Professional Selection

Quarterly Review

An ALP federal election victory? It's not just about franking.

March 2019

Glenn Hart, Co-head of equities, Portfolio Manager Dividend Builder, Antares Equities shares his thoughts on the upcoming Federal election and the implications for markets of an ALP win.

While the change to the use of franking credits for non-tax paying investors is capturing the headlines, there are other proposed policy changes that I believe will likely affect investment markets if the ALP win the upcoming election. Nine actual or likely policy areas have been identified and their potential impact is discussed:

1. Franking cash rebate abolished;
2. Capital gains tax discount reduction;
3. Negative gearing changes;
4. Introduction of a living wage;
5. Higher renewable energy targets;
6. Support for unions;
7. Private Health care;
8. Increase in taxes and imposts; and
9. Possible NBN changes.

1 Franking

Under the proposed ALP policy, investors will no longer be able to receive a cash refund if they do not have other taxable income to offset the franking credit. But where an investor earns taxable income and has an excess of franking credits, the franking credits will still be able to be used to offset tax on that income.

The change is likely to impact around 20% of franking credit users with those most likely to be impacted being retired investors with Self-Managed Super Funds (SMSFs). We expect some will be hit hard, especially those who have structured their portfolios around the taxation rules that existed in the build-up phase and will no longer apply.

In assessing possible impacts on stocks, we note that generally the largest holdings in SMSFs are typically the Banks, Telstra, Woolworths, BHP and RIO. How is this change likely to impact these stocks?

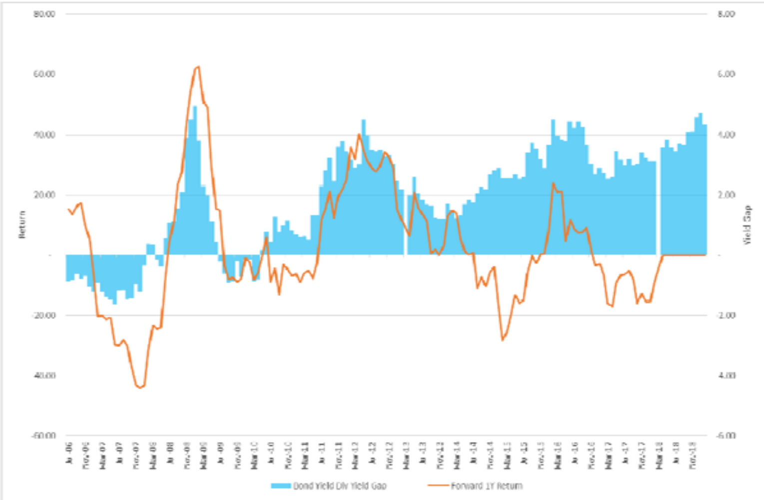
Banks - the yield from bank shares is around 6.6% whereas the yield on 10 year government bonds is just below 2.0%. This ignores any franking. For a superannuant seeking an income stream, it seems likely the decision to hold or not own bank shares is probably more dependent on yield than just franking. Even with the possibility of dividend cuts, history suggests the market may respond favourably - the last major bank to announce a dividend cut was ANZ in 2016. Their share price increased by 4% on the day of the announcement as the market viewed the decision as a sensible one that would promote future growth. And in 2009 the banks also announced huge dividend cuts, yet their share prices rose substantially.

The correlation between Bank share prices and the RBA cash rate is also unclear. The latter declined from 2011 until mid-2016 and has been flat since. During this period banks have had several large rallies and several large sell offs, hence we do not think bank share price performance can be causally linked to short term interest rates.

Banks may rally if the 2019 budget is pitched at increasing consumer spending or if a new Labor government was to embark on a major stimulus program. A rate cut by the RBA could also be a positive as it would help stabilise house prices. But if a government chose to use big banks as a perpetual source of new funding imposts, their share prices could decline.

Our conclusion – bank share prices respond to a variety of factors and while there is a significant yield differential with the cash rate it is difficult to replace them as an income stream.

Chart 1: Bank yield and returns (%)



Source: Antares Equities; Bloomberg; April 2019

Chart 1 shows the yield from Australian bank shares minus the Australian 10-year Government Bond yield, plotted against the subsequent 1 year returns of the bank index (not including dividends). This chart suggests the possibility of reasonable returns on a one year view.

