The hunt for yield takes a new turn

Look out for stocks with prospects of dividend growth

JAMES KIRBY

Take out the big four banks and Telstra from the sharemarket this year and the Australian market would be still be up. But unfortunately the banks and Telstra make up fully one quarter of the wider market. Put simply, they've dragged the whole index down.

Just how severe that downward drag has become is quite alarming. The former "bond proxy" favourites have fallen through the floor.

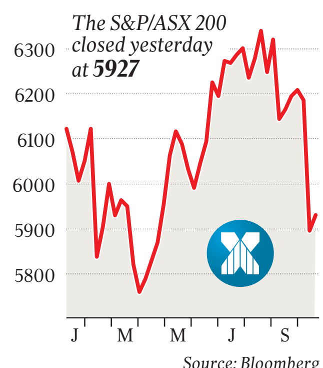
As Hasan Tevfik, senior research analyst at MST Marquee explains, "The ASX 200 has provided a capital return (so not including dividends) of about -2 per cent so far this year, but the ASX 200 excluding the selfies (Tevfik's term for the special place these stocks have among self-managed super funds) is still up by about 2 per cent."

And according to Tevfik's calculations the five stocks — ANZ, CBA, NAB and Westpac and Telstra — are down 14 per cent over the year to date. All up they have lost a collective $64 billion in market capitalisation, an enormous sum in our market.

Ironically, the dividend yields of these so called bond proxies are now higher than ever. The problem is that confidence in the companies has waned amid poorer trading conditions and endless scandals. To put it another way, dividend yields of 7 per cent are poor compensation when you've lost twice that in a share price downturn.

What to do? For income-seeking investors, especially older Australians, the choices are tough.

Until recently when bond yields and interest rates finally started to lift the decision was easy: cash was hopeless while the banks and Telstra paid a 5 per cent yield. Now, with the eruption of "bondcano" — the inevitable losses on the bond market as rates move higher — the game has changed. Cash rates nudging 3 per cent are better, though they have still not moved high enough to comfortably exceed inflation, while sharemarkets are becoming more volatile.



But it is worth noting the average dividend yield across the sharemarket is now 4.45 per cent, one of the highest rates in the world. Those average yields are three times higher than the cash rate and there are choices well beyond banks and Telstra.

In fact, yield investors who moved early and diversified to other high yield sectors within the ASX have fared reasonably well.

For example, key players in the A-REIT property trust sector have continued to perform well, especially those trusts that concentrate on commercial and industrial property.

BHP is offering a yield of 4.7 per cent and has managed a total return this year of 21 per cent

In fact several A-REITs can boast positive total returns (share price growth combined with dividend payments) such as Cromwell and Growthpoint.

But this year's seriously big contributors in the "hunt for income" are the miners and leading industrials: BHP is offering a yield of 4.7 per cent and has managed a total return in the year to date of 21 per cent. Fellow miner Rio Tinto offered an even better dividend yield of 4.9 per cent, with total returns of 11 per cent.

Non-mining industrial winners include Wesfarmers, with a 4.52 per cent yield and a total return of 12 per cent, and JB Hi-Fi, with a yield of 5.8 per cent translating to a total return of about 4 per cent. Moreover, these high-income returns are coming from a market which — though currently enduring a sell off — is by most measures trading at reasonable levels: Shares are trading at around long-term averages in terms of price earnings ratios.

Importantly, leading players in this new dividend crop, such as the miners, are promising dividend growth, a promise that is not on the table at Telstra and which seems increasingly ambitious for the bank stocks.

Professional investors are reflecting this thinking, but they also have the same issue as private investors in that the banks have hit their returns.

The popular Plato Australian Shares High Income Fund now has as many resource stocks as it has major banks in its top 10 portfolio. But Plato had a rare negative month in September, and October will also be challenging.

Similarly, exchange traded funds focusing on high income will be stuck with the bond proxies — The Betashares Legg Mason Equity Income Fund which has Telstra, ANZ and NAB in it top 10 holdings has peeled off from $8.40 in August to about $7.80 today.

We never know where the market is heading next but there are a handful of reliable signals emerging. For yield the sharemarket remains the place to be — cash is still too low and bonds (even if you can afford them) are facing very tough conditions.

Some investors will seek to ride it on banks stocks — perhaps even with Telstra. But on sharemarket the hunt for yield must now be seen through a wider lens — stocks which offer convincing yields, the prospects of dividend growth and franking will be most favoured.

Know your product, don't get in too deep and keep some money in hand

MY WAY

Peter Morgan came to fame as a star fund manager at Perpetual. These days he runs his own private investments and has emerged as a powerful voice for independent investors

JAMES CROUCHER

Peter Morgan: 'The (Globe) chairman bought a million shares on market at about 65c, something you hardly ever see'

Are we heading for a serious sharemarket downturn?

Corrections are impossible to time and nobody rings a bell. In recent weeks, we have seen some sharp falls and there has been some recovery. That also happened earlier this year and it suggests to me times are getting more uncertain.

I would tell investors three things. One, valuations are high globally; debt is very high globally; international tensions are high and risk is priced complacently.

