LOGICAL THOUGHTS

logical financial management

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Part 1 - Should retirees continue investing in the big four bank's shares?

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Introduction

Not surprisingly, the big four banks continue to be a drag on the Australian share market as the Hayne Royal Commission into Misconduct in the Banking (and other) sectors continues to reveal some "deeply unsettling, quite disturbing and trust shattering" truths about the operations of their various business divisions.

Change within financial services and the big four banks is likely to occur following the Hayne Royal Commission's findings. We don't know what the bottom line impact will be for the banks, but when there is uncertainty it is never positive for a company's share price.

This 'Logical Thoughts' looks at some of the key reasons why a client would continue to invest in the big four banks in uncertain times, what type of capital growth could you expect from the banks, whether the banks preserve investor's capital during share market volatility and some of the portfolio issues investors need to be aware of when investing in the big four banks.

What are some reasons for investing in the big four bank stocks?

Two key reasons why an investor may need to invest in the big four banks (Westpac, Commonwealth Bank, ANZ Banking Group and National Australia Banking Group) are:

- A need to generate a reasonable and reliable amount of tax effective investment income from the equity component of their portfolio.
- Historically, the level of dividends received from the banks are not impacted significantly by their share price.

Going forward, it is unlikely the big four banks will provide the investor with the following:

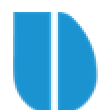
- Substantial capital growth over the next three to five years.
- Preservation of portfolio capital during volatile financial markets.

An investor needs to be aware of the following portfolio issues:

- If you have a substantial direct holding in one or more of the big four banks as a proportion of your total portfolio, it will contribute significantly to the volatility of your total portfolio.
- This factor will then be a key driver of your portfolio's total return (capital loss and gain), see Logical Thoughts - October 2015.

Income Generation

Retirees have different needs to accumulation phase investors, and tax is one of the big differences. The role of franking credits is crucial in the decision on whether to hold bank shares in a retiree's portfolio, while capital gains tax is not an issue at all.



Plato Investment Management has shown that dividend franking particularly benefits investors on low tax rates, such as age pensioners and super pension recipients. To a tax-free investor, including superannuation funds in pension mode, each dollar of a fully franked dividend is worth $1.43. That dollar of a fully franked dividend would be worth $1.21 to an investor paying tax at 15 per cent, including superannuation funds in accumulation mode. However, an individual paying the highest individual tax rate of 47 per cent, that dollar of a fully franked dividend would be worth only $0.76 cents.

As shown in the table below, the banks currently provide attractive income yields and franking credits for retirees. A retiree who invests $20,000 in each bank would expect the following total income and yield: Westpac ($1,880), CBA ($1,740), ANZ ($1,660) and NAB ($2,080). The total yield generated is 9.0% and income is $7,200.

Table 1: Expected Yield and Franking Credits assuming $20,000 in each bank

	Yield (%)	Franking Credits (100%)	Total Yield (%)	Income (incl. franking)
Westpac	6.6%	2.8%	9.4%	$1,880
Commonwealth Bank	6.1%	2.6%	8.7%	$1,740
ANZ	5.8%	2.5%	8.3%	$1,660
NAB	6.7%	2.9%	9.6%	$1,920
Total			**9.0%**	**$7,200**

Source: Commsec – 12 month forward yields.

The market consensus expects dividend growth for the Banks to remain flat this year before resuming low single-digit growth in financial year 2019. Because of its excessive dividend payout ratio, many believe NAB will take longer to raise its dividend going forward.

Capital Growth

Ultimately income needs be generated from underlying capital, so most pension-phase investors need to protect – and even grow – their nest egg. This total return focus is key to managing longevity risk and when done well, will hopefully maintain the income stream needed by the pension investors. So, what are the expectations for the big four Banks' share prices or underlying capital growth?

If we take a three to five-year view, will sufficient good news (or less bad news) come along to make the market see the value and rerate banks? The market consensus believes that there will not be sufficient news to rerate the banks over the medium term, some of the reasons include:

- Slow core earnings growth could resurface because of margin compression, subdued wealth and markets income, lower banking fee income, higher bad debts, and a worse-than-expected outcome on costs.
- Current Basel III capital requirements, stricter regulations on capital, funding, and liquidity could dampen net interest margin growth and return on equity.
- Increasing pressure on stressed global credit markets could increase wholesale funding costs and reduce wholesale funding availability. Recouping higher funding costs by increasing lending rates is more difficult because of tougher pricing competition between the major banks.
- The credit cycle will turn from historical lows, and bad debts will eventually increase over coming years.
- A couple of the banks are heavily exposed to Australia's booming housing market. Should cracks start to appear, this could prove very damaging.
- Management changes could facilitate slower earnings growth, increased loan-loss provisioning, higher restructuring charges, pressure on capital levels, and potential for lower dividends. They see this as another classic case of a new CEO "clearing the decks".
- A slowdown in core earnings growth could resurface because of slower than expected business loan growth, margin compression, slower growth in banking fee income, subdued wealth and markets income, and a worse than expected cost outcome.

