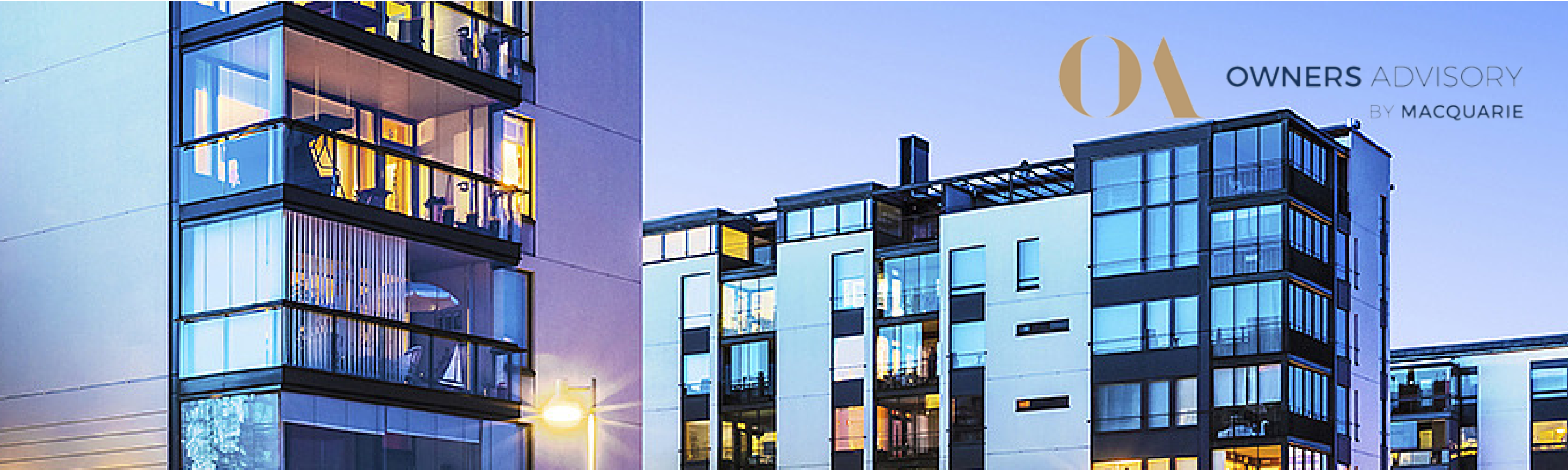


SMSFs and Banks – should I stay or should I go now?

by John O'Connell

SMSFs seem to get blamed for a myriad of sins, the latest being the press claiming they are responsible for the surge in Australian house prices. Nice theory – big bucket of money to invest, limited recourse borrowing enabled in 2007, Australians' love affair with residential property, and a multi-year surge in house prices. Therefore the villain must be SMSFs right? Wrong. The evidence does not back up this assertion.

SMSFs aren't overly at risk from a housing market downturn – directly at least.

However they are likely more at risk indirectly through both bank stock holdings and paradoxically their large cash holdings – more on that later, but first let's kill the myth of SMSFs turbo-charging residential property.

According to CoreLogic, the Australian residential real estate market is worth $6.5 trillion. That's over three times the value of our super savings pool (roughly $2trn), or our stock market (roughly $1.7trn). Makes sense – I mean after food we look for a roof over our head before we worry about an investment portfolio. Residential investment properties are $1.37 trillion of this $6.5trn. Still a very big number. But that is where it ends. According to ATO data, as at December 2015, SMSFs only held $24.4 billion in resi-property.

This is less than 2%. And the rules were changed to allow borrowing almost 10 years ago! This is not the sort of animal spirits that causes irrational exuberance.

So next time a commentator shrieks that SMSFs are evil because of concentration risk in residential investment property, tell them to back off and read the data.

In fact the figures support the notion that SMSFs are far more likely (3.2x more likely in fact) to own non-residential property – offices/commercial/retail/industrial units. Why? Because they trust themselves as a tenant. In this case the SMSF trustee is often times a professional small business owner who has purchased their place of work. They understand the asset, they understand themselves … a bit more concentration risk, yes, but at 13.1% of SMSF balances, not the sort of risk that brings the system down. Commentators stop shrieking please.

The data also shows that even if you put direct property balances to one side, SMSFs are still over five times more likely to do it themselves than use a fund manager to do it for them. I guess self-managed means … self-managed.

