EXPENSIVE DEFENSIVES

PERPETUAL
13/09/2016

Equity income vs bond income

In most circumstances investors will buy equities for growth and bonds for income. The appealing attribute about a bond is that – in the absence of default – the investor knows what income will be received (the ‘coupon’) and when their original capital will be re-paid (the ‘face value’ on maturity).

Equities are completely different. They do generate income – often lots of it and often with an attractive imputation credit attached – but the regularity and timing of that income is very different from bonds.

Firstly, the dividend depends on the company’s ability to generate earnings **after** paying interest, tax and allocating capital for reinvesting in the business.

What’s more, the return of the original capital invested is not guaranteed and valuations fluctuate from day-to-day. You get your reward for that variability via higher long-term returns (the equity risk-premium). But these differences explain why you need to look at bond and equity income very differently.

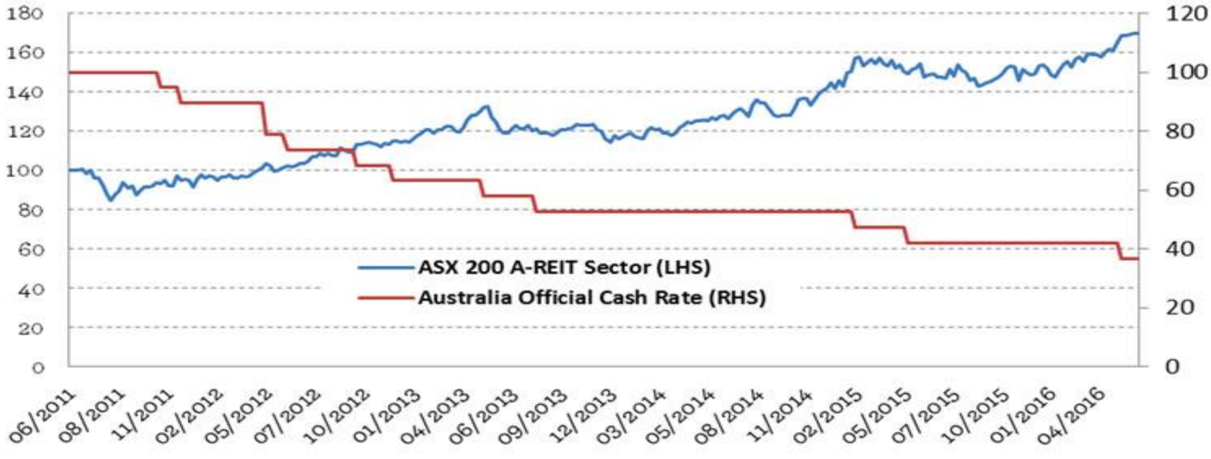
Buying tomorrow’s dividend – a flawed approach?

In our view buying a company based on what dividend the company is going to pay next year is fraught with danger. As discussed above, the dividend paid to the owners of a business is a decision made by the company’s board who have a responsibility to protect and grow that business – not pay a specific dividend each year. The proportion of earnings paid out in dividends is subject to many factors. So basing long-term investment decisions on a one-year dividend expectation makes little sense.

Hot Property

Another manifestation resulting from the search for yield is the dramatic re-rating of Australian Real Estate Investment Trusts (A-REIT) – as shown in Chart 1.

Chart 1 - ASX200 A-REITs and the Official Cash Rate *(5 years to 30 April)*



Source: FactSet

At its simplest, falling bond yields tend to boost the attractiveness of REITs. After all, income from property is relatively predictable and property is regarded as defensive given the hard asset-backing (the land and buildings).

This hypothesis makes perfect sense on the surface, but it fails to take into account the fact that rental leases (which underpin property earnings) are linked to economic conditions such as retail spending.

The key point is that central banks' loosening of monetary policy reflects softness in the underlying economy. Today however, this cautionary note is being ignored by markets.

We've witnessed this scenario of falling rates and rising REITs valuations play out in Australia over the past five years with capital continuing to flow into listed property trusts. Many A-REITs are now trading at a 20-50% premium to Book Value.

