Martin Bros

MONITOR

Creating Long Term Financial Success For Our Clients

Welcome to the March 2015 Edition of the Martin Bros Monitor.

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The Illusion of BIG Numbers

Just this week there was an article in the Australian Financial Review (AFR) titled “CBA chief Ian Narev the latest winner from Sydney’s house boom”. The title is pretty self explanatory and would make sense given the backdrop of 85% auction clearance rates in Sydney and a property market that from all reports has been doing very well in the last couple of years. However, after reading the article it was clear to us (must be the mathematical mind) that as is often the case with property investments, the large numbers involved can be masking a very different financial outcome than what it appears.

The article starts by stating that the CBA chief has become a personal beneficiary of the hot housing market when he quietly sold his home in Sydney’s trendy Paddington for a $600,000 profit!

Then comes the detail. Ian and his wife bought the house in 2008 for $2.26 million, which sold for $2.9 million last week. Purchase costs (incl. stamp duty, etc.) generally run at 5%. Sale costs generally run at 2%. So the net purchase price would have been closer to $2.37 million and the net sale price $2.84 million. The $600,000 reported gain is now a $470,000 gain. They bought the house 7 years ago, resulting in a gain of $470,000 on a purchase cost of $2.37 million. That equates to a simple return of 19.83% over the seven year period or 2.83% per annum. On a compounded return basis, which is the norm, they have achieved a 2.45% annual return (taking into account inflation it would be close to 0%).

This also assumes they did not spend any money on the house such as kitchen renovations, bathrooms, new carpets, blinds etc. This would only serve to reduce their rate of return. What appears on the surface to be a fantastic gain in a booming market, you can see that a 2.45% return would even struggle to stack up against a cash rate return over the same period.

Hence, what we call the “Illusion of BIG numbers”.

Yield Compression

For several years now we have been talking about equity prices being supported by the yield (dividends) they offer, driven by the dismal (and worsening) cash and term deposit rates on offer. This has caused share prices to rise over the last few years as people look for better income from their investments in a falling interest rate environment. Yield compression is a term that refers to dividend yields on offer falling, simply due to share prices rising and not because dividends being paid are reducing.

Dividend yields (%) have an inverse relationship to share prices (assuming the dividend is maintained). As an example, let’s say Company A pays a 50 cent dividend and its shares trade at $10 per share. This would mean Company A has a 5% (50 cent dividend / 1000 cent share price) dividend yield. If Company A pays the same dividend next year, but the share price has risen to $12 per share (or 1,200 cents), its dividend yield would be 4.16% (50 cents / 1200 cents). The dividend yield has fallen while the share prices has risen, hence an inverse relationship. This falling dividend yield does not mean the company’s performance has been poor. To the contrary, it is simply because its share price has appreciated 20%. For companies that pay a growing dividend yield, share price appreciation would have to be even greater to experience the same yield compression as a company paying flat dividends.

Risk, as defined by volatility, is greater in shares than fixed interest of course. Accordingly, investors can and should expect to be paid a premium income to be invested in shares. Historically, as a very general guide, this premium would be double. That is, if you can obtain a “risk free” rate of 2.5% on short term cash deposits then you would expect dividend yields to be roughly twice this rate. The Bond market is not a simple one to understand. Buying a bond will provide the owner with a guaranteed (to the extent of the issuer) interest payments for the life of the bond and their capital back at maturity. Bond prices will move during the time of ownership however, so capital values will rise and fall with interest rate expectations (inversely to each other). Bond rates are commonly used by research analysts in their valuation models as they use these as the risk free rate of return.

You may recall we have warned of a bond market bubble that at some stage will burst, meaning yields will rise sharply, causing significant capital losses. This will occur well before official interest rates rise. In Australia however, the cash rate has again been reduced by the Reserve Bank (with more cuts likely to come), 24 other countries globally have reduced official interest rates already in 2015 and the European union is now embarking on a large scale QE program like the US did five years ago. In the US, it appears they will be the only developed country in the world to raise interest rates this year. With everyone else cutting interest rates, the US may begin increasing their rates later than expected and by less than expected, at least initially.

All of this points to interest rates globally looking like they will stay lower for longer. Below is a table of some of the major economies current interest rate settings and 10 year bond market prices.

Country	Cash Rate	10 Year Bond Yield
USA	0.00% - 0.25% target range	1.91%
Australia	2.25%	2.36%
United Kingdom	0.50%	1.59%
Germany	0.05%	0.19%
France	0.05%	0.47%
Canada	0.75%	1.32%
South Korea	1.75%	2.26%
Japan	0.10%	0.35%

With rates this low, which in many instances are actually negative real rates (after taking into account inflation), it is no wonder equity prices are being bid up in the chase for yield. Like all good things this will come to an end at some stage and equity investors will again be reminded about risk versus reward. That’s why having the right asset allocation for your circumstances is ever important. Being able to tactically maneuver around these allocations as current market conditions dictate is one of our roles.

ASX Market Hours - Easter Period

Please note the amended ASX trading hours below over the upcoming Easter period. Members of the Martin Bros. Team will be available each day the market is open.

- Friday 3rd April - Market & Office closed (Good Friday)
- Monday 6th April - Market & Office closed (Easter Monday)
- Tuesday 7th April - Normal Trading Resumes

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