with a relatively large balance of cash, to take advantage of bargains.

In the interim we will look like we are out of touch and our returns will continue to lag those of our more optimistic and fully-invested peers.

But keep in mind, holding cash when nobody else wants any will give you an asset that is most valuable when nobody else has any.

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

THE COACH

I am employed full-time and receive employer superannuation support. In addition, I make personal contributions to my super. I have previously been told I can't claim a tax deduction for these contributions. I recently read this may have changed. Has there been a change in the rules and what are the opportunities?

From July 1, 2017 anyone eligible to contribute to superannuation will be able to claim a tax deduction for their personal super contributions.

Broadly speaking, to be eligible to make a personal super contribution, you need to be under 75 at the time of making the contribution and have a tax file number. If you are 65 or older, you are obliged to satisfy the work test of 40 hours of work in a 30-day period, in the financial year you make the contribution.

Personal super contributions made where you intend to claim a tax deduction count towards the concessional contribution cap.

This cap has been reduced, effective from July 1, to $25,000 a financial year.

In the 2016-17 tax year, this cap was $30,000 for those aged 48 or under at June 30, 2016, and $35,000 for those aged 49 or over at June 30, 2016.

It is important to recognise that the concessional contribution cap applies to all employer and personal deductible contributions in aggregate per financial year.

You need to be aware and monitor how much employer super support you receive, when it is received by your fund, and within which financial year it is received.

So be careful — a liability for an employer contribution may arise in one financial year but paid by the employer in the next one. Contributions that exceed the concessional contribution cap are taxed at your marginal tax rate and will count towards your non-concessional contribution cap.

To claim a tax deduction for personal contributions to super, you will need to give written notice to your super fund.

This is typically done by submitting a notice of intent that you wish to claim a tax deduction for all, or part, of the contribution you have made to the fund within the specified timeframes. This notice must be submitted before you lodge your tax return.

The new deductible personal super contribution rules will be of benefit to those who have a mix of employment and self-employment.

Previously these people were unable to claim a personal tax deduction if their employment income was greater than 10 per cent of their taxable income.

Others that stand to benefit will be those whose employers previously did not allow salary sacrifice. They will now be able to control the timing and size of contributions they wish to make towards funding their retirement tax effectively.

Some employers have exploited the loophole that exists whereby their super guarantee obligation is reduced by employees electing to salary sacrifice, thereby reducing the income their super guarantee contributions are based on. The ability to claim a tax deduction for personal super contributions removes this loophole, effectively putting these employees in the same position as if they are able to make salary-sacrifice contributions without this penalty.

Those who have life insurance, total and permanent disability insurance or income protection insurance through their super fund, will be able to fund the premium costs as a personal deductible contribution and therefore gain the benefit of a tax deduction.

Visit the Wealth section at www.theaustralian.com.au to send your questions to Andrew Heaven, an AMP financial planner at WealthPartners Financial Solutions.

Bunnings Warehouse Trust in battle for relevance as tenants move on

EVA BROCKLEHURST

As one of the most reliable A-REITs in Australia, the Bunnings Warehouse Trust (BWP), which manages roughly 80 Bunnings store properties, has been a long-time favourite of conservative income-seeking investors.

But at present the stock — 25 per cent of which is held by Wesfarmers — is facing a range of issues its original supporters might never have imagined.

Trading at about $2.91, it is still priced at a premium to reflect income security, but analysts believe investors will increasingly question this position.

One issue is flat earnings. The trust reported earnings per security of 17.51c for the 2017 financial year, up 4.3 per cent. Distribution forecasts are unchanged for the 2018 financial year.

The result reinforces Citi's view the company is facing operating as well as sentiment headwinds.

So what's the problem? The reasons are several and include the potential for vacancies to rise and tenant quality to weaken, shorter leasing terms and higher gearing.

Management needs to reposition several properties. In fact, up to 5 per cent of the portfolio could be vacant next year as Bunnings is likely to vacate these premises.

The impact of lost rent will probably build into the second half and rise again in 2019, based on the timing of lease expiries. One close observer, broker Ord Minnett, believes this is the start of a challenging period for the company. Management would not quantify the extent of the expected decline in underlying earnings over the next 12 months, but the broker estimates it to be about 2 per cent.

On the other hand, management calculates that repositioning and/or development capital expenditure, along with incentives, could be about $200 million for the next two years.

The trust manages roughly 80 Bunnings store properties

Ord Minnett points out this is a lot of money for a company of this size to spend in a relatively short period.

UBS, which has a sell rating on the stock, does not believe the 6 per cent distribution yield compensates for the execution risk that lies with the re-leasing and re-developing of a material proportion of the portfolio.

The lack of clarity surrounding capital expenditure over the next two years and the returns do not instil confidence either. The trust, led by CEO Michael Wedgwood, has introduced the concept of a core portfolio, which includes 68 properties, or about 85 per cent of the entire portfolio. The remaining assets have been designated as non-core based on present status — that is, looming vacancies.

Citi, another broker with a sell on the stock, suggests the non-core assets need to be sold, or could resume a place in the core once leases are settled.

The current core outlook appears reasonable to the broker, with the company reporting organic growth of 2.1 per cent.

Regardless, the stock trades at a generous price/earnings ratio and, given the elevated uncertainty, a sell rating is maintained.

As Morgan Stanley puts it: "BWP has been traditionally held for its simplicity, being close to 100 per cent leased with a long weighted average lease expiry (WALE) and in the past there has been limited capital expenditure, supported by a growing Wesfarmers-backed tenant. Now changes to the business may cause investors to reassess the value proposition."

Across the market there are three sell ratings and one hold (Ord Minnett) on Bunnings.

The consensus target is $2.77, signalling a small downside to the last share price. Targets range from $2.60 (Morgan Stanley) to $3.10 (Ord Minnett).

Eva Brocklehurst is an analyst at stock research service www.fnarena.com

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