Holding out for Hayne — an investor's guide

Monday's potent report is sure to affect many stocks

JAMES KIRBY
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Every new year presents a fresh set of opportunities and challenges for investors, but rarely has political and legal change loomed so large over local investment conditions with the forthcoming Hayne inquiry report due on Monday.

We should not try to guess at this stage what Kenneth Hayne will actually deliver. The plan is that the government retains the report over the weekend in order to review what should be a shopping list of recommendations. Then when the ASX trading session ends at 4pm AEDT on Monday it will be released to the public.

The fact that the Morrison government pencilled the release to be "post-market" should be evidence enough as to just how potent this report will be for all sharemarket investors.

After this milestone document is digested and the government responds, consumers should be better protected and financial service executives may increasingly face not just penalties but jail time.

Indeed, if the Hayne report delivers even half of what is expected, financial services will never be the same again.

For investors, the perspective is different — yes there is the desire for greater protection but also the need to navigate these changes to make decent returns.

Everything is on the table with this report — your rights and protections as an investor, your access to superannuation, the standard of your insurance, not to mention the immediate outlook for any investments you may have on the market.

Here's what to watch out for.

- New rules that could stop banks running wealth services. The bank most exposed here is Westpac, which alone among the big four has remained committed to wealth management while its rivals have been selling or seeking to spin off their wealth divisions. Stocks in the spotlight: ANZ, CBA, NAB and Westpac.
- Financial advice reforms. The elimination of the disgraceful "grandfathered commissions" that rolled on endlessly in the wake of major reforms in 2014 is surely a given. But Hayne will almost certainly tighten regulation of both qualification and operation of financial advice practices. Hopefully, he will rid the system of so-called "tied planners". Stocks in spotlight: banks, insurers, IOOF.
- Moves to eliminate the worst-performing funds in superannuation. This would be a win for all investors. Alternatively, a move to have a "best in show" default menu for workers would be a mixed blessing that might ultimately stamp out competitive energy in the sector. Stocks in spotlight: again, the big four banks and major insurers stand to lose most if this comes to pass.
- New regulations that will bring insurers directly into mainstream regulation. Bizarrely, the insurance business has major "carve-outs" that allow it to run a self-regulation regime outside mainstream regulation. Hopefully, this will change. Stocks in spotlight: AMP, IAG and QBE.
- Reform of commission system among mortgage brokers. A flat fee for mortgage broking would rewrite the relationship between banks and their product sellers. It would reduce the attraction of mortgage-broking stocks and claw back power to bank stocks. Stocks in spotlight: CBA, Mortgage Choice.
- Outlawing of cold-calling of online financial services. New companies designed to exploit current conditions would be hit immediately if this change gets up. Stock in spotlight: iSelect.

Indeed, the report will have consequences well beyond the best known financial stocks. Among an assorted list that will also be in the news we might see Challenger, IOOF, Bendigo and Adelaide Bank and Bank of Queensland.

On the other hand, a "lighter touch" than expected from Hayne will almost certainly prompt a "relief rally" among these stocks.

Big bank stocks in particular could move higher if the report seeks to change the game by targeting tighter execution of existing laws and tougher fines. The report may also make recommendations on bank remuneration.

Any — or all — of these possible changes would give us better banks but they would not change the fundamental investment proposal from some of our most important stocks.

Under this scenario the major banks would face enlarged compliance costs but their situation as a de facto oligopoly with legal and government protection at the heart of our market would allow them to regain favour with local and overseas investors.

With banks selling on around 11 times earnings and offering yields of close to 7 per cent, such an outcome may immediately trigger bargain hunting.

Future of financial advice, neither cheap nor free

For the majority of investors it is the vexed issue of financial advice that may emerge as the crucial area of change in the wake of the Hayne Commission.

In this segment of the inquiry it became blatantly clear a lopsided financial advice system had emerged across Australia. Essentially the system revolved around "products" created by banks and insurers. Worse still, those products could then be sold on a commission basis by operatives who worked for the same banks and insurers.

Hayne's report is a big opportunity to rid the system of its worst aspects — the "tied planners" who work for the same group that create the products, the poorly educated advisers who may sell complex products they don't understand, the cold-callers who can take advantage of anyone who answers the phone (as in the now notorious case of the Stewart family where a Freedom Insurance sales operator pushed a young adult with Down syndrome into taking out a "protection plan".

To reform the system Hayne must leave no doors open such as the infamous "grandfathered arrangements" on commissions that were created as run-off arrangement in 2014 and still make money for banks today.

In essence, Hayne needs to separate the sellers from the product manufacturers in the same way as doctors and "big pharma" are separated today.

As banks rush to dispose their wealth management arms — and a generation of financial advisers consider leaving a tarnished sector — some hard lessons are already clear. In the end financial advice can't be free, it can't even be cheap.

