

Low interest rates matter. So do imputation credits

Tim Farrelly | farrelly's | 27 February 2017

In a recent, widely circulated article, Roger Montgomery suggested that the major Australian banks were overpriced on the basis that, to justify their current prices, bank EPS will need to grow at an implausible rate of 4.5% to 5.5% per annum in perpetuity.

Now, the major banks pay dividends of around 5.5% on average. If they grow EPS at 4.5% or 5.5% in perpetuity, they will return 10% to 11% per annum in perpetuity. And at first blush, a fair value equities return hurdle of 10% per annum doesn't seem too unreasonable.

Except that it leaves out two of the most important considerations for Australian investors – low interest rates and imputation credits.

In the old, pre-GFC world, government bond rates of 5.5% were 'normal'. And, if we add to that the long-term equity risk premium of around 4.5%, we end up with a fair value hurdle of 10% per annum for Australian equities. Seems fair.

But we don't live in the old world anymore. Bond rates haven't been above 5% since 2011. Currently, Australian 10 year bonds yield around 2.7%. The historic 4.5% equity risk premium suggests we should be targeting 7.2% fair value equity returns. At that rate, we just need 1.7% per annum EPS growth from the banks to achieve fair value returns. Even if we make the reasonable assumption that bond rates will go higher – to, say, 3.5% – it implies a required growth of just 2.5% per annum to meet a new fair value return target of 8% per annum.

But this leaves out imputation credits from the calculations. Put them in and the bank dividend yield goes to 7.9%. Now we don't need any EPS growth – ever – to get fair value returns from the Australian banks.

Including the effect of imputation and having a view on interest rates makes a huge difference to the investment decision. Banks go from appearing wildly overpriced to being very attractively priced. A sell becomes a buy.

We need to know this stuff if we not to fall for the next eloquent story we hear... Just saying!



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