Two: Be careful and know as much as possible about what you are invested in and the risks. As Warren Buffett says, you only know who's been swimming naked when the tide goes out.

Three: Don't be leveraged and do have some cash to deploy if there is a correction.

The biggest overseas interest among Australian retail investors are Facebook, Amazon, Netflix and Google. Is that going to pay off for them?

I couldn't tell you whether Amazon is worth $US1 trillion ($1.4 trillion) or $US500 billion over the long term. Facebook has come back a bit and Instagram might be a potential sleeper but to me the overall FANG trade feels stale.

On risk I'd watch regulation, key person risk, diversification moves and cash spend closely.

Everyone is down on bank stocks. What about you?

I have been nervously buying the banks recently but the investment is not the 25 per cent of my net worth that would be the starting point for a local fund manager.

The risk factors that worry me the most with the banks are that bad debt charges are low and will rise one day; banks are very leveraged, liabilities at 13-14 times net assets, and the asset side is skewed heavily towards property loans.

On the positive side, the royal commission was ahead of the curve in terms of timing. Unlike the GFC, it came ahead of any banking difficulties. A fair bit of negativity is priced in (historical yields are 6 per cent-plus) and credit growth is not out of control.

Are CEOs overpaid?

Most CEOs are overpaid but its not a black and white answer. Remuneration reports have become a joke. Some run to 10 pages and 99 per cent of investors don't understand them.

Most investors are caught between a fading property market and a scarily high stockmarket. What is your advice?

I'd suggest ultra low interest rates have distorted a lot of things. It is 10 years since the GFC and 25 years since the last Australian recession. That's a lot of investment professionals, let alone people, who haven't seen tough times. There are three things you can do in investing: buy, sell or do nothing. The latter two are the most forgotten in a bull market.

I'd tell investors to avoid excessive debt, invest within your means (allowing for risks such as higher rates) and know as much as you can about the positions you have. Sometimes doing nothing can be rewarding and allows you to fight another day.

What is your main investing activity these days?

Over the past 30 years, I managed as much as $9 billion for other people and I'm now back to managing my own money. Today my first port of call is not to lose my money; and make money next.

Are exchange-traded funds good or bad for the wider market?

Conceptually, ETFs are good for the market cost wise but they have become extremely diverse in terms of individual make-up and have never been tested in less liquid falling markets. Some ETFs are highly leveraged and many are invested in similar stocks. It's important to know what you are invested in and why. It's no use saving on costs if a capital loss is going to outweigh the saving.

What was your best investment decision?

One of the better calls was the skateboard/surf company Globe. A few years ago, the company fell below net asset backing to around 40c; the balance sheet had a fair bit of cash on it, not much debt and a reasonable revenue line.

It was a low-risk turnaround if management got it right, which to date they have. The chairman (an ex-accountant) bought a million shares on market at about 65c, something you hardly ever see here. That helped my conviction.

I reckon an investment like that pops up once or twice a year.

What was your worst?

Two that haunt me the most are Fairfax and CSL. With Fairfax I totally missed the power of the internet and its impact on newspapers and media. With CSL it was selling an exceptional company far too early and thinking it would be easy to replace. We tripled our money but that decision cost billions.

Investors, take advantage of the calm to reassess, raise cash before storm hits

ROGER MONTGOMERY

Are we relaxed about risk in this market? Let's take a brief examination of some of the recent best-performing stocks.

In the medium term, there exists a strong relationship between share price performance and earnings growth. In the short term, the relationship also exists but earnings revisions also play a part, especially revisions to the expected earnings for the year after next.

This is where minor modifications to near-term retained earnings and capital expenditure can compound to have a larger impact on earnings per share and free cash flow.

At the tail end of our reporting season, the average earnings revision for ASX 200 companies was negative 1.5 per cent, yet in August, the market, as measured by the S&P/ASX 200 accumulation index, rose 1.4 per cent.

But take a closer look at the top 10 performing stocks in August. We saw their share price rise an average of 34 per cent despite the fact that their 2020 earnings were revised up just 3.4 per cent.

For some of these companies, the theme of rolling out a globally scalable platform has helped with expectations of revenue growth translating to rising profits and margins in the future.

For others, such as Webjet, Breville and a2 Milk, where share prices rose about 30 per cent, 28 per cent and 21 per cent in August respectively, earnings expectations were unchanged. And for another group, TPG announcing its merger with Vodafone as an example, short covering also assisted performance. Despite the fact that two-year forward consensus earnings was revised down, the shares rallied 50 per cent.

Economic conditions are currently benign and backward-looking measures such as GDP suggest the economy is growing solidly. But wages growth is low at just 2.1 per cent annually and, while that might be considered positive for business today, remember that salary earners are also customers. The economy has been boosted by households drawing down their savings, which are now at post-GFC lows, and consequently debt levels are at record highs.

Systemic over-lending by banks fuelled a property boom in Australia, as it did elsewhere in the world, but the royal commission will put an end to any notions of a property price recovery. Limits on debt-to-income and interest-only ratios, as well as tougher responsible lending obligations, will ensure the banks will not lend to as many, and will not lend as much to those to whom they do choose to lend.