A stricter code post Hayne will mean wealthier investors will continue to get good advice, mid-market investors will be pushed to move higher up the line and pay more for quality service: The vast majority of people may be left to the robo-end of the market where generic advice will be pushed out to everyone ... it's not the best arrangement, but at least people should not be conned as often as they were in the recent past.

JAMES KIRBY

My elderly widowed father will need to move to an aged-care facility in the next 12 months as he needs support beyond his current home care. We don't have an enduring power of attorney in place, and he has been diagnosed with early-stage dementia. Are we able to act on his behalf?

An enduring power of attorney is a legal agreement that enables a person to appoint a trusted person, or people, to make financial and property decisions on their behalf. It is an agreement made by choice that can be executed by anyone over 18 who has full legal capacity.

Under the law, adults are presumed to have the capacity to make their own decisions unless it can be shown they lack capacity. If your father is struggling to make decisions and manage his own affairs, you should speak to a health professional and request a capacity assessment test be undertaken. The decision as to whether he has lost capacity would typically be made by a neuropsychologist, a geriatrician or a psychiatrist referred by your father's GP.

If the medical opinion is that your father has lost legal capacity, he will be unable to grant you an enduring power of attorney. Without this, you will be unable to make financial decisions on his behalf. Once he has been deemed to have lost legal capacity, any contract signed by your father after the diagnosis becomes invalid or unenforceable. Therefore an aged-care facility will be unable to admit your father as a resident, or allow you to sign the application for admission on his behalf. This is a major problem and will cause delays in his admission.

If your father now has legal capacity, then establishing an enduring power of attorney and enduring guardianship should be a matter of priority. Speak to a solicitor who is an estate-planning expert. While you are speaking to the solicitor, it might be timely for your father to review his will to ensure the will is up to date and reflects his wishes. Typical examples of issues where wills need to be updated include: the original will is lost; executors are dead; bequests are in place for assets that no longer exist; and beneficiaries who may be dead or unknown to the executor. Regardless of whether your father is happy with his current will, locating a copy of the will and checking its validity should be an important start and could save considerable inconvenience and expense later on.

If dad is deemed incapable of making his own decisions or managing his affairs, what are our options?

In the absence of a valid enduring power of attorney, you would need to make an application to the Civil and Administrative Tribunal (CAT) in your state for a financial management order to obtain control over your dad's financial affairs. Information can be found on your state's CAT website outlining the application process and what you need to consider. If you are a resident of NSW the website is www.ncat.nsw.gov.au.

Once a financial management order is granted, you should be able to manage your dad's financial affairs. You need to be aware that CAT can be appointed as a co-financial manager under a financial management order. This would mean that financial and legal decisions you make on his behalf may need to be passed and approved by CAT on an ongoing basis. You may also be required to report back to CAT on an annual basis, updating them on your dad's personal and financial circumstances.

Be aware that financial management orders do not cover day-to-day lifestyle or care decisions. A separate application will need to be made to obtain guardianship orders. A guardianship order allows CAT to appoint you as your dad's guardian to make personal, medical and lifestyle care decisions.

Having to apply to CAT for guardianship or financial management may cause considerable inconvenience and delays in managing your dad's financial and personal care needs.

If your dad now has legal capacity, then establishing an enduring power of attorney and enduring guardianship should be a priority.

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Have shares fallen far enough to offer value? Buffett doesn't think so

ROGER MONTGOMERY

Recent falls in stocks around the world have tempted many investors to dive in and grab some value. Before doing so, it is vital to understand where value sits.

Investors should always think about risk as well as returns.

One way of doing this is to compare the implied returns of one investment against another. By way of example, suppose you'd like to buy a two-bedroom apartment in Manly, Sydney. That apartment would set you back about a million dollars (without a view) plus $40,490 in stamp duty.

Keeping in mind there are currently 52 two-bedroom apartments available for rent in Manly, the apartment might yield between $600 and $1400 a week. Taking the midpoint of $1000 the gross yield on your investment would be 5 per cent. But of course, there's council rates to pay, water rates, building and landlord insurance, body corporate fees, property management fees of up to 9 per cent of the rent, tax on the rental income, repairs and maintenance costs and re-letting fees if the tenant vacates.

And we haven't added any interest charges if money is borrowed to acquire the property. The net yield on the property is typically very low and possibly negative: as you might have guessed by now, I think shares are much easier.

Despite recent falls in "FAANG" stocks (Facebook, Amazon, Apple, Netflix, Google parent Alphabet), which have rendered them much more attractively priced, the broader S&P 500 remains at relatively elevated levels.