Mining – the share prices of large mining companies like RIO and BHP are not simple to predict. The past year has been historically unusual in that mining company share prices have been rising while OECD leading Indicators have been falling. Will they fall? Or will they rise? The US Federal Reserve looks to be signalling no more rate rises with a rate cut possible if the economy weakens further. This is likely to contribute to USD weakness, which is generally very positive for BHP and resource stocks.

Commodity prices are also potentially not a great predictor as the following table highlights with BHP trading approximately 16% below its 2012 peak yet each of its two key commodities are 40% below their 2012 peaks (although I note that currency differentials are a factor):

Table1: BHP share price vs Commodity prices

	BHP Share price ($)	Iron ore share (USD)	West Texas Intermediate Crude Oil price (USD)
2012 (peak)	45.12	150	100
2019 (current)	38.00	84	60
Change (%)	-15.8	-44.0	-40.0

Source: Bloomberg, Antares Equities; March 2019

My conclusion is that the sustainability of the BHP (or RIO) dividend will be driven by many factors and implied assumptions, changes to franking being only one.

Franking changes - summary and impact

This policy is a clear negative to those whom it directly impacts. But there are around 80% of current users of franking credits (i.e. those with taxable income), who will still find them attractive. As such, it may be reasonable to expect that franked income will remain valuable and a consideration in these investors' minds.

For the listed bond proxy type yield investments, which include REITs, Infrastructure and Utilities, most of these securities pay no or little tax and will likely be unaffected by the proposed changes to franking. Historically these types of securities make up a significant part of a portfolio seeking yield as they provide high and stable yield income with expected long term growth in distributions. I would expect this to continue and possibly increase as a proportion of portfolios for those investors who have no taxable income. The changes could be a small positive for these sectors.

2 Capital Gains Tax (CGT) discount reduction

The ALP proposes to reduce the CGT discount for new investments from 50% to 25%. This is a material change to policy that will affect all investors, be it property or shares. In effect this will mean that if you own an investment for say five years, and make 50% capital gain, the tax paid will occur at the marginal rate less 25% discount, instead of less the current 50% discount. As such if this policy is implemented, it will result in a permanent reduction in expected capital returns for all investors who are above the zero tax rate. While the impact of this policy will not be immediate, over time we expect that it will result in less capital being available to fund new projects and investments, or less funds being available for consumption. Either way I expect such a policy could potentially reduce the long term growth rate of the country, unless the revenue raised is used productively.

3 Abolition of negative gearing except for new properties (existing positions grandfathered)

This will mainly impact investment properties, but also investors in other growth assets such as equities. The desired impact of this policy is to generate new dwellings which is supportive of the building industry as well as to add more affordable properties to the economy. Coming off a housing downturn, it is possible the market may require new stock and thus provide negative gearing opportunities for residential real estate investors. One wild card to consider is if interest rates fall, with the already lower house prices, investors may return to the market as they find positive yield carry investment property opportunities.

4 Movement towards a "Living Wage" for workers

The prospect of a living wage seemed to have been ignited by Sally McManus of the ACTU and furthered by Bill Shorten. The OECD defines a living wage as 60% of the "median" wage. In Australia this would very roughly imply the minimum wage would need to rise about 10%. This would be a positive for the recipients who would likely spend at least part of the increase. Negative impacts may include increasing the cost base of business, and would likely make life more difficult for small business as well as putting pressure on prices as companies would try to recover costs. Longer term this could result in job losses, small business closure, higher inflation and higher prices which could reduce exports and make imports more attractive. While the short term impact could be positive for consumer discretionary stocks, longer term there could be detriment to sectors involved in export earnings from manufacturing, small business and tourism as well as to companies that have low profit margins and return on investment and large, lowly paid workforces.

5 Pressure on industries with perceived non-union friendly work practices

While there is nothing specific, the regulatory "vibe" could be somewhat negative. Industries that have traditionally locked horns with trade unions are many and have included miners.

6 Higher renewable energy targets

This is a huge political hot potato that is very complicated. The policy change envisioned would tend towards increasing the cost of power, and result in large carbon imposts on manufacturing in "heavy" industries. At this stage, details are scarce but large job losses could be an outcome in a worst case scenario. It is also likely some further regulation will occur in the provision of gas and electricity to consumers and business, which leaves open the possibility that some companies, such as gas producers, may be unexpectedly targeted, along with the more traditional targets of retail providers. Over time we would expect that Australia will become less competitive in a global context, potentially leading to a loss of heavy industry and manufacturing.

