Income from Australian equities

Hello, and welcome to our sixth episode of Conversations, a monthly podcast from GSFM. The series focuses on investment concepts and outcomes of interest to you and your clients. Our first series has focused on income, and today's instalment continues that theme. In today's environment, where can investors go in their search for income?

Today's podcast features GSFM's CEO, Damien McIntyre, and Redpoint investment management's CEO and senior portfolio manager, Max Cappetta, discussing income from Australian equities. Together, they'll look at the Aussie equity dividend landscape, and if and how it's changing now that inflation is rampant and rates are rising. Before I hand over, I need to read this important notice.

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GSFM responsible entity services has produced a target market determination in relation to all of the GSFM funds. The TMD sets out the class of persons who comprise the target market for the various funds, which can be downloaded from our website. This podcast was recorded on Friday, the 1st of July, 2022. Damo and Max, happy new financial year to you. The floor is yours.

Damien McIntyre

Thank you very much, Tracey, and happy financial new year to you too and welcome aboard, Max.

Max Cappetta

Thanks, Damien. It's great to be here and happy new year to you, too.

Damien McIntyre

Well, as Tracey discussed in the outline, this is the sixth episode of Conversations and we have focused on income in the first series. So perhaps what we might do, Max, is make this the income series swansong for now. And we've chosen another topic for the next series, which is responsible or SRI investment and impact investment. So we'll be looking to populate the next series with managers in GSFM's stable with disciplines, and dare I say, products in that SRI and impact space. So Max, no pressure, but we've got to make our last episode today the most interesting of the lot, I dare say.

Max Cappetta

Well, let's give it a go. I'm sure we can, Damien.

Damien McIntyre

So having gone through six episodes, the story really has become more complex as the series has gone on and it's been exacerbated by rising inflation, which has really made real interest rates or term deposits and bonds, it's really made it hard for them to keep up. Bonds and cash of course have no growth component to the asset class. And when compared against inflation...

Yesterday, for example, I bought a term deposit for my father-in-law, at the lofty height of 1.45% per annum, and then when you factor in an inflation rate that's arguably four times that, in real terms, he's really being left behind.

Max Cappetta

Yeah. That is difficult, isn't it?

Damien McIntyre

Yeah. So that gets us to equities and why they're important; because equities of course are a hedge to inflation. So what I might do, Max is just let's just quickly recap on market activity since the beginning of January. And I've heard you refer to this recent bound of market volatility as, the valuation readjustment that we had to have. So talk us through that.

Max Cappetta

Yeah. Look, thanks Damien. Look, I think when we look at what's really transpiring, there's a couple of key things which really become obvious in terms of investing in Australian shares for income. Firstly, if you look at the volatility of dividend payments over the last few years, the more things change, as soon as you average out over a three year window, what you see is that cash dividend payments have been reasonably consistent and growing consistently when you take that broader window. Now, what we've seen so far this year is interest rates essentially having to renormalise away from those emergency settings that were set in place back in 2020.

But it's been a little bit more interesting than that because the Central Bank's old foe inflation has really now, actually, come back into the fray. And so what we are seeing is interest rates being risen, just not in terms of coming back to, quote unquote, more normal levels. But in fact now needing potentially to go higher to actually curtail inflation, both as it is today, and expectations for inflation in the future.

And what's happened there is we've obviously seen pricing for equities drop off. The US market's probably had its worst start to a calendar year in decades, being off 20%. The Australian equity market has also fallen. It's probably down just about 10% year to date.

But nonetheless, what we are seeing is that equities are being repriced for that higher inflation. But what I think is interesting at the moment when we look at earnings, earnings expectations are still reasonably solid, both for fiscal year 2022, which we just completed yesterday, and we'll head into reporting season shortly, and also for fiscal year, 2023, so the year ahead.

Which then actually means that at the moment, we're expecting a cash dividend yield of approximately 5% from the ASX200, which, compared to that interest rate that you got from the bank yesterday, obviously is very attractive in terms of being multiples of that 1.4%.