To break the myths around SMSFs just add data

Leaving direct property to one side, over 5 times more likely to DIY than use a fund manager

preferred assets are liquid

big cash drag

Asset Allocations within SMSF's	%	$Bn
Listed shares, trusts, ETFs	34.3%	204
Cash and Term Deposits	27.3%	162
Unlisted managed funds	14.8%	88
Non-resi property	13.1%	78
Residential property	4.1%	24
Other assets	6.4%	38
Total		**595**

office/industrial preferred

Resi exposure is small

Source: ATO OwnersAdvisory, June 2016

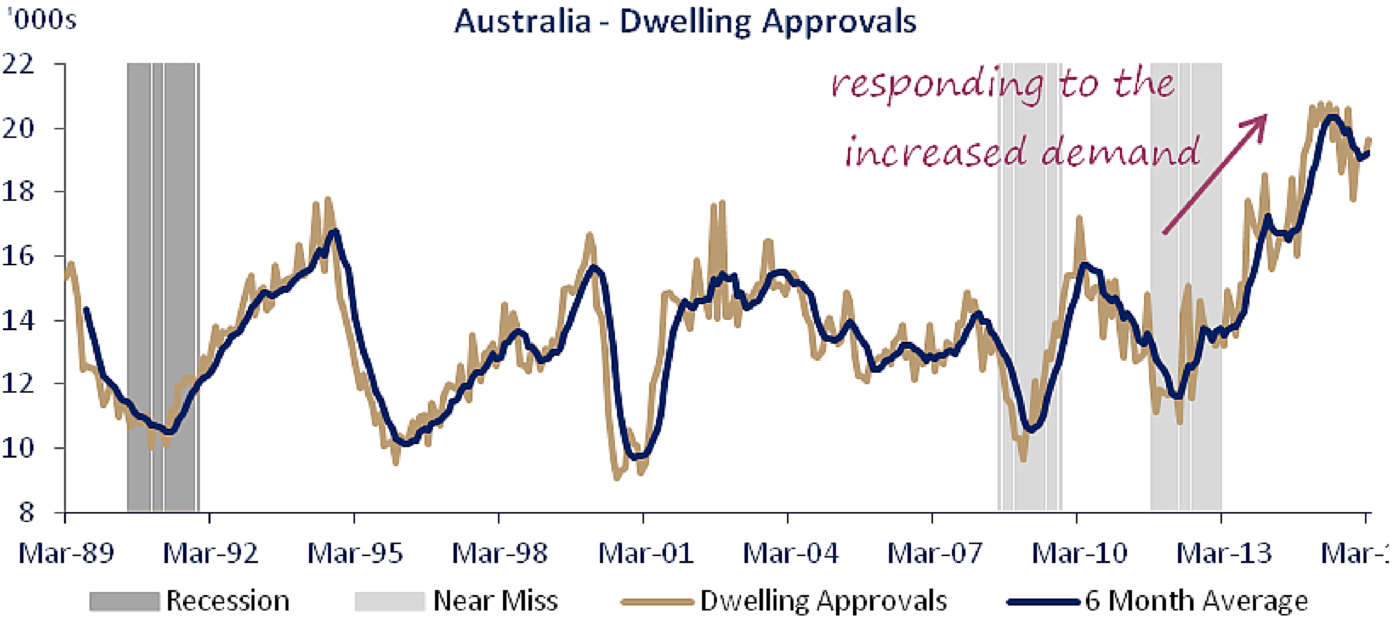
So is there risk somewhere in investment property? You betcha. It is in the large run up in investment properties – the vast bulk of which sit outside super.

Of all the housing stock in Australia, investors now own 27% up from 22% only two years ago. This means 93%, by value, of residential investment property is held outside super. Investor concentration is on units where investors own a whopping 48% versus only 17% of detached housing.

As everyone knows, there has been a boom in prices. And when you get a boom in prices the sector usually attracts capital as the marketing messages increasingly play on our fears of missing out. Builders, whose business is to build, ramp up their production to meet the increasing demand. Much of these dwellings have been in high rise units. Like all assets, supply responds to the greater demand, eventually it catches up (situation today), and usually overshoots (likely as we move through this year and into next).

Approvals – the lead indicator of commencements – demonstrate just how much demand has ramped up over the last few years versus long run trends.

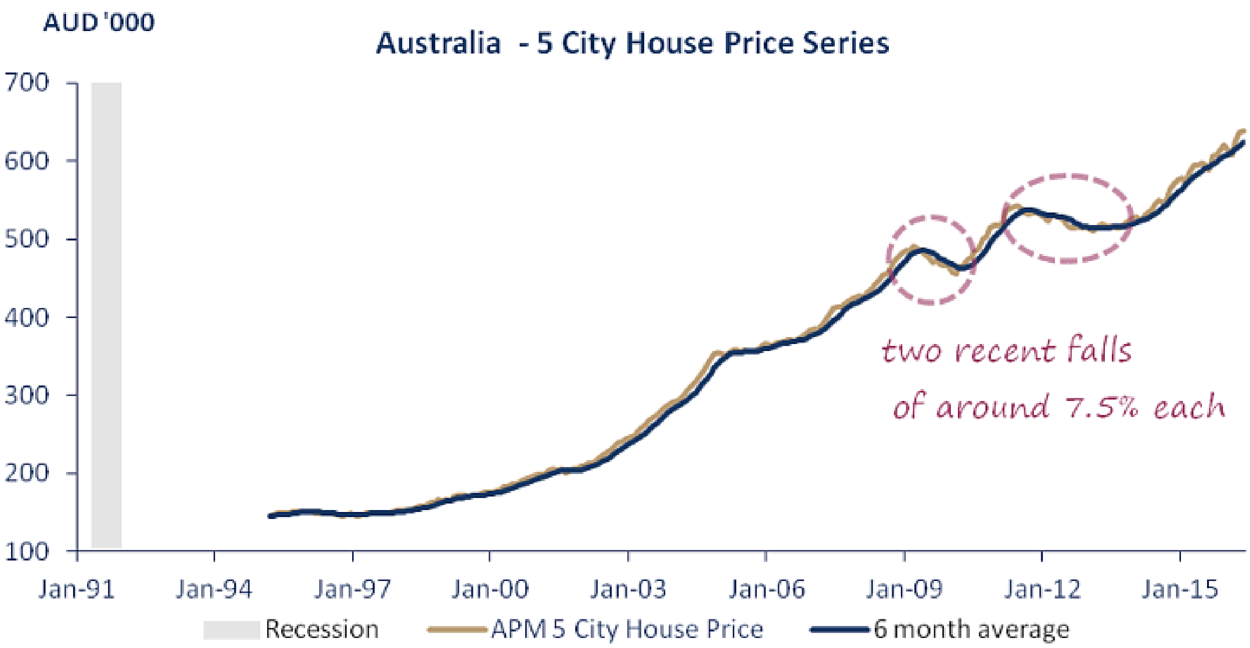
Approvals, then commencements, then completion ... now where is the buyer?



