crestone

OBSERVATIONS / AUGUST 2019

Franking credits

more than a simple return boost

ROB HOLDER
ASSET ALLOCATION SPECIALIST

SCOTT HASLEM
CHIEF INVESTMENT OFFICER

Over the last five years, franking credits have been an attractive option to non-taxpaying investors, adding an average of 1.56% compared to returns from the S&P/ASX 200 Accumulation index. This obvious return benefit has prompted investors who are able to fully utilise franking credits to ask whether they should be increasing their exposure to domestic equities. At first glance, the most obvious answer to this question would appear to be 'yes'—but, as we discuss below, there is more to the equation than a simple return boost.

The optimum allocation to domestic equities from a return perspective

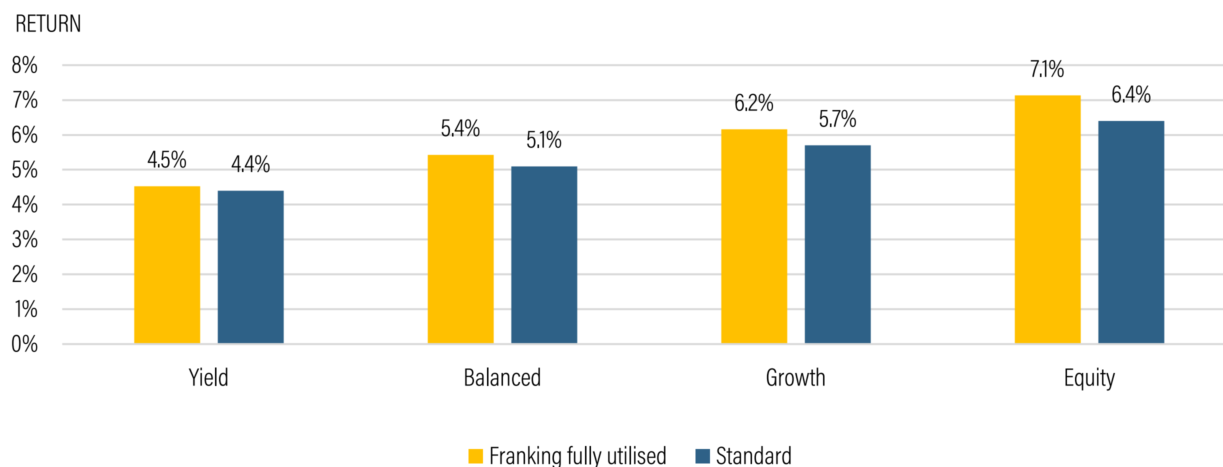
If we compare the annual returns of the S&P/ASX 200 Franking Credit Adjusted Total Return index to the S&P/ASX 200 Total Return index, we find that franking credits have provided a 1.56% pa return boost for tax-exempt investors who are able to take advantage of them.

Assuming all other variables are unchanged (risk, return and correlation to other asset classes), we can model two outcomes for our forward-looking (capital market) return assumptions—one that utilises franking credits and one that doesn't. In doing this, we are able to build optimal portfolios under both assumptions and compare the two, thereby establishing the optimal allocation to domestic equites for those investors able to take advantage of franking credits.

The chart on the following page shows the total expected portfolio return for each of our model portfolios (Yield, Balanced, Growth and Equity), utilising the franking credit capital market return assumption and the standard (or non-franking credit) capital market assumption for domestic equities. Not surprisingly, by using the franking credit capital market assumption, returns are enhanced across the board, with the greatest impact felt by those portfolios with larger allocations to domestic equities.

This finding alone leads many investors to overweight domestic equities within their portfolios. However, often this is without a full understanding of the impact on both the expected risk and return. To see the fuller picture, we need to introduce portfolio risk to the discussion.

Franking credits provide a boost to overall portfolio returns



Source: Bloomberg and Crestone.

The optimum allocation to domestic equities from a risk perspective

A rational investor will seek to maximise the return generated for the risk taken—something we call portfolio efficiency. This means that those investors who have skewed their portfolio towards domestic equities to take advantage of the return boost from franking credits should be expecting to improve their risk-adjusted returns. The key question, of course, is to what degree franking credits justify increasing a portfolio's allocation to domestic equities.