But I think the other important element is that what we know over the longer term is that earning an income by taking a share of the profits that successful companies pay as dividends, those payments do grow over time, and, over a long enough window, the share prices are always going to be more volatile than earnings. The earnings are more volatile than the dividends, but over time, you actually end up in a better place, because the equity market and the value of those shares grows over time in line with the economy.

In many ways, I think while there has been some volatility in dividends over the last few years, we're actually in a really good place at the moment. Really, it's all about whether interest rates will be taken up to the point where they actually incur a recession, and then I think people need to think very carefully about how they position their portfolios over the next year, to make sure that they capture both a decent dividend yield, which will still be probably better than interest rates on offer on term deposits, but then can also capture reasonable growth for the long term, in terms of the value of the shares that they own.

Damien McIntyre

Yeah. As painful as equity market volatility is for those who regularly mark to market, and those who look at the absolute value of their wealth fluctuate, the silver lining in volatility is that it does create buying opportunities along the way. But of course, we all have to reach a point in the cycle where equities stop falling before people really get the courage to continue to buy or to re-enter the market in any stealth.

The prudent investor always has a percentage of cash in his portfolio that he can deploy for these very opportunities, and certainly that's what we've seen emerge. As you say, equities are down 10% year to date and that certainly made the dividends more attractive and (provided) great buying opportunities in some blue chip names.

Max Cappetta

Yeah, exactly right, Damien. I sometimes think about it, to give a very simple example, there's certain times, if you're lucky enough at the supermarket that you'll see the gift cards where it's a $50 gift card on sale for $40. And I've always had fun with my children to get their Apple card topped up and they say, hang on, it's $40, but I actually get $50 worth of value. And that's what happens with equity markets.

There's sentiment and behavioural biases and animal spirits that make prices fluctuate, and I think if you are an income investor for the long term, if you actually see at times when prices are being depressed because of sentiment, because of maybe expectations or extrapolation of interest rates going higher and inflation going out of control, that can actually set up and open up an amazing set of opportunities to actually buy income for cheap, because those prices are depressed. But quite frankly, the earnings that these companies are going to continue to produce are far less volatility than share prices would have you think on a day to day basis.

Damien McIntyre

Yeah. Look, at the end of the day, the dividends that are paid to shareholders really are a function of companies' profitability. And you're right, earnings and profits are volatile through the cycle, but that said, it is actually a big decision for a chief executive or a board to cut the dividend. It's a far easier decision to raise it. It's very tough for them to cut it, isn't it?

Max Cappetta

Yeah, absolutely right. And I think companies will have their policies around payout ratio and so they'll want to stay within the realms of their dividend payout policy. I think the other interesting element is that if you look at the demographics of where we are here in Australia, and in many ways around the world, we actually have almost a third of our retirement savings pool at the moment going into retirement over the next 10 years. So that's almost a trillion dollars that will move from accumulation to retirement.

And we see that there's going to be a greater focus on companies paying dividends, being able to maintain a consistent dividend, because that will become attractive to a far greater proportion of investors in the marketplace. And quite frankly, there will be demand for that kind of activity by companies to be managing their cash flows properly and to pay a consistent dividend.

So in many ways, while we see that there is this demand and people are going to invest that way, we also think that there may in fact be a tailwind, that some of these stocks that can actually maintain that consistency of dividend will actually trade at a slight premium to what they may have done so in the past, because those characteristics will be more and more in demand.

Damien McIntyre

Yeah. Well, that's right, isn't it? It's where we are in this continuum of an ageing population, and as you say, a third of the population will enter retirement over the next 10 years. And that's, as you've outlined, that's a lot of dough. So that means that those companies that are good dividend payers will consistently be well bid, which is terrific for those of us who hold them, but the superannuation industry itself is moving in that direction by virtue of the government, not so much mandating, but having a retirement incomes policy at the forefront of fund structures.

Max Cappetta

Yeah. And look, I think that's really important. And I think when investors and the big super funds come to appreciate that requirement and that need, and the demand, I think there's going to be a range of opportunities that they need to be looking at, in terms of how best to actually deliver that outcome.