7 A focus on Private Health Care

The ALP's current policy centres around holding Private Health Care Fund premium growth at 2% pa for two years. This has been extensively publicised, and the listed Health Insurers have had plenty of time to try to mitigate their costs. As such this policy should largely be in the price of these stocks.

What would be a far greater concern is if the Labor Party's proposed Productivity Commission Review into private healthcare finds that it is appropriate to abolish the health fund premium tax rebate. We expect the probability of this occurring is likely to be very low, and the time frame for the final recommendations would probably be more than one year away.

8 Proposed higher taxes

A 0.5% increase in the medicare levy for those earning over $87,000 and a 2% deficit repair levy for high income earners (earning over $180,000) have been mooted. As a general principle, higher taxes mean lower growth and less money available for investment, which will increase the price of capital. High cost growth in areas such as utilities and health, together with higher taxes which have been eating into spending power have been exacerbating the problem of lowish wages growth and consumer sentiment.

9 Selling NBN?

There is a widely held view in the market that a Labor government would be more likely to write down the value of the NBN, and may consider selling it to Telstra's infrastructure co. Not surprisingly some market participants think Telstra is one stock that will positively benefit from a change in government (notwithstanding the franking changes).

Table 2: Summary of potential policy impacts if there is a change in federal government

	Impact	Sectors/Stocks	+ve/-ve
Franking credits	80 % users of franking credits unaffected	Banks, TLS, WOW, BHP, RIO Non franked high yielders eg REITs	Slight –ve Slight +ve
CGT discount	Property & equities	Broad	-ve
Negative gearing	Investors	Developers	Slight +ve
Living wage	Low income earners & particularly small business	Consumer Exporters/ manufacturers	+ve short term -ve short and long term
Non-union friendly workplace scrutiny		Mining	-ve
Renewable energy	Across the board	Energy sector	-ve
Private health care caps and review	Fee rise caps	Health funds	Already built in
Higher taxes	Higher income earners	General/Investment	-ve
Selling NBN		TLS	+ve

Source: Glenn Hart, Co-Head of Equities, Antares Equities, March 2019

Postscript:

The Federal election result is not a given. Scott Morrison appears to be performing better than many expected and the NSW election did not result in an ALP victory. Perhaps the biggest surprise could be the return of the coalition government.

Antares market & fund updates

Below is a brief review of how the Australian share market performed during the quarter as well as short commentaries on each Antares Fund, outlining their net performance and the main contributors to performance.#

Australia share market review

Global shares (unhedged) made a very strong return of 11.3% over the three months to 31 March 2019. This strong performance was a welcome recovery from the painful negative returns for the final quarter of 2018 and reflected a combination of positive factors including lower interest rates, diminishing global trade tensions and some stabilising signs on global growth prospects.

Australian shares also posted a double digit return (+10.9%) for the first quarter of 2019. The market posted good gains in January (3.9%) and February (6.0%) followed by a smaller increase in March (0.7%). There was divergence between sectors with Resources up by 19% for the quarter, driven by higher iron ore and metal prices. A sharply higher global oil price underpinned the Energy sector's 15.4% rise. Both the Real Estate Investment Trust sector (+14.8%) and the Utilities sector (+11.6 %) posted strong gains given lower government bond yields. Financials (ex AREITs) remained out of favour posting a 6% decline for the quarter.

Australian Equities Fund

The Antares Australian Equities Fund returned 10.0% (net of fees) for the March 2019 quarter, underperforming its benchmark S&P/ASX200 Accumulation Index return of 10.9% by 0.9%[1]. The main contributors to quarterly performance were overweight positions in Fortescue Mining and Nine Entertainment and an underweight holding in CSL. Detracting from performance were overweight holdings in AMP and Star Entertainment and the decision not to own Rio Tinto.

Dividend Builder

Antares Dividend Builder returned 7.5% (net of fees) for the March 2019 quarter, underperforming its benchmark S&P/ASX200 Industrials Accumulation Index return of 8.9% by 1.4%[1]. The main contributors to quarterly performance relative to the benchmark were overweight positions in Viva Energy, Amcor and Harvey Norman. Detracting from relative performance was the decision not to own Macquarie Group and overweight holdings in AMP and Star Entertainment.