Source: FactSet, Owners Advisory, June 2016

And the myth that Australian house prices only ever rise also doesn't hold up to scrutiny when you view the data. The contention that we have seen an extraordinary rise over the past 20 years does! This is due to several factors – immigration, increased national wealth, lower interest rates, greater foreign investment – some of which are permanent changes and some are cyclical.

No asset – including Aussie house prices – are ever a one way bet!



Source: FactSet, Owners Advisory, June 2016

It is the rate of increase that typically brings a trend unstuck. In the context of Australian property, the rate of supply increase has been greatest in the residential unit sector. This is where Macquarie and most commentators are now forecasting oversupply. With oversupply comes falling prices.

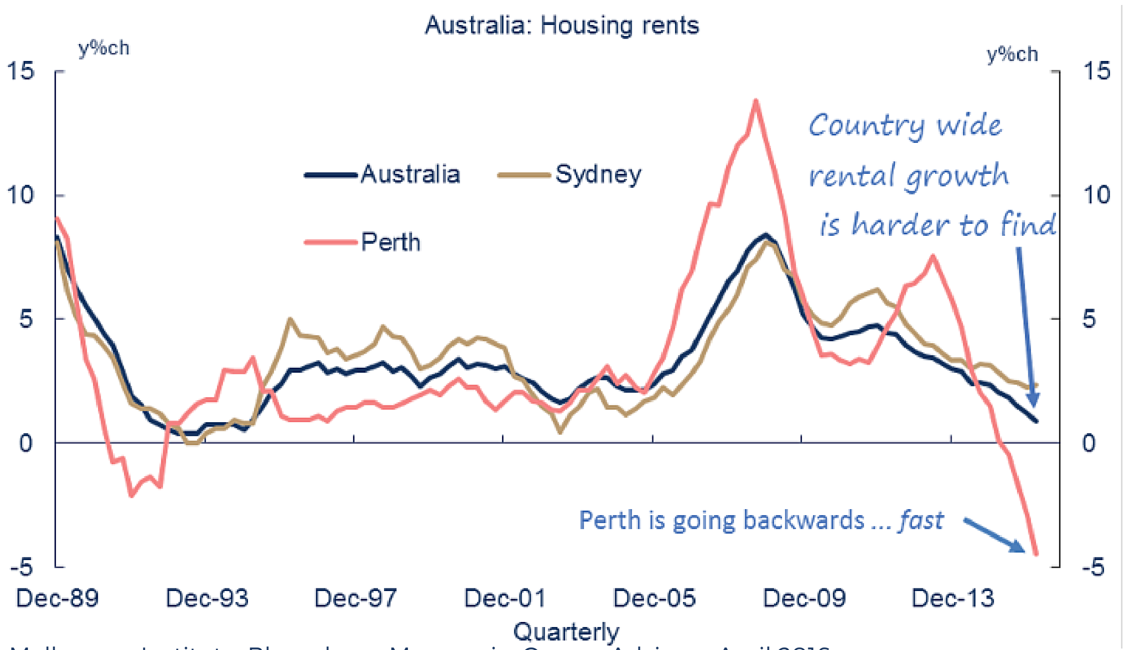
So to recap:
Investors own a high proportion of residential units compared with history.
There is increasing oversupply in residential units.
When you get oversupply in any asset, the price falls.

And how do investors react to a price fall? Differently to an owner occupier as the benefit each group gets from the asset is different, hence motivations are different. The owner occupier lives in the unit, so the decision to buy or sell is often tied in with the emotional attachment of the area and lifestyle the unit affords. An investor is less emotionally attached to these aspects and more attached to whether the asset can make them money – after all this is an investment!

The two primary aspects of residential property as a good investment are the rental stream, and any capital appreciation. Oversupply doesn't just affect rising prices. It also means more competitive rents.

