contango ASSET MANAGEMENT LIMITED

CIO MONTHLY NOTE

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Bank dividends at risk post-Budget – but markets will carry on

Budget time is never a boring event if you are a fund manager.

Equities markets are naturally impacted by macroeconomic events, interest rate settings by the RBA (monetary policy) and fiscal policy, and the Federal Budget never fails to leave it mark.

Over the years Budget announcements have negatively impacted the pathology sector, leasing finance, gaming and alcohol businesses, just to name a few. We are conditioned to anticipate policy changes and to be quick to adapt to the impact on future earnings.

The Australian banking sector is globally regarded, and with good reason, thanks to a high quality regulatory framework and strong management and boards. Our local banks are also very pragmatic and durable. But the May Budget announcement of a $6.2 billion bank levy took many by surprise. It will clearly impact bank earnings and their ability to keep growing their dividends.

The new levy will also challenge banks' margins at a time when their profit growth is under pressure. In recent years, they have begun to exit non-core business units such as funds management, wealth management, insurance and trustee businesses. These areas tend to have a lower return-on-equity target relative to the core bank business. The higher costs involved with additional regulatory capital requirements imposed on the banks since 2009 have left the sector with few alternatives.

Ultimately, it means Australian banks are becoming more streamlined, focusing on what they do so well, best - core retail banking and business lending.

Some of the new bank levy will clearly be passed through to clients. After all, the levy will impact bank margins and dividends in the years ahead. The risk of a dividend cut should be anticipated but I encourage investors not to be alarmed.

The absolute level of dividends and consistent high payout ratios imply income will continue to be delivered to investors who are very much dependent on bank dividends and the bonus of franking. Investors should simply expect that initially the growth of dividends will slow at first before we eventually see a dividend cut in the years ahead.

It is also important to note that dividends can be delivered outside of the traditional dividend income strategies that include owning major banks and Telcos. There are some good ex-20 dividend income strategies that will not be impacted by the proposed bank levy. Companies such as ASX Ltd (ASX), IOOF Holdings (IFL), Spark Infrastructure (SKI), Adelaide Brighton (ABC), Tabcorp (TAH) and the regional banks, Bank of Queensland (BOQ), Bendigo & Adelaide Bank (BEN) are all good quality midcap dividend exposures that will complement the big four banks when targeting dividends.

These mid-cap dividend strategies tend to compliment the dividend contribution from the top-20 stocks and help diversify a dividend-focused equity portfolio.

Blending the portfolio to have banks, utilities, A-REITs, infrastructure, diversified financials and core industrials will ensure a more consistent dividend stream. Further, investors who look for more growth opportunities tend to go to the small, micro and nano-cap segment of the local market (i.e. ex 100 strategies) or overseas.

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Local and global equities – looking for income and growth

Global equity markets provide access to growth opportunities that tend to be under-represented in the local market, and they also come with less concentration in certain sectors. As we noted in March, one of the most obvious examples of this is the IT sector, which makes up just 1.3% of the Australian market but 16.1% of the MSCI All Countries World Index.

Both Australian equities and international equities provide the domestic investor with different but complementary outcomes. Investors in Australian equities receive higher dividends versus offshore, even after the now anticipated dividend cuts. In the local market, the large cap sectors deliver consistent dividends versus their offshore peers, with the added boon of franking.

Further, the benchmark index for Australia – the ASX/S&P 300 – has just 300 companies. Compare that to over 2,000 companies in the MSCI All Countries World index.

In summary, this month's Budget will impact bank profits and their ability to hold their healthy dividends at current levels. However, this is not all bad as the domestic equity market has a consistently higher yield compared to their global peers.

Going forward the typical Australian share fund should deliver a dividend yield of around 4.5% net, compared to 1.5-2.0% for a global growth strategy. The bank levy will be a challenge for banks and their investors to absorb. But the bank sector and their management teams will adapt. It is good politics to impose a bank levy and it appears to be a sign of the times looking ahead.

Does 6,000 really mean anything?

Over the past five years 6,000 has been an unattainable nirvana for the ASX/S&P 200. The market has hovered around it in recent weeks but never seems to reach it. The closest we got was back in April 2015.

While we believe we will breach this mark soon, it's important to realise that it's not a particularly meaningful target. It's a nice round number and it would be an important indicator of market confidence, but the real test will be whether or not the market can be supported above it for a reasonable length of time.

Besides, as I often say in these notes, look globally (or small cap) for growth and locally for dividend income. This means that although our market struggles breaching magic markers like 6,000, the important indicator for income – the accumulation index – is currently near all-time highs.

In terms of individual companies, we like what's happening at Woolworths. They have turned the corner after a few years of sluggish growth. Competition will continue to come from the likes of Aldi and Coles, and it will be a long repair job for the company, but the worst is behind it.

As to that old investment adage – sell in May and go away – I'd suggest not to panic too much about what happens in this particular May.

Domestically earnings are growing following recent years of contraction. They are plateauing following the recent spike in the February report period but still growing and are, more importantly, sustainable. Even if there is a volatility event, the Aussie dollar will fall and holders of global equity holdings will be delivered a capital gain.

Also, remember that in Australia, while you are trading off growth, you are getting a high degree of certainty of dividends of between 4.5 to 5.5 per cent. That remains significantly higher than most global markets.

So, sell in May and go away? Personally, I wouldn't be going anywhere, and I'd be keeping an eye out for the dips so I could get back in.

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