Elite Opportunities Fund

The Antares Elite Opportunities Fund returned 10.0% (net of fees) for the March 2019 quarter, underperforming its benchmark S&P/ASX200 Accumulation Index return of 10.9% by 0.9%[1]. Detracting from performance was an underweight position in Rio Tinto and overweight holdings in Star Entertainment and Westpac. Contributing to performance were overweight holdings in Fortescue Mining and Santos and the decision not to own CBA.

High Growth Shares Fund

The Antares High Growth Shares Fund returned 10.5% (net of fees) for the March 2019 quarter, underperforming its benchmark S&P/ASX200 Accumulation Index return of 10.9% by 0.4%[1]. Overweight holdings in Fortescue Mining and Santos as well as an underweight holding in CBA contributed to performance, while overweight positions in Star Entertainment and Computershare and underweight position in BHP detracted from performance.

Listed Property Fund

The Antares Listed Property Fund returned 12.9% (net of fees) for the March 2019 quarter, underperforming its benchmark S&P/ASX200 A-REIT Accumulation Index return of 14.8% by 1.9%[1]. Contributing to performance was an overweight holding in Mirvac, an underweight position in Vicinity and the decision not to own Shopping Centres Australasia. The decision not to own Charter Hall, an underweight holding in Goodman Group and an overweight position in Scentre Group all detracted from performance.

#All returns are net of fees. Please refer to page 3 for a summary of returns which are gross of fees. 1. Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document.

Antares Investments Returns

Performance to 31 March 2019[1]

Professional Selection		3 mths %	1 yr %	3 yrs % pa	5 yrs % pa	10 yrs % pa	Since Inception % pa
Antares Australian Equities Fund	**Net Return**	**10.0**	**9.1**	**10.5**	**7.2**	**10.0**	**9.4**
S&P/ASX 200 Acc Index	Gross Return	10.2	9.8	11.4	8.1	11.0	10.3
	Benchmark Return	10.9	12.1	11.5	7.4	10.4	9.3
	Net Excess Return	**-0.9**	**-3.0**	**-1.0**	**-0.2**	**-0.4**	**0.1**
	Gross Excess Return	-0.7	-2.3	-0.1	0.7	0.6	1.0
Antares Dividend Builder	**Net Return**	**7.5**	**4.4**	**5.1**	**5.6**	**11.4**	**7.1**
S&P/ASX 200 Industrials Acc Index	Gross Return	7.6	5.0	5.7	6.2	12.1	7.7
	Benchmark Return	8.9	8.4	8.2	7.4	12.3	7.4
	Net Excess Return	**-1.4**	**-4.0**	**-3.1**	**-1.8**	**-0.9**	**-0.3**
	Gross Excess Return	-1.3	-3.4	-2.5	-1.2	-0.2	0.3
Antares Elite Opportunities Fund	**Net Return**	**10.0**	**7.6**	**10.2**	**7.9**	**10.6**	**10.6**
S&P/ASX 200 Acc Index	Gross Return	10.2	8.3	11.0	8.6	11.4	11.4
	Benchmark Return	10.9	12.1	11.5	7.4	10.4	9.2
	Net Excess Return	**-0.9**	**-4.5**	**-1.3**	**0.5**	**0.2**	**1.4**
	Gross Excess Return	-0.7	-3.8	-0.5	1.2	1.0	2.2
Antares High Growth Shares Fund	**Net Return**	**10.5**	**8.4**	**12.0**	**9.1**	**10.9**	**10.8**
S&P/ASX 200 Acc Index	Gross Return	10.8	9.5	13.2	10.2	12.1	12.3
	Benchmark Return	10.9	12.1	11.5	7.4	10.4	8.1
	Net Excess Return	**-0.4**	**-3.7**	**0.5**	**1.7**	**0.5**	**2.7**
	Gross Excess Return	-0.1	-2.6	1.7	2.8	1.7	4.2
Antares Listed Property Fund	**Net Return**	**12.9**	**16.1**	**6.7**	**12.3**	**13.3**	**8.2**
S&P/ASX 200 A-REIT Acc Index	Gross Return	13.1	16.9	7.5	13.1	14.1	9.0
	Benchmark Return	14.8	26.2	9.9	14.7	15.1	8.1
	Net Excess Return	**-1.9**	**-10.1**	**-3.2**	**-2.4**	**-1.8**	**0.1**
	Gross Excess Return	-1.7	-9.3	-2.4	-1.6	-1.0	0.9

Disclaimer:[1] Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document. Investment returns are based on exit prices, and are net of management fees and assume reinvestment of all distributions. Gross returns are provided to show performance against the investment objective.

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