And I think one of the things as we look forward into 2023, we're actually coming off really what is going to be a record year for dividend payments in 2022. 2023 looks like it's going to be slightly better again, but it's really interesting the dynamics underneath in terms of which industries and which companies are actually growing their earnings, growing their profits, and being able to maintain this dividend growth.

We've done some research recently where we've really seen the steady decline of the banking sector in terms of the proportion of the dividends that come out of the financial sector relative to the rest of the ASX200. And last year, as many people will know, it was the mining sector, particularly the iron ore miners that were just having this bumper year.

And what we forecast is that the material sector is probably still going to have a very strong year in terms of dividend payments in 2023, but it's likely to be weaker than last year. The real standout, and again, in many ways, maybe not surprisingly, is the energy sector.

The energy sector in Australia is the only one that actually posted a positive return on a year to date basis, maybe with the exception of the utility sector as well. But there's not many stocks in that sector. And in the energy sector, we know that the pricing of oil and gas, and particularly coal, is driving those stocks to have supernormal profits, and they will be the ones that will have large dividend payments.

I think the interesting thing for investors here is to watch out in terms of the volatility of commodities and the resources sector. It's great to see those dividend payments, but companies and investors need to be really looking ahead in terms of what is the profile of those dividend payments.

A lot of people might say that, look, the mining and the energy sector are trading quite cheap at the moment. I think resources always trade cheap at the peak of their earning cycle, and what we expect to see is that those earnings will then drop off over the next couple of years and we'll then see some further, albeit less aggressive, growth out of the financials, healthcare and other sectors.

And this is where it really, I think, becomes important in terms of having some diversification across different businesses and different sectors, particularly when we're faced with the uncertainty of interest rates and the impact of inflation on profits in the year ahead.

Damien McIntyre

Yeah. It's a conundrum for the...well, it's an interesting dilemma for the banks. On the one hand, their interest rate margins will improve as rates rise. But at the same time, it's very hard to maintain loan growth in a rising interest rate environment. So it'll be very interesting to see how those two dynamics play out in the next few quarters.

Max Cappetta

Exactly right. I think the thing to keep an eye on is obviously what is happening with inflation, because if we do start to see inflation actually start peaking and actually rolling back, then expectations for where interest rates are going to be increased to will obviously change. And people will expect that interest rates will peak slightly lower.

If inflation is in fact even more entrenched than we'd expected, then interest rates will most likely be put up higher to obviously stop that, and that will have an impact on growth. It'll have an even bigger impact on a pretty heavily indebted consumer in Australia, albeit we do know that, and the banks have said this, that people have been sitting on quite a stash of savings, higher than normal. And so while interest rates are going up and mortgage costs are going up, there does seem to be quite a buffer within the system.

But nonetheless, we do expect that consumer demand will soften, and then that starts to indicate maybe the sectors where there may be opportunities for needing to avoid companies that maybe are going to see revenue drop off versus the other sectors where maybe demand is less elastic. Maybe for example, in healthcare. People are unwell or they need to take a particular test, then regardless, they will make the budget for that, whereas maybe discretionary spending might soften as personal budgets get hit a little bit harder.

Damien McIntyre

Yeah, well, it's the double whammy lately, isn't it? Consumers have been hit on multiple fronts. Food prices, energy prices, both petrol, electricity, gas, of course, higher mortgage payments. So, yeah, talk about headwind, that'll be one we come back to. I just want to do talk for a moment, I've heard you discuss the 142 opportunity. Enlighten us.

Max Cappetta

What exactly is that? Yeah, look, it's actually a funny thing. So what I mean by the 142 opportunity is that companies, when they earn their profits, especially the ones that are domiciled here in Australia, and they pay tax on their profits, when they then go to pay a dividend to investors, they can actually attach a franking credit to that dividend.

So for example, if a company earns 100 dollars, they pay their 30% tax, so there's 30 cents in the dollar goes out to tax, and then the company distributes all of the remaining 70 cents. Then what'll happen in the hands of investors, they'll get the 70 cents cash per share. And then at year end, they can actually claim back the tax which was paid on those dividends by the company. And this is the imputation credit system, which has been in place here since the 1980s to avoid the double taxation of dividends.

