AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

By Hugh Dive

21st August 2015

What to do with the Australian Banks?

Travelling around Queensland this week and meeting with clients one of the questions most frequently asked was, "*What should I do with my bank shares*?" Furthermore today has been one of the worst trading days for the banks since the GFC and with 30 minutes to go before the close the major banks have fallen roughly 3.5% today. Assessing future prospects for the major banks is currently one of the biggest issues facing investors; from the largest institutional equity fund manager at Colonial First State to the smallest retail investor who bought shares in CBA when it was floated in 1991 at $5.40. Over the last 3 months the banking sector's share prices have declined -14%, significantly worse than the -6.5% total return posted by the ASX200. In this piece we are going to set aside today's emotional selling and are going to look at the causes of this correction along with some thoughts for the future.

Higher Capital

Aside from employing over 200,000 Australians and touching every sector of the Australian economy, the banks comprise 31% of the ASX100 and are the four largest stocks listed on the ASX with a combined market value of A$392 billion. After several years of delivering strong profit and dividend growth, primarily due to the tailwind of declining bad debt charges, all bank share prices have been sold off aggressively over the past quarter due to a combination of capital raisings from NAB ($5.5B), ANZ ($3B), Commonwealth Bank ($5.1B) and one stealth capital raising via Westpac's $2B underwritten dividend reinvestment plan.

These capital raisings and subsequent dilution of future returns for shareholders were conducted to boost capital in anticipation of impending higher risk weights from Basel 4 allowing the Australian banks to meet the Murray Financial System Inquiry's recommendation that APRA should '*set capital standards such that Australian authorised deposit-taking institution* [ADI] *capital ratios are unquestionably strong*'.

The rationale behind these capital raisings is that during the GFC many banks globally were forced to seek direct financial support from governments (and ultimately taxpayers). In the media showed bank executives flying in on corporate jets with their cap in hand and leaving with cash injections or guarantees provided by the taxpayer. For example, the US government injected US$45 billion into my former employer Citigroup at the height of the GFC. This proved to be quiet profitable for US taxpayers with the government selling their Citigroup shares in 2011 for US$57 billion! Whilst the Australian banks did not require similar levels of government support, additional banking capital is designed to reduce the probability of Australian banks needing assistance from taxpayers during future crises.

Global Selling

Over the last quarter, there has been significant offshore selling of stocks in many Australian companies and in particular higher yielding sectors such as the banks. A factor contributing to the fall in these companies share prices has been the unravelling of the AUD *"carry trade"* caused by the prospect of rising bond yields in the US later on in 2015 and a sharp fall in AUD. The carry trade is an investment strategy where an investor borrows in a country with a low interest rate like the US at 0.5%, then uses these funds to buy an asset in a different currency yielding a higher return, such as Westpac shares at 5.5% or Australian government 3 year bonds yielding 2.58%. In the case of investing in Westpac shares, this strategy will give a profit of 5%, provided the AUD/USD does not change significantly and these profits are often magnified by the use of leverage. The risk inherent in this strategy is when a sharp downward move occurs in the AUD such as what we have seen over the last 3 months, where the AUD has fallen -7.5% vs the USD. Obviously moves of this magnitude in the currency can wipe out all the returns being generated from interest rate differentials.

Higher Capital Costs

We see that the impact of higher capital requirements won't be as dire as many in the market believe. Over the last 30 years the Australian banks have proven to be effective at passing similar costs onto customers and we expect that profits will be maintained through a combination of reduced discounts for new mortgages, lower term deposit rates and wider spreads on some business loans.

During 2012 Sweden introduced higher capital requirements on banks writing mortgages to rein in a very buoyant Swedish housing sector and provide greater bank capital requirements. These moves cooled down the Swedish housing sector, slowing housing credit growth from 10% to 5%. However this ended up being a positive development for shareholders in the Swedish banks (*Svenska Handelsbanken* and *Swedbank*); as the banks repriced their mortgage book upward to account for this additional capital and saw margins expand and earnings per share rise by approximately 15%!

Effectively we see that it will be lenders, rather than shareholders that will bear most of the cost for "gold plating" of the Australian banking system, though the banks will have to be careful about putting through rate increases given the quantum of the profits they are currently reporting. We have already seen signs of this with ANZ and CBA announcing a 0.27% increase to Investment Property Loan interest rates and NAB increasing all interest-only mortgages and lines of credits by 0.29%. Politically right now it is probably more palatable to increase rates out of cycle for property investors, than for owner occupiers, but we would expect margins to be repriced upwards in the near future for both business and household borrowers. This is most likely to come in the form of the banks not passing on the full amount of future rate cuts.

	MKT WHT (ASX 100)	Last Price	MCAP ($M)	6M Return	1YR TR Per annum	3YR TR Per Annum	5YR TR Per Annum	FWD PER	DIV Yield	Grossed Up Yield	Margin over 1 year TD (2.45%)
COMMONWEALTH BANK	10.0%	$ 75.24	127,784	-13.8%	0.1%	16.9%	15.3%	13.2	5.8%	8.3%	5.8%
WESTPAC BANKING	7.8%	$ 31.53	100,389	-13.9%	-2.5%	15.3%	14.2%	12.5	6.1%	8.7%	6.2%
AUST AND NZ BANK	6.4%	$ 28.32	81,418	-16.5%	-7.5%	11.4%	11.2%	10.8	6.5%	9.3%	6.8%
NATL AUST BANK	6.4%	$ 31.40	82,445	-12.8%	0.3%	16.0%	13.4%	11.9	6.3%	9.0%	6.6%
BENDIGO AND ADEL	0.4%	$ 10.87	4,963	-13.9%	-8.4%	16.0%	12.2%	11.4	6.4%	9.1%	6.7%
BANK QUEENSLAND	0.4%	$ 12.80	4,744	-6.0%	11.2%	26.2%	12.5%	12.5	6.1%	8.7%	6.3%
Total Index Weight	**31.3%**									**8.9%**	**6.4%**

Valuations

Currently the banks trade at a 15% discount to the ASX 200, the biggest discount since 2007. Moreover the banking sector dividend yield is currently at 6.4% margin over the 1 year term deposit (TD) rate (above table). As the banks report positive margin growth in late October/early November and now that the spectre of large capital raisings are mostly recede , we can see strong catalysts for buying support in these stocks, especially from retail investors dismayed at the deposit rates offered when they roll legacy term deposits.

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