According to the cyclically adjusted price to earnings, or CAPE, ratio developed by Robert Shiller, the S&P 500 is sitting on a multiple of 29.1 times. To put that in perspective, even if you go all the way to the year 1870, you can only find two occasions where the market was this expensive. The first time was right at the peak of 1929 — just before the great crash, and the other occasion was in 1999 and early 2000 during the first tech bubble.

Before you go jumping at shadows, the CAPE ratio isn't particularly useful as a predictor of crashes. It is, however, an excellent predictor of returns over the subsequent decade. At current levels, it is suggesting that index investors buying today should expect no more than low single-digit annual returns over the next 10 years.

BLOOMBERG

Warren Buffett's Berkshire Hathaway is cashed up

Once again, if we compare the implied low single-digit returns from the US stockmarket index, with capital at risk, to the zero risk option of cash at 2.8 per cent, it looks like cash could be a viable risk-adjusted alternative.

Perhaps the high market level is one reason that Warren Buffett's Berkshire Hathaway is holding almost $US130 billion ($180bn) in cash. Indeed, he noted that value was one of the factors notably absent in many of the deals he has looked at in 2017.

Since then of course the market has travelled even higher until September 2018 and even after recent falls it remains roughly at 2017's highest level.

A quick look at the Australian market reveals the S&P/ASX 200 has recently fallen by about 7.6 per cent from its August highs (that is including the brief bounceback in mid January).

But many individual names have fallen much further. Kogan is 59 per cent off its highs, and Afterpay (-26 per cent), Wisetech (-20 per cent), Xero (-20 per cent), Altium (-17 per cent) and Pushpay (-17 per cent) have all fallen substantially.

One cannot, however, lump all of these names into a "high-quality" basket. Nonetheless, even higher-quality names have fallen. CSL and Cochlear, two standout quality businesses, are 15 per cent and 11 per cent respectively lower than their 2018 highs and even the oligopolistic banks are down between 11 per cent and 20 per cent.

Whether these falls are sufficient to represent value again requires an examination of their prospects followed by a comparison of conservative estimates to current prices.

On that score many of the highest-quality names remain out of reach of the value investor and to be sure of achieving a higher risk-adjusted return than cash, lower prices are still required.

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Look past day-to-day market gyrations: three small caps that are paying big dividends

RICHARD HEMMING

Dividends really do reduce a portfolio's volatility.

Day-to-day gyrations don't matter if you are receiving a halfway decent interim and full-year dividend. Watch the company, don't watch the market.

Across the market the average forecast dividend yield is 5.1 per cent (excluding franking), which is double the average for the US market, which is closer to 2.5 per cent on the S&P 500 index.

In fact, the sell-off in the fourth quarter of 2018 was much more aggressive in the US market, where the S&P 500 fell 14 per cent, compared with the ASX All Ordinaries index decline of 9.7 per cent.

When you look at the paltry 2.4 per cent rate of return you get on a 12-month fixed-term deposit, it's no wonder Australian investors look to equities for income.

In the past we have had blue chips that paid too much. Telstra is a classic example. The company paid out more dividends than its cash flow warranted, failing to invest in growth and to take into account the competition arising from the NBN.

All the while it was eroding its balance sheet strength. Then the crunch came when the company could not maintain its fiction that profit margins were being sustained and it was forced to reduce its dividend payout.

Which brings us to small caps. These companies generally have higher risk than their bigger counterparts but, because the universe on the ASX is diverse, I have had no trouble finding three stocks that I am willing to nominate:

MyState

I like both the regional banks we cover, but the Tasmanian-based MyState is probably a safer bet because of rival Auswide Bank's concentrated Queensland exposure. The company has proved to be a steady performer and provides ballast in the volatile small-cap world through the provision of modestly growing fully franked dividends supported by its strong capital position and pristine asset quality. At current levels the company trades on a fully franked dividend yield of more than 6 per cent.

Gale Pacific

The shade-cloth maker's earnings aren't as consistent as MyState, but it's 2c a year of dividends is, which puts it on a 6 per cent dividend yield. The company has exposure to changes in exchange rates and raw material prices and the vagaries of weather, yet trading on a price-earnings ratio of under 10 times, it's good value.

Moreover, the company has a strong core business, which sells into markets as diverse as the Middle East and the US. Growth is a big possibility and you get compensated in the meantime.

Ingenia Communities

Long-term readers of this column will know that Under the Radar has long been a big fan of this retirement accommodation operator, where the yield is low compared to MyState and Gale Pacific at 3.6 per cent.

What you get in return is a company with a recurring revenue stream and strong development pipeline supported by demand from retirees with a limited budget. In its innovative model, Ingenia offers accommodation based on either a land or lease model where a person buys a home within an Ingenia community and rents the land on which the home sits on, or just rents the home.

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