And the amazing thing here is that for retirees that are at a zero tax rate essentially, they can actually reclaim the full value of those tax credits in their tax return. So what it means is that if you are getting a $1 dividend and it's fully franked, technically you're going to get a dollar and 42 cents of value, and that additional 42 cents will come back to you at the end of the year, when you go and actually put your tax return in.

And what happens is you'll get taxed on that additional income at your marginal rate, but you'll get a credit for the 30 cents in the dollar, the 30% tax paid by the company. Now, the beauty of that, as I said beforehand, is for every dollar of fully franked dividends you earn from a company, for a retiree at a zero tax rate, they're actually getting $1.42 worth of value. For every dollar of interest income that you earn from a bank deposit, you get a dollar of interest income.

Now, on the flip side, of course, the dollar of interest income, when you go and reclaim your term deposit, you'll get your full capital back. But when you go, if you want to go sell your shares, there's obviously volatility in share prices and you may or may not get back the amount that you invested.

But again, what we know is that if you're investing in the share market for the long term to get a capture of this dividend stream which is tied to the earnings of corporate Australia, over the long term, those prices end up going up.

I think people can rest assure that even though there will be volatility in prices, over the long term, assuming economic growth continues, you'd certainly expect the value of the ASX200 and the companies they're in, to grow in line with that over time, which gives you this inflation protection over the long term.

So I think that that's a really valuable element for investors to be considering, because when I say the ASX200 trading on a 5% cash yield for next year, if you can reclaim all the tax credits, it's more like a 6.7% yield.

Damien McIntyre

Wow.

Max Cappetta

Which I think, compared to even where interest rates may go in the foreseeable future, I'd like to think it's a pretty attractive outcome, and making some investment in that space probably makes sense in any retirement income plan.

Damien McIntyre

Well, look, if it's 670 basis points and inflation is 500 basis points, call it or more, well, inflation has to go north of 670 for an investor to be going backwards, in real terms. That's the power of it, isn't it?

Max Cappetta

Exactly right. And look, I don't think there's a strong belief around the marketplace that we're going to see 6% inflation for a prolonged period. It may be longer than we might have liked, but I don't think anybody's looking at consistent inflation like we saw in the 1970s, but of course, that's going to be a critical economic piece of information that everybody's going to be watching very closely, both here in Australia and around the world.

Damien McIntyre

Yeah. I do find it amusing listening to, let's just say politicians generally, rather than pick out politicians, saying that the inflation rate, they're confident they can get the inflation rate down. And really, it's just math. The inflation rate is a comp to a number at either this time last month or this time last year. And so of course, inflation is going to come down over the next year if lettuces don't go from $10 to $20, or if oil doesn't go from $100 to $200.

So I think it's reasonable to expect that inflation will come off, which of course will be beneficial to the interest rate cycle and equally, equities in general. But just coming back... I just want to just pick your brain about how you see earnings for the remainder of calendar year. Well, let's just, now that we're in the new financial year, what are you thinking for the next year or so, and what do you think are the headwinds and opportunities?

Max Cappetta

So look what we've seen so far, as much as equity markets have dropped in price, we haven't really seen any strong negative revisions to earnings expectations in 2023 thus far. Now, we are heading into reporting season in August. I think most companies will probably report a pretty robust financial year for 2022, and it's all going to be about the forward guidance companies might give in terms of costs and where their profitability is going. At this stage, what we are seeing is that profit margins overall are probably slightly above average, and if we did see them come back to average by maybe dropping about 1%, then that might actually lead to earnings expectations dropping by around 5-10%.

So I think the interesting thing is that while people have said this conundrum between say growth investing and value investing, and maybe growth is now on the decline with interest rates going up and value investing is back on the rise, I think in many ways, what we are doing is looking at the growth profile in terms of company earnings, because what's going to be really critical over the next year is where the companies can actually continue to eke out some incremental growth or whether the cost pressures that they're starting to see they can't maintain their profit margin.

It's going to be about identifying those companies that can incrementally continue to grow and that's then going to lead through to their earnings, maybe staying as they are, growing, or at least falling less than others. And then them being able to maintain their dividend.