The troubling news is rental growth across Australia is slowing dramatically, and of course dependent upon local issues is actually going backwards. The below chart shows the capital city spread. Perth the worst (mining boom hangover), Sydney the best (finance- and IT-driven city).

Diminishing rental growth is adding to the woes of landlords



Source: ABS, Melbourne Institute, Bloomberg, Macquarie, OwnersAdvisory, April 2016

"When you get oversupply in any asset, the price falls"

But can't we just rely on the Chinese? They will keep the money coming ... hmmm. In my experience investors the world over are much the same. When the asset is rising in value (and hence producing good returns) they chase it, and when it is falling in value it gets shunned. The Chinese are no different. Their domestic stock market attests to this as does their domestic property market – yes, even at home Chinese property investors have been pro-cyclical; chasing the rise and shunning the fall. So I doubt they will be much different down under. As prices cool, so will the Chinese appetite for Aussie property.

Chinese investors go cool on property when prices slip just like everyone else

Source: Wind, OwnersAdvisory, June 2016

So as investor returns cool, so will investor appetite for the asset class. At best we are in for a period of very flat property prices and little rental growth, and more likely a modest downturn much like the prior recent pullbacks. I don't expect an across-the-board crash because the jobs data is improving and this will underpin the owner occupied segment.

So where could SMSFs ‘feel this’?

We’ve established that SMSFs aren’t overly exposed directly to where we expect the greatest pressure – residential units. However our own data does indicate that Australian banks are over-represented in SMSF portfolios. Understandable given banks are intermediaries in the economy and the role for the intermediary increases when you have a period of deregulation and sustained economic growth as we have had since 1992 – our last recession. This means it has been a long period of improving profitability and with that, rising dividends to shareholders.

Bank stocks are currently maintaining their share prices largely due to one metric – dividends! In a low interest rate environment, dividend yields of 6–7%, mostly fully franked, are obviously attractive for maintaining income.

However, bank stocks are what is termed 'deep cyclicals'. That means they move in the same direction as the overall economy, but at a greater amplitude. So when the economy is turning down, their earnings (and hence share prices) turn down hard, and when the economy is expanding they turn up hard.

Dividend growth has been the mainstay of banks share prices

Security	Company Name	Market Cap ($M) 2016E	Share Price 2016E	EPS 2016E	EPS 2017E	DPS 2016E	DPS 2017E	Payout ratio 2016E	Dividend yield 2016E
CBA	Commonwealth Bank	123,542	72.03	547	550	419	418	76.7%	5.8%
WBC	Westpac Banking Corporation	95,637	28.67	234	243	188	190	80.5%	6.6%
ANZ	ANZ Bank	67,775	23.23	203	233	162	166	79.9%	7.0%
NAB	National Australia Bank	66,237	25.04	240	233	181	167	75.5%	7.2%
BEN	Bendigo and Adelaide Bank	4,206	9.11	86	87	68	68	79.1%	7.4%
BOQ	Bank of Queensland	3,981	10.45	95	102	76	77	80.4%	7.3%

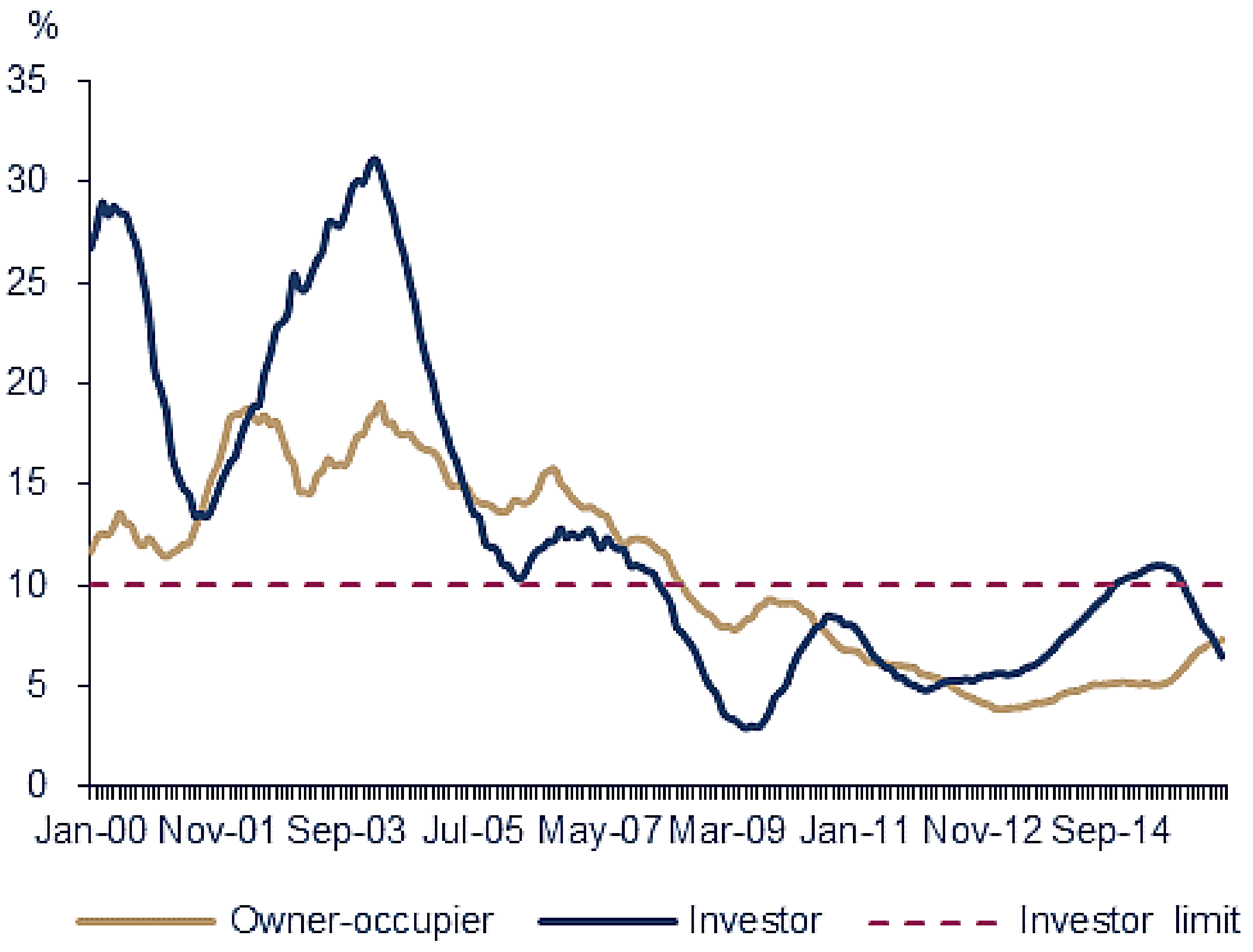
Source: FactSet, Macquarie Research, Owners Advisory, June 2016

