Lessons to be learned from franking credits scare

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The parliamentary franking credits inquiry visits South Australia.

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In common with a lot of other financial advisers, one of the key issues I had to deal with during the election was the fear of franking credit changes. Day after day I had retirees beginning to review asset allocation in their portfolios. This cohort is made up of older people with portfolios comprising mainly Australian equities and Australian dollar cash and therefore with a strong “home” to review bias.

Post the upset election result, Robert Gottliebsen suggested investors had “dodged an incredibly dangerous bullet” with the surprise victory for the Coalition. While I agree with his view, it would be a great shame if those investors with a strong home bias do not now grasp the absolute risk they are exposing themselves to. This is an opportunity to look at a more dedicated asset allocation philosophy going forward.

Of course I acknowledge the value of franking credits and see why investors have constructed portfolios with extreme home bias, this is not an approach that delivers the balance between risk and return that is so vital in portfolio construction.

Some simple facts on the Australian equity market at the moment help clarify. In a recent presentation, fund manager SG Hiscock pointed out that some sectors in Australia have performed well, highlighting that one reason for outperformance — and therefore the premium they are trading at compared to these same sectors globally — is due to the low weighting these sectors have in our indices versus global indices.

As an example, the IT sector is 3 per cent of the Australian index against 26 per cent of that in the US. It shows 12-month performance of 31 per cent to the end of April 2019 against IT in the MSCI ACWI of 22 per cent.

Likewise, SG Hiscock makes the point that the Australian market is trading at a premium across every segment of the market against its 20-year averages. However, the extremities are in the ASX100-150 segment, which is trading at 19.1 times earnings, a 34 per cent premium. At the same time, the ASX200-300 segment is trading at 15.7 times earnings a 26 per cent premium.

My concern is that the Coalition victory on May 18 will lull investors into a false sense of security. Many will breathe a sigh of relief about fully franked dividends being left untouched. But investors who leave their thinking at that point are not balancing risk and return. In other words, having 90 per cent of your retirement savings in Australian shares is to be 90 per cent weighted to one sector of purely risk-based assets.

With that, an investor is thus exposed to potentially high levels of volatility in both the good and unfortunately the bad times.

Time to diversify

Portfolio management should be about achieving both balance and diversification within and among asset classes according to an investor’s objectives and appetite for risk. Diversification should enhance returns over the long term and importantly manage but not eliminate the risks that are inherent in investing. As I often point out to our clients, a properly constructed portfolio which is correctly diversified should bend but not break in times of market stress.

Hence, the fourth quarter of 2018 and the market volatility seen then, combined with the franking credit debate, should have investors thinking about the balance between risk and return.

Markets have bounced back in the first half of 2019, now investors should be asking themselves the question: “How much risk am I prepared to take on in my portfolio?” Those with a strong home bias have taken on not only market risk but can also potentially experience an income shock.

“A disciplined approach”, is the key phrase and the ultimate objective. Clients should be careful not to be swayed by a false dawn and then knee jerk react. If the GFC taught us anything, it is that investors who move to fixed income and cash at the wrong time or even at the bottom of a cycle can produce not only the lowest income and therefore an income shock but a negative return. What they should have been seeking was a balanced portfolio which produced reduced volatility, reduced risk, and a more consistent income stream — and a growth element that recovered out of the bottom of the GFC. In particular, don’t go to extreme limits and, at some point, go to cash.

One more thing: we are now in the 10th year of economic recovery in what is the longest upswing in economic growth since World War II. Cycles will always exist. The current rally in equities may have further to run.

If we are in the optimism stage of the cycle, as I believe we are, we could even see further “melt ups” in equity markets and therefore good gains ahead of us.

What I do also know though is that we are in the fifth set of the match. I don’t know if we are in the tie beak or the second or third game of the set.

My fear is that those who don’t heed the lessons of the franking credit debate and now employ disciplined asset allocations and portfolio construction could be looking at potential capital losses and even possible income shock down the road.

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