Table 1 - Property Trusts are looking expensive

Company	FY17e P/BV	Share price implied Cap Rate
Westfield (WFD)	1.5x	4.3%*
Scentre (SCG)	1.4x	5.1%
Shopping Centres Australasia (SCP)	1.2x	5.9%

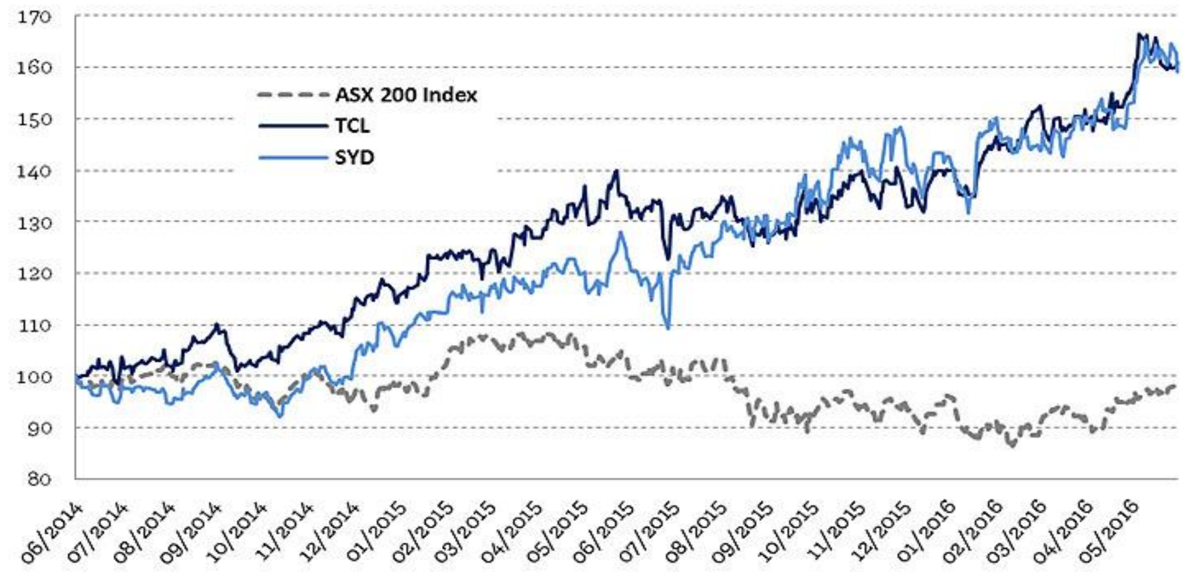
Source: FactSet and Perpetual, as at 31 May 2016

*WFD implied cap rate assumes the intangible asset values move proportionately to the value of the tangible assets

Sky-High Infrastructure

A similar storyline is playing out in the infrastructure space – as shown in Chart 2. Again, many of these stocks have the characteristics investors typically cherish: high quality assets, they operate in markets with oligopoly structures and have stable, predictable earnings streams.

Chart 2 - Pricey Infrastructure *(2 Years to 30 April)*



Source: FactSet

Apart from these characteristics, investors have fallen for these stocks for the strong dividend yield they pay, which has become more and more attractive as the cash rate continues to fall.

However investors are seemingly ignoring the valuation they're paying for these stocks, and are thus exposing themselves to significant risk. Moreover, companies in this sector typically carry very large levels of net debt so when interest rates eventually rise the cost of servicing this debt also increases. This threatens the sustainability of their dividend policies – bringing the whole investment thesis into question.

Table 2 – Infrastructure metrics

Company	Market Capitalisation	FY15 Net Debt/Equity	FY17e Dividend Yield	FY17e Price/Earnings
Transurban (TCL)	$23.9 billion	296%	4.4% (16% franked)	74.3x
Sydney Airport (SYD)	$15.7 billion	814%	4.7% (0% franked)	47.7x

Source: FactSet, as at 31 May 2016

Perpetual – staying true to label

While not owning many of these ‘income’ stocks has detracted from Perpetual’s recent performance we remain true to our core value management style, and rather than chase these expensive names up we continue to invest our clients’ funds into well run, high quality but attractively priced companies.

We believe there is much better long-term growth to be had in quality companies whose attraction is based on business fundamentals rather than short-term dividend payouts.

Where we feel the market is looking expensive we are happy to be patient and hold cash, knowing we will have the opportunity to buy excellent businesses at more rational valuations when the market corrects.

This disciplined approach, together with our conservative attitude towards managing money, has helped us navigate many different market cycles and deliver for clients over the long run.