The market consensus expects no major rerating of banks in the next three to five years and plenty of challenges with at best modest capital growth.

Preservation of Capital during volatile financial markets

It is also important to understand how the share prices of the four major banks are expected to behave when the Australian share market trends down or upwards. This is especially important for pre-retirees who are entering retirement and their superannuation balances are more susceptible to market downturns.

To gauge the expected behaviour of the banks against the market we need to understand a measurement called Beta. Beta is the historical measurement of any individual stock (e.g. ANZ, WBC, CBA, NAB) or investor portfolio against the risk of the market portfolio (e.g. S&P/ASX 200). Let us consider the following example to understand beta and how banks should not be expected to preserve your capital in down markets.

The beta of ANZ is 1.33 (over the last 7 years to 30 April 2018), which means that ANZ is 33% more volatile than the market (beta = 1, 1.33 -1=.33). So, if the market declines by 5%, then ANZ would be expected to decline by 6.65% or 33% more than the market. The ANZ price change in the market value is multiplied by its beta to estimate its movement in the future. Hence ANZ is a high beta stock. How about the beta of the other 3 major bank stocks? WBC=1.26, NAB=1.25 and CBA=1.04 (over the last 7 years to 30 April 2018).

All the major banks have betas higher than the market and therefore could be expected to fall more than the broad market index in a correction.

Implications for a Client Portfolios

Depending on which stage of your life cycle you are in, bank stocks still warrant a place in portfolios.

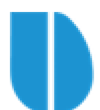
Despite all the current negative headlines, banks continue to have a role in portfolios if you are focused on yield (fully franked) and modest capital growth.

The two questions for retirees are the total portfolio weighting they should give to banks, and how should they access the banks?

The total portfolio weighting is determined by several factors including the amount of investment income and franking credits the retiree needs to generate, their risk profile (e.g., moderate, balanced, growth), how much risk the direct bank shares contribute to the total portfolio and what other income generating assets they hold in their portfolio.

Retirees need to be aware that there are alternatives to the big four major bank shares which generate comparable tax effective income (8.9%-9.5%, including franking credits of 1.8% - 2.4%) with better diversification benefits. These Australian equity strategies also aim to outperform the Australian share market. They are specifically managed for zero tax investors who can utilise franking credits and use a range of strategies such as options and off-market buy-backs.

At Logical we are conscious of the impact that banks have on your portfolios and total returns, and we diversify across investments and asset classes to reduce the risk. If diversified portfolios are constructed based only on total return objectives and not inclusive of downside risk, then it will likely leave the portfolio highly susceptible to volatility and market downturns.



Part 2 – Top 10 End of Financial Year Tips

Here we are again heading towards EOFY where we tend to reflect on how fast the year has gone. It's a busy period for many of our clients so to make things a bit easier, here's our top end of financial year tips.

Kate Cramsie
Financial Adviser

You'll need to meet certain eligibility conditions before benefiting from any of these strategies. If you're thinking of implementing any of them, please contact us first. We can help you decide which strategies are appropriate for you.

If you're thinking about investing more in super remember that money held in super generally cannot be taken out until you permanently retire or reach age 65. Also remember that the contribution has to be received and allocated to your account by 30 June, which falls on a Saturday this year. Most funds will take a couple of days to process the contribution, so don't leave it too late!

1. Concessional Contributions

These are the pre-tax super contributions and include SG, pre-tax salary sacrifice and personal deductible contributions. They are limited by a cap of $25,000 for this financial year. Penalties may apply if you exceed the cap – so it's important that you stay within the limits.

The cap will remain the same for 2018/19 at $25,000, so those making regular monthly contributions in line with the cap will not need to adjust them.

All employees can now claim a deduction for personal contributions to super. In the past, you could only claim the deduction if you earned less than 10% of your income from employment.

If you contribute some of your after-tax income or savings into super, you may be eligible to claim a tax deduction. This means you'll reduce your taxable income for this financial year – and potentially pay less tax. And at the same time, you'll be boosting your super balance.

The contribution is generally taxed at up to 15% in the fund (or up to 30% if a higher income earner). Depending on your circumstances, this is potentially a lower rate than your marginal tax rate, which could be up to 47% (including the Medicare Levy) – which could save you up to 32%.