We are currently in a very slow grinding cycle – i.e. low amplitude – but the direction of grind is down, not up. Given the Aussie market is dominated by the big four banks, and the past 25 years has been a positive cycle of credit growth without many material setbacks, it is no wonder they form the core of investor portfolios. Some of the reasons to blindly follow the 'own the banks' logic is now coming to an end. This means bank stocks will need to be 'timed' far more than the 'buy and hold' logic when there was a favourable tailwind.

Current conditions aren't about to see the banks’ share prices collapse, but overweight positions should be pared back as the conditions aren't conducive to dividend growth and the current payout is fully valued.

In the big picture, banks grow their earnings by lending money to households and businesses. Both these groups look like they are slowing their appetite for credit (loans), and that will mean banks compete even harder than they do today to maintain the shareholder pressure for growth.

Investor loan growth has fallen well below the 10% 'speed limit'



Source: Macquarie Research, OwnersAdvisory, June 2016

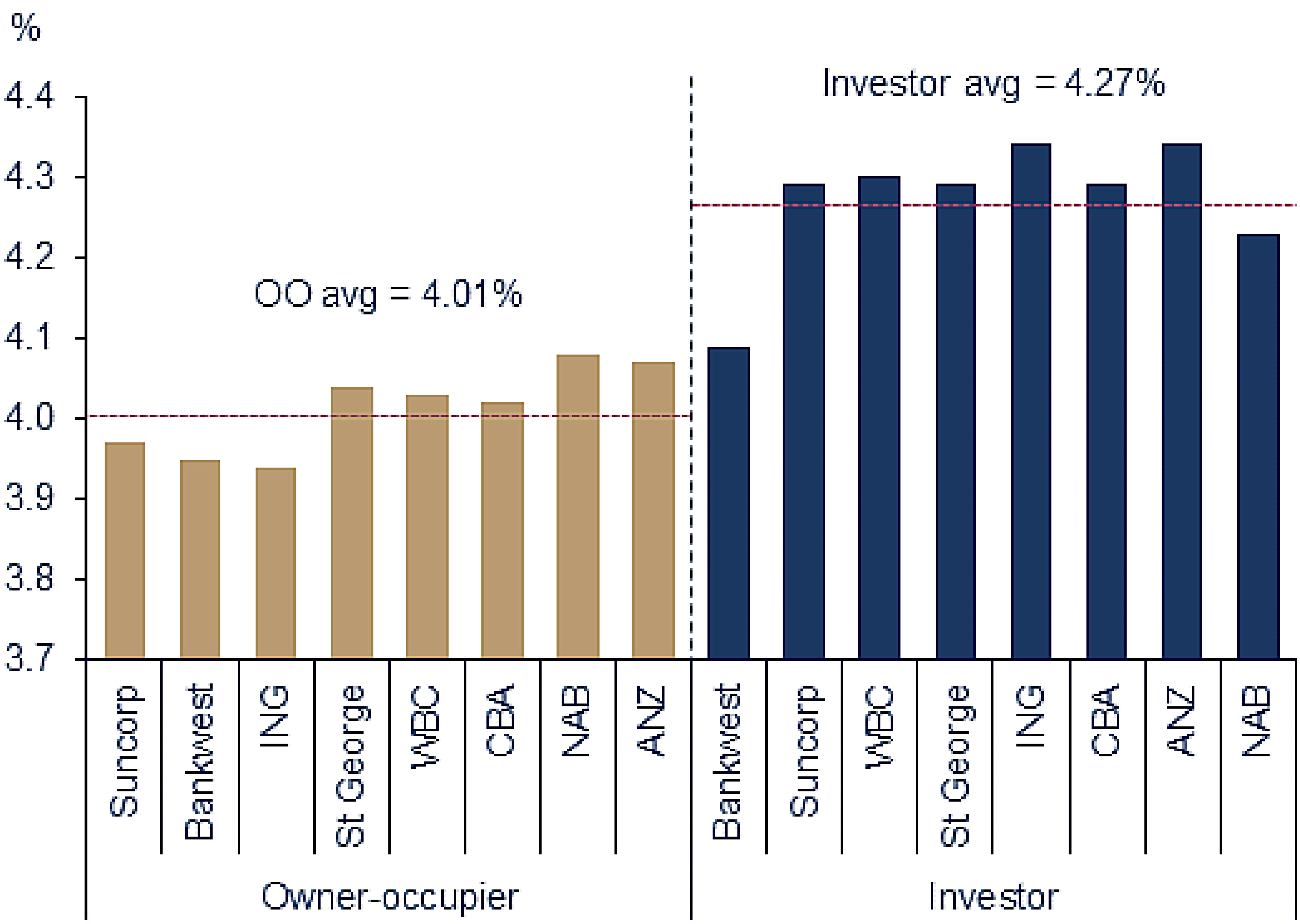
It should be stressed here that the Australian banks have very solid balance sheets due to regulators moving early to set high core tier 1 capital standards. In other words, how much buffer the banks need to retain when they lend. This means they can resist some slowdown – and this is what is currently occurring. They all have high dividend payout ratios – in the high 70%–low 80% range – and thus far it is only ANZ that has seen it prudent to trim its dividend.

