PRIMARY SCHOOL MATHS DRIVES THE MARKET

By Peter Warnes

We reprint this article from Peter Warnes, Morningstar's head of equities research because it is an excellent summary of the current market situation. It's the flow of money from savings to risk assets with higher rewards that drive the equity market. These waves of capital slosh through asset classes and provide the fundamental background to asset allocation. Boring stuff, but is the fuel that drives the market and makes trading easier and more profitable.

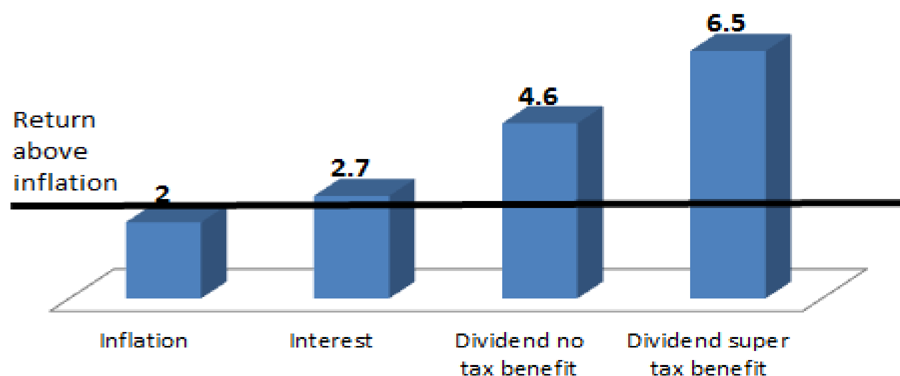
There is one factor Peter does not fully discuss and that is the risk to capital. If in five years the Telstra dividend is 40 cents per share, the yield will be 6.1 per cent IF the share price is at current levels of $6.55, but who knows what the share price will be. That is the risk. For us, this is the risk of time in the market. We counter this risk by reducing time in the market and actively trading the stock. Buy at $6.55, take the dividend, and then sell outside of the 42 day dividend holding window to avoid a taxation penalty. This reduces capital risk, and captures the reward.

This is not new thinking. We write about this in the original 1996 edition of SHARE TRADING when interest rates were at 16% plus. The objective then, as now, was to capture returns that were greater than those available from leaving cash on bank interest.

Peter writes that equities (and hybrids) are more risky than bank term deposits, no argument. The Commonwealth government guarantees deposits up to $250,000 in authorised deposit-taking institutions (ADIs) such as banks, building societies and credit unions.

The deposit is guaranteed should anything happen to the ADI. The $250,000 cap applies per person and per ADI. If the depositor has $250,000 with one ADI and $250,000 with another, both deposits are guaranteed. In the case of joint accounts, each holder is entitled to an individual guarantee of $250,000.

But the maximum gross return over the life of a term deposit is the interest rate. The current advertised one-year term deposit rate with a major bank is around 2.70 per cent. A $100,000 deposit returns $2,700 in interest. Assuming 2.0 per cent inflation the real return (increased purchasing power) is 0.7 per cent.



The $100,000 principal is secure, guaranteed -- term deposits sit at the lowest level on the risk curve. There is no tax advantage to interest payments, which are taxed at the individual's marginal rate.

A $100,000 investment in Telstra (TLS) at $6.55 (15,200 shares at 0.5 per cent commission + GST), based on a fiscal 2015 dividend of 30 cents per share, returns $4,560 and franking credits of $1,954, a dividend return of 4.6 per cent, and if untaxed, say via superannuation in pension mode, the return is 6.5 per cent.

The final dividend could be (highly likely) increased from 15 cents to 15.5 cents, a 3.3 per cent lift taking care of inflation. The interim dividend was increased by 3.4 per cent. The ability for dividends to grow with inflation is a key difference between term deposits and equity.

Clearly there is no guarantee the Telstra share price will be $6.55 in a year's time, it's the added risk with equity.

I know this is primary school stuff, but this arithmetic continues to be the driving force behind the stock market as term deposit rates are likely to stay at current levels for some time and may decline further. Reflecting this, the All Ordinaries Accumulation index has surged to all-time highs, breaking through 50,000 for the first time in recent days.

No one can say with 100 per cent certainty in which direction the share price will go, which is why I say "investors are being forced out the risk curve" -- from a no-risk term deposit to a higher-risk equity investment, in this example Telstra.

If in five years the Telstra dividend is 40 cents per share, the yield will be 6.1 per cent at $6.55, but who knows what the share price will be. That is the risk. On the other side of the coin, what will the one-year term deposit rate be? Both are unknowns but clearly the Telstra investment has more risk.

The expectation dividends will grow over time is what attracts investors to the share market. Data shows income is responsible for 60-65 per cent of long-term total shareholder returns. Our research methodology tries to reduce the risk (it can never be expunged) by choosing companies with an economic moat (a sustainable competitive advantage), low/medium fair value uncertainty and Standard or Exemplary stewardship rating.

More details are available from the http://www.morningstar.com.au