When individuals who could formerly obtain loans to finance major purchases suddenly find themselves unable to acquire such funds, a credit crunch follows; homeownership rates drop; and businesses are forced to cut back due to declining revenues. Like a pebble dropped in the middle of a pond, the reverberations are felt through the entire economy.

With debt already at record highs, interest rates rising due to increased bank funding costs and the trough of cheap money being removed, there is every chance that consumers will not only start to feel less wealthy but they will either be forced, or will actively choose, to spend less.

It should come as no surprise that the Reserve Bank doesn't want to raise rates.

For stockmarket investors, there is every risk that any stocks that appear cheap today, say those in the discretionary consumer sector, could prove to be a value trap.

Companies such as a2 Milk, Afterpay Touch, Xero, Wisetech Global, Altium and Appen have an aggregate market capitalisation of $26.3 billion, combined revenue of less than $2bn and combined net profits are just $245 million.

In other words, this group of hot stocks is trading at 107 times their forecast profits and of that profit, a2 is responsible for 53 per cent, or $131m, and Xero and Afterpay Touch are losing money.

It's worth mentioning that a quarter of Afterpay's revenues come from late fees, which jumped more than 364 per cent in 2018.

Unsurprisingly, in the sell-off since October 1, some of the largest falls have been in these very stocks. Afterpay is down about 28 per cent, Wisetech is about 20 per cent lower, Altium is down about 16 per cent and Appen has declined almost 15 per cent.

You cannot help but wonder whether hope has driven share prices well in advance of management's ability to execute on those expectations. Rarely, if ever, has Australia produced so many global success stories and all at the same time.

The bottom line is that investors are having to accept very low prospective returns for the risk they are taking on. History has looked dimly on investors who chase high prices knowingly locking in low returns on long duration assets.

I suspect we will look back on 2018 as a transition year. It will be the year that high returns and low volatility gave way to lower returns and higher volatility. The cost of debt will continue to rise, reducing asset valuations and the tide of liquidity will go out, thanks to the end of quantitative easing, ensuring vendors will have to lower prices to meet remnant demand.

Just because the markets remain sanguine about this transition should not be regarded as proving the thesis wrong.

Storms are often preceded by a period of calm and investors should inquire about taking advantage of the relative stability to reassess their exposures, reduce debt and raise some cash.

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

www.montinvest.com/

I am in the process of preparing my income tax return for last financial year. I am employed and occasionally work from home. What deductions am I eligible to claim and what mistakes or traps should I be aware of?

Taxpayers may claim work-related expenses incurred as a direct result of working from home. Typical examples of expenses would be phone, internet, depreciation of your computer, printing and stationary. But you must be able to provide clear evidence that you have not blurred the lines between personal and work-related expenses.

There is no default level of deduction that you are entitled to claim and you obviously cannot claim where expenses have not been incurred. While you don't need receipts for claims under $300 for work-related expenses, $150 for laundry and 5000km on a motor vehicle, you still must have incurred the costs and be able to explain how you calculated your claim.

You are not entitled to claim for expenses where they are reimbursed by an employer, for example where you receive a car or laundry allowance. In all cases, you must have documented records supporting any work-related claim.

If you are claiming a portion of household running costs like electricity for heating, cooling and lighting, you need to be able to demonstrate that these were additional costs incurred by working from home. Other examples would be the internet or mobile phones where you can only claim the work-related component.

If you have a dedicated work space within your home, be careful what you claim as an expense. For example if you were to claim "rent expense" for a home office then that may mean that you lose your principle residence exemption and therefore your home may be subject to capital gains tax in the future.

Before making any claims for work-related expenses, seek advice from a tax adviser and ensure you satisfy all requirements for record keeping to substantiate a claim and that you are aware of the broader tax consequences.

We own a holiday home that we personally use but also rent out via Airbnb from time to time. What expenses are we able to claim on the property?

Holiday home owners are able to claim legitimate expenses incurred on their property. However, you cannot claim expenses for the time that the property is either used by the family or friends or is unavailable for rent at market rates.

Deductions can only be claimed if the property is actually available for rent. To assist property owners, the ATO applies four rules to ensure that a holiday home is genuinely available to rent: the property should be advertised to a wide audience; the property needs to be in a condition making it rentable; the rental rates must be at genuine market rates, and; you cannot refuse tenants without legitimate reasons.

If the property is rented out to friends at "mates rates", deductions can only be claimed on expenses up to the income received.

Ensure you keep accurate records of the income you receive from your rental property, expenses you incur and evidence of the property being rented or genuinely available for rent at market rates. Keep accurate records of who stayed at the property and when, including the time you and your family stay at the property.

From July 1, 2017, taxpayers are no longer able to claim any deductions for the cost of travel to their investment property for "inspections", with very few exclusions.

For further information on legitimate property expenses on holiday homes, visit www.ato.gov.au or contact your tax adviser.

Andrew Heaven is an AMP financial planner at WealthPartners Financial Solutions.

andrew@wealthpartners.net.au