So at the moment we still see, while we saw iron ore in reporting season last year, be very strong in dividends, we're going to see that in the energy sector as we go through August and September. Again, I think we're just looking at the volatility of those kinds of stocks in the resources sector, because they really are driven by that commodity price. If oil comes off, then we'll obviously see those stocks come off as well.

The benefit in many ways to Australia, and I think why the Aussie equity market has done better than global equity markets in the last six months, is our exposure to commodities. And what we haven't seen today is the potential for China to actually come out of its COVID lockdown and essentially to be growing again, which will be potentially quite countercyclical to the rest of the developed world, mainly Europe and the United States.

Again, that could be really positive for particularly our resources market, and then that just funnels through to the rest of the Australian economy. That's definitely a place to keep an eye on for us. I think the other area is in banks, Damien. They're still trading quite cheaply. They have done a lot of work over the last few years in terms of exiting their wealth businesses and refocusing in on their core business.

We really like Commonwealth Bank and National Australia Bank because of the fact that they are tilted more towards business banking. And we think that while maybe mortgage growth may slow, there is still good lending and growth opportunities for them across the business sector. And as long as we don't end up in a recession type scenario, definitely, as you said beforehand, they'll have the tailwind of that interest margin expansion.

And again, look, we're not looking for massive growth in bank dividends. We're probably still slightly below their pre-COVID highs, and I think it's probably going to take them another couple of years to get back to pre-COVID dividends, but nonetheless, there are some attractive dividend yields out there. The nice thing about the banking sector is that those companies pay dividends at different points in the year, which enables people to take a more active approach and both capture a higher yield as well as getting those additional tax credits, which as we spoke about beforehand can be really valuable in the hands of low and zero tax rate investors.

Damien McIntyre

So just summarising that point, it's obviously very important for a focus to be on companies at the operating level, and what you're looking for is to see operating income increase year over year, and that dividends are funded from that increase in operating income, rather than selling the furniture to pay a dividend.

Max Cappetta

Exactly. And I think, another element within the mining sector, for example, there are still a number of what we call concept stocks, particularly in the lithium mining sector that a lot of these stocks actually are still trying to get the capex in place to be able to move into production. And while some of their share prices have risen substantially, we see that there's just massive risk in that space, even though over the long term, we know that this trend in terms of decarbonising the economy is going to mean that some of those commodities are going to be in massive demand.

But what we'd prefer to be invested in is those companies that are already in production today, already have the capex in place and are enjoying the benefits of the cash flow that is coming from those commodities now, and that will give them optionality in terms of being able to reinvest where they need to and also then to be able to throw off capital and cash flow to investors over the long term.

And I think that's a real interesting dynamic within this broader resources sector to be really focused on that production side of things, because what you have with these companies that are yet to deploy their capex and not yet in production, they have two major risks. They've got the commodity price risk, which everybody has to deal with, but they've also got a commissioning risk. And that really is a bad combination for companies in this space, if either one of those moves against them.

Damien McIntyre

Now, Max, the last point I wanted to discuss with you is how Australians traditionally have constructed their Australian equity income portfolios, in that they generally look to buy certain stocks, blue chips, hold them for long periods of time, and by and large, that's been a successful strategy.

However, the Redpoint Australian equity income fund runs a quantitative process, which is actually complementary to that strategy. Can you comment on that for us?

Max Cappetta

Yeah, sure, Damien. I think when you look at the traditional approaches to trying to earn a higher dividend income from your Australian equity portfolio, you're dead right that people will generally look at the highest yielding stocks and maybe some of the blue chip names in the index and hold them for the long term. Now, they will end up being successful in terms of generating income, because Australia's largest banks as well as companies like Telstra and Woolworths, even BHP, have produced a consistent and growing dividend income over time.

But if you simply focused on that one concept of yield, oftentimes you can have a very concentrated portfolio that's invested maybe in just a couple of sectors, like financials and in the mining sector at the moment. And also too, you might also be investing in companies which maybe have low growth opportunities, hence why they're passing out a lot of their cash flow to investors because they don't have many dividend opportunities or growth opportunities.