Once you've made the contribution to your super, you need to send a valid 'Notice of Intent' to your super fund, and receive an acknowledgement from them, before you complete your tax return, start a pension, or withdraw or rollover the money.

2. Non-Concessional Contributions

Another way to invest more in your super is with some of your after-tax income or savings, by making a personal non-concessional contribution.

Although these contributions don't reduce your taxable income for the year, you can still benefit from the low tax rate of up to 15% that's paid in super on investment earnings. This tax rate may be lower than what you'd pay if you held the money in other investments outside super.

Before you consider this strategy, make sure you'll stay under the non-concessional contribution cap, which in 2018 is $100,000 – or up to $300,000 if you meet certain conditions. That's because after-tax contributions count as non-concessional contributions – and penalties apply if you exceed the cap. Also, to use this strategy, your total super balance must have been under $1.6 million on 30 June 2017.

3. Government Co-contribution

If you earn less than $51,813 in the 2017/18 financial year, and at least 10% is from your job or a business, you may want to consider making an after-tax super contribution. If you do, the Government may make a co-contribution of up to $500 into your super account.

The maximum co-contribution is available if you contribute $1,000 and earn $36,813 pa or less. You may receive a lower amount if you contribute less than $1,000 and/or earn between $36,814 and $51,812 pa.

Be aware that earnings include assessable income, reportable fringe benefits and reportable employer super contributions. Other conditions also apply – speak to us to find out more.

4. Spouse contribution

If your spouse is not working or earns a low income, you may want to consider making an after-tax contribution into their super account. This strategy could potentially benefit you both: your spouse's super account gets a boost, and you may qualify for a tax offset of up to $540.

The income thresholds increased on 1 July 2017. So now, you may be able to get the full offset if you contribute $3,000 and your spouse earns $37,000 or less pa (including their assessable income, reportable fringe benefits and reportable employer super contributions).

A lower tax offset may be available if you contribute less than $3,000, or your spouse earns between $37,001 and $39,999 pa.

5. Spouse contribution splitting

The equalisation of super balances between members of a couple can be important where one member is approaching the $1.6m transfer balance cap. One strategy that can be used is for a spouse to split their concessional contributions (e.g. SG, salary sacrifice) to their spouse.

The contribution splitting rules only apply to concessional contributions made in the previous financial year. So, any decision to split the concessional contributions received in 2016/17 must be advised to the super fund trustee before 30 June 2018. Some funds may stipulate a cut-off date earlier than 30 June of the applicable financial year to allow for processing.

Concessional contributions have been subject to 15% contributions tax, so only 85% of the contributions remains eligible to be split. Only up to the concessional contribution cap can be split i.e. excess concessional contributions cannot be split.

6. First Home Super Saver (FHSS) scheme

Individuals can make contributions in 2017/18 that count towards the FHSS scheme. These contributions will be able to be withdrawn from July 1, 2018.

The FHSS scheme allows people to make voluntary contributions to super to later withdraw them to help purchase their first home. A lifetime limit of up to $30,000 can be withdrawn. The tax savings via this strategy could be in the thousands. When two members of a couple or siblings combine to purchase a property together these tax savings can certainly help.

7. Downsizer contributions

Downsizer contributions are only available to those who enter a contract to sell their home on or after July 1, 2018. So, delaying a sale may allow a greater proportion of proceeds to be placed into super.

These contributions are limited to $300,000, can only be made by people over age 65, and the dwelling must have been the person's main residence for at least part of the time it was owned. Properties owned purely for investment purposes and never lived in personally do not qualify.

8. Centrelink gifting

The social security gifting rules apply on a financial year basis. The gifting rules allow a single person, or a couple combined, to gift $10,000 per financial year up to $30,000 in a rolling five financial year period before gifts are assessed as assets and deemed for income test purposes.

Clients receiving social security payments, who are looking to make total gifts of more than $10,000, should consider making part of their gift this financial year, and part next financial year. This may minimise the impact those gifts have on their Centrelink or DVA entitlement.

9. Bringing forward deductible expenses

Up to 12-months' worth of deductible expenses can be brought forward in order to benefit from the deduction this financial year. Costs such as income protection insurance premiums and deductible borrowing costs may be paid in advance to take advantage of this rule. Businesses should pay particular attention to this strategy.

10. SMSF considerations

End of financial year is always a busy time for those clients with Self-Managed Super Funds. With the implementation of the Transfer Balance Cap and Total Superannuation Balance rules in 2017/18, June 30 valuations are more important than ever for members of SMSFs.

Similarly, issues such as ensuring the minimum payment has been made from a pension, reviewing the investment and insurance strategy, and ensuring in-house assets remain under 5% of the fund's value are important areas to consider in the run up to the EOFY.

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