"...banks grow their earnings by lending money to households and businesses. "

For the big four Australian banks, housing makes up 55% of their loan books, with owner-occupied housing being 62% of this and investor loans the remaining 38%.

Macquarie's shadow shopping survey shows that there is currently a 26bps differential in interest rates between the two types. And the level of discounting is similar in both types at around 140bps off rack rate.

Shadow shopping survey shows competitive pressures in both owner-occupied and investor channels

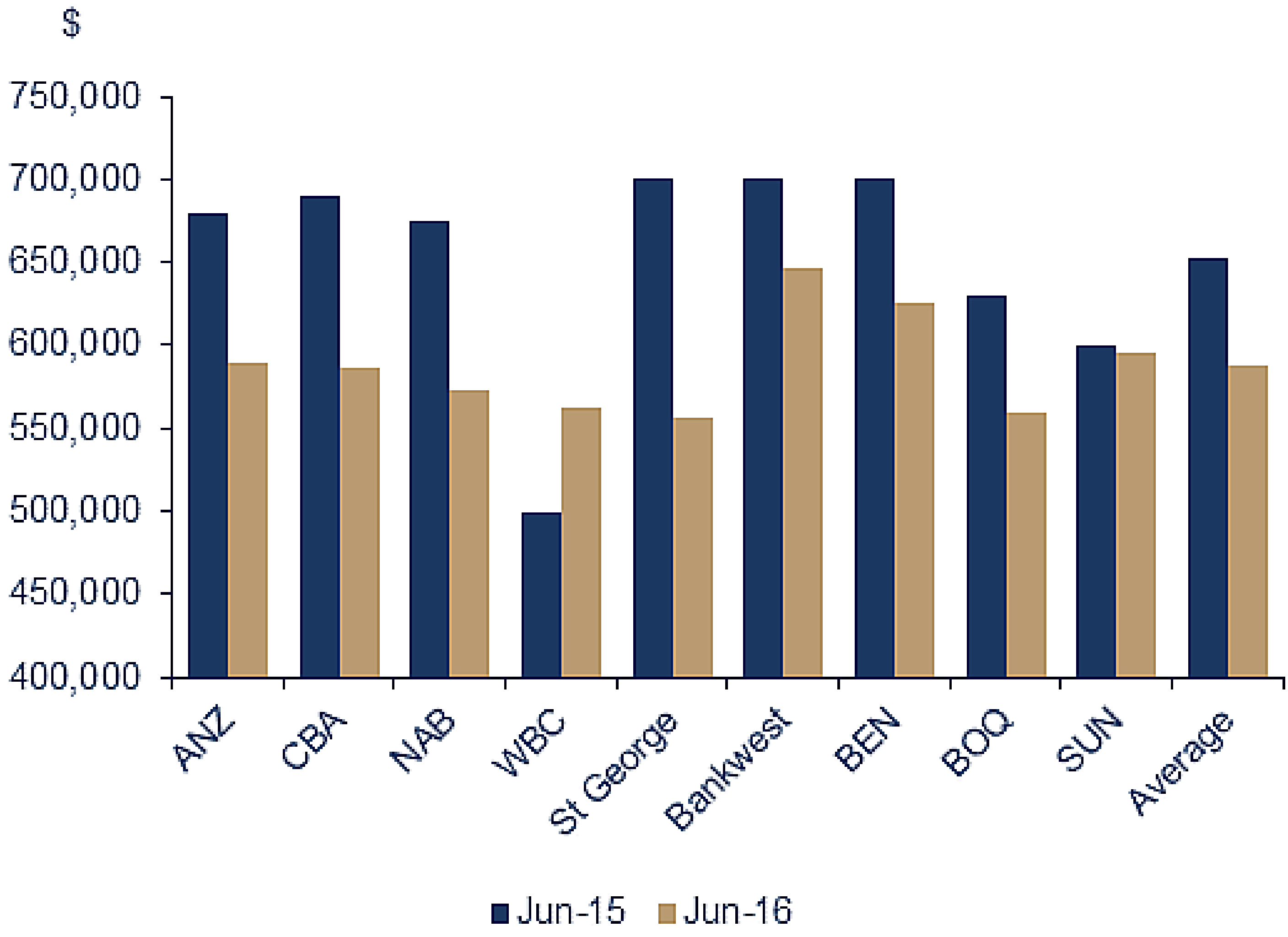


Source: Macquarie Research, Owners Advisory, June 2016