So we use our quantitative approach, which gives us both an income perspective on what companies are going to be paying in the future in terms of dividends, and also a broad range of stock selection insights that are aimed at identifying those companies, which we believe are going to be more outperformers of the marketplace versus underperformers.

And what we can do is because we have these multiple views across each and every one of the ASX200 companies each and every day, we can make quite interesting trade-offs as we head into the different periods when companies pay dividends over the calendar year. And what happens for us is that because we can trade across different companies that pay dividends at different times, we can earn a higher income over time because we can earn a higher income by being more active.

It also enables us to diversify the portfolio and have investments across pretty much every sector of the ASX300, because sometimes when you just focus on yield, you'll probably actually not invest in maybe healthcare stocks, which are low yielding. You may have zero exposure to it companies that again are probably reinvesting for future growth, as opposed to paying out dividends or maybe just paying very small dividends. And that 142 opportunity that I spoke about beforehand, you may not invest in real estate stocks because they generally don't pay any franking credits. They just simply pass through their retail income.

And so for us, it's really about blending together these different perspectives, looking to earn a consistent and above average dividend by looking at the dividend cycle of companies over the calendar year, and then informing those decisions through a broad range of stock selection perspectives.

We look at the street view of earnings for these stocks. How are investors responding in terms of rerating or derating these companies in terms of their momentum over time, and then what kind of news events in terms of company guidance and company announcements and how are investors reacting to that, we use all of that information, as well as your traditional views around quality and growth and sustainability to determine which of the better yielding stocks we would want to invest in, which stocks maybe that are in the mid yield bucket that we believe are good investments, and even some of those stocks that are maybe in those lower or zero dividend yield areas that we believe are good investments for the long term.

They may not be paying a dividend today, but they can give you capital growth that can pay you good dividends in 10 years' time. And that really I think is at the heart of what we're trying to do, capture that consistent dividend income by being active across the dividend calendar over the year, and then using our stock selection and risk management to inform those decisions as we go about our investing on a day to day basis.

Damien McIntyre

It's a really comprehensive approach, isn't it? Which really does complement the buy-and-hold strategy, because, really that's what we're looking to do. We're looking to add to existing income strategies employed by Australian investors with a different approach.

Max Cappetta

Yeah, look, we definitely love the fact that a lot of retirees and investors do have their share portfolio. I think the role that we play is to provide them with this much broader diversified exposure to a broader range of companies that they may not otherwise focus on.

And there's also a broader range of opportunities. Apart from dividend payments, there's quite valuable transactions like off market buybacks of shares. Companies like CBA, the National Australia Bank, Woolworths, have all undertaken these types of transactions, which on an after tax basis, can be really attractive for investors. However, the process in terms of having to tender your shares and find out which shares got accepted into the tender and then getting the cash back, all of these things can actually be quite complicated, and I think that a lot of investors maybe actually leave value on the table.

Whereas our approach is, we're looking specifically for those transactions and have our processes ready to pounce in terms of capturing that extra value add that investors can get by participating in those types of transactions when they present themselves.

Damien McIntyre

Well, thank you. So, if I can just summarise the key points that you raised with myself and the listeners today, and that is, is that share prices are, of course, more volatile than dividends. It's a big decision for a CEO or a board to cut a dividend. So that, through time, you'll find they tend to remain static to growing as opposed to decreasing.

Of course, the profitability of companies and sectors are cyclical, and that, of course, drives the cyclical in dividend payments. And this is what it's all about. It's all about an economic cycle. So yesterday's dividend payers may not be necessarily tomorrow's dividend payers, and income seeking investors should always have one eye on the total return of their portfolio.

And this is why stock selection and diversification now becomes really critical. So that's where the Redpoint Australian Equity Income Fund complements a buy hold strategy, in that you really do think about and implement portfolio allocations and changes through time, taking in those three key points.

So Max, on behalf of GSFM, Tracey and myself, thank you very much for participating in today's podcast. And we look forward to talking to you about SRI or perhaps impact investments in the future.

Max Cappetta

I'm looking forward to it, Damien. It's been great to have a chat.