The past few years have seen tightening loan standards being applied to the banks from the regulators. This is slowing credit availability. The two main effects on any individual borrower is a decrease in borrower capacity (how much you can borrow for a given income and savings level) and falling loan-to-valuation ratio, known as LVR (how much deposit you need). The LVR tightening is mainly seen in the investor loan space where the regulators wanted system growth below 10%. They have certainly achieved this.

And other than Westpac, who looks to have played catch-up to the pack, everyone would lend our Macquarie shadow shopper less than 12 months ago.

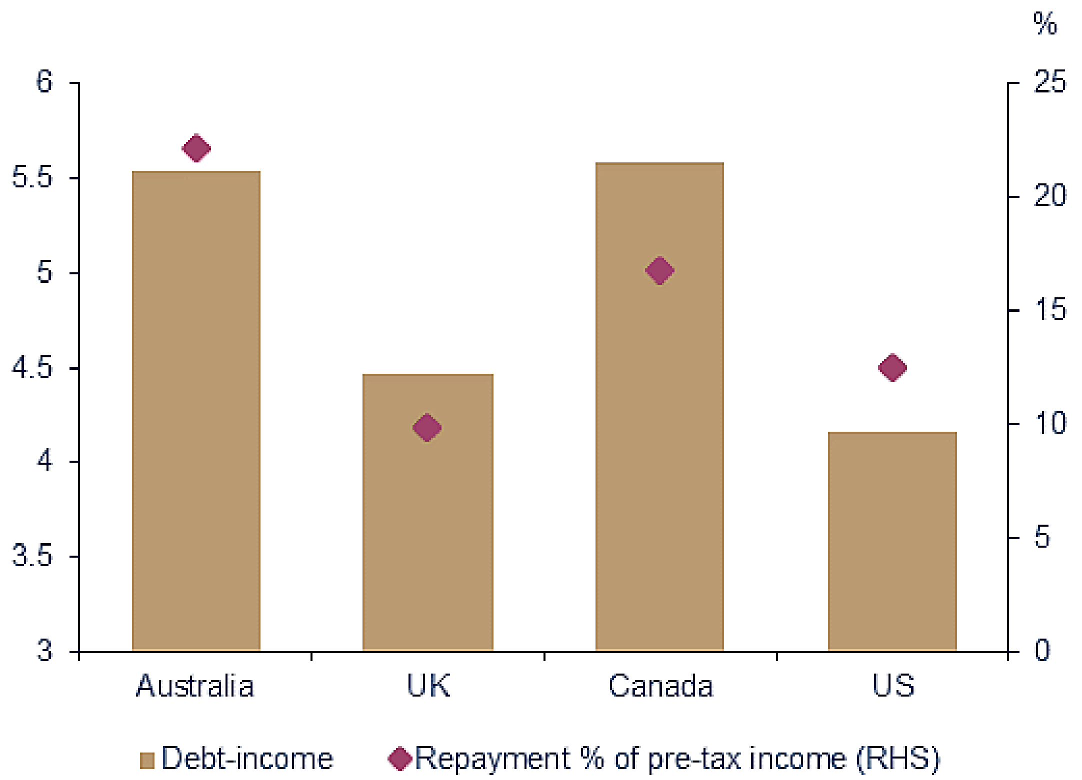
Lending standards have tightened over the past 12 months ... which means lower growth



Source: Macquarie Research, OwnersAdvisory, June 2016

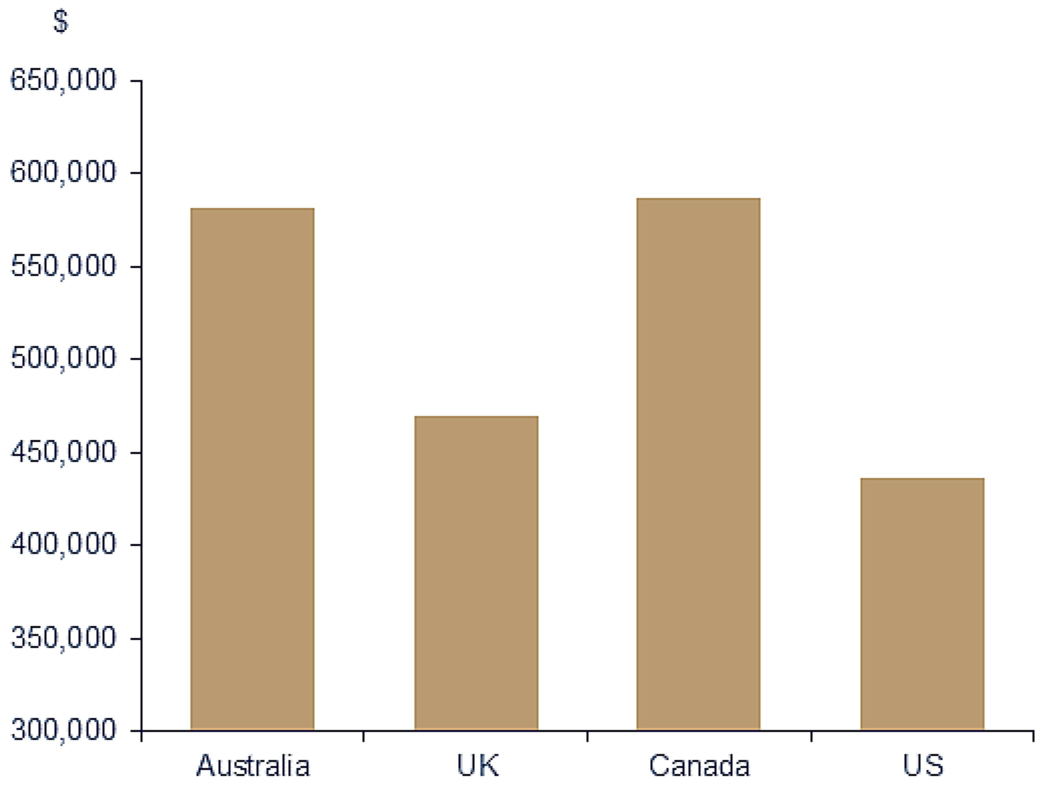
And it's not as if Australia is cheap for housing. After a 25-year uninterrupted economic expansion, which also saw a significant population rise, Australia's house prices are high compared to other jurisdictions. Coincidentally the other expensive market is Canada where similar drivers of the resource boom and Chinese immigration and investment have also played out. The Macquarie analysis found that for Australia, banks are prepared to lend approximately 6.8x income (excluding rental income benefits) for investor loans and 5.3x for owner-occupied properties. At the aggressive end, some lenders were prepared to lend at 9.4x income for investors, and 6.2x for owner-occupied properties.

Australia and Canada are the house price stars, so to speak … implied debt-income and interest burden



Source: Macquari

Average borrowing capacity (in AUD), for $105k wage shadow shopper



Source: Macquarie Research, Owners Advisory, June 2016

And of course, it is this ability to borrow that underpins the valuation of the Australian housing stock. So growth in credit, whether on the demand side or supply side, is all important for bank growth.

My concern is the conditions that drove the multi-decade strong credit growth are quickly abating.

There are four interrelated factors that could see all the big four slowing and hence needing to trim divvies further. They are:

1. Australian households are highly geared. This means there is scant further capacity to 'lever up'. As a result I foresee slower credit growth from the household sector over the next few years.

2. Business capital expenditure intentions remain subdued. Capital expenditure is the driver of business loan growth, and while this will eventually pick up, it is very slow to get going post the mining/energy boom ending.

3. As Australia's interest rates get lower, we look more and more like other investment opportunities to offshore funders. This means we compete more for these savings. Onshore, deposits are the holy grail of funding a bank's balance sheet. This area is going to be more competitive between the banks, which will mean savers get some more bargaining power.

4. The property boom is cooling. Investors will turn away from adding property to the portfolio, this will decrease bank credit growth

Putting these four together paints a picture of slower top line growth, and increased funding costs. This squeezes the net interest margin (NIM). The reason it isn't a collapse is because it is happening very slowly, which means the banks can try to offset some of the effect through process efficiencies – more digital banking, fewer branch staff. Expect the AGM season to talk a lot about costs!

For an SMSF there are two points of intersection.

-Overweight bank positions in the share portfolio creating concentration risk.

-Overweight cash positions that are increasingly being squeezed to find a different income source as banks lower the interest paid on deposits.

The tragedy would be if the squeeze on deposit rates saw SMSFs 'trade up' into the bank shares because of the attraction of dividends ... and then these get cut.

John O'Connell
OwnersAdvisory by Macquarie
www.ownersadvisory.com

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John O'Connell is Chief Investment Officer, Macquarie Banking & Financial Services, and Founder, OwnersAdvisory. He has 18 years experience with Macquarie Group in financial research and analysis including Global Head of Research.