In the following table, we have again taken our model portfolios (Yield, Balanced, Growth and Equity) and gradually skewed the weight away from our standard strategic asset allocations (SAAs) to favour domestic over international equities (all other asset class weights remain unchanged). In this scenario, we are able to analyse the expected risk-adjusted return by looking at each portfolio's Sharpe ratio—this is a ratio that measures the average return in excess of the risk-free rate per unit of volatility.

We can analyse the expected risk-adjusted return by looking at the Sharpe ratio

	SHARPE RATIO			
DOMESTIC EQUITIES AS A % OF TOTAL EQUITIES	YIELD	BALANCED	GROWTH	EQUITY
45	0.856	0.676	0.593	0.516
50	0.856	0.675	0.595	0.521
55	0.852	0.674	0.596	0.524
60	0.849	0.672	0.595	0.527
65	0.843	0.669	0.594	0.527
70	0.837	0.664	0.590	0.525

Source: Crestone.

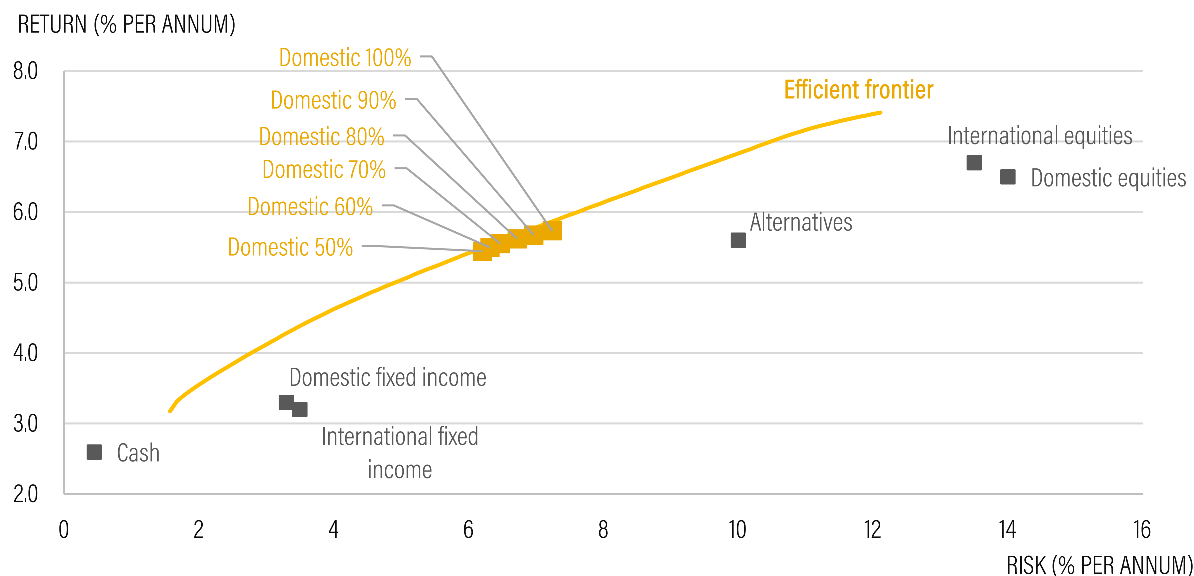
No benefit for Yield and Balanced investors

The results show that for **Yield** and **Balanced** investors there is actually no benefit in increasing their allocation to domestic equities. As we can see, when an investor deviates from our standard SAA weights (which is 50/50 domestic/international for Yield and a marginal preference for international in Balanced) we actually see risk-adjusted returns fall. Although the absolute return of the portfolio may rise slightly, its risk will increase more, likely undermining the benefit of any such move.

A modest benefit for Growth and Equity investors

As we move through the risk profiles to **Growth** and **Equity**, however, we do start seeing a very modest improvement in risk-adjusted returns when an investor increases his or her exposure to domestic equities. The benefit to the Growth SAA peaks at around 55% while the Equity SAA peaks at around 60%. So, if a non-taxpaying investor were to increase the allocation to domestic equities from 50% to 55-60% of their total equity exposure they could, in fact, moderately increase the return of their portfolio in line with a similar level of risk. The improvement, as shown in the table, is at best modest. Any increase beyond these levels and we start to see risk-adjusted returns fall.

Domestic equities as a percentage of total equities in a balanced portfolio



Source: Morningstar and Crestone. Domestic allocation is the share of the portfolio equity allocation.

But what about portfolio diversification?

As we can see, utilising franking credits does increase absolute return expectations, so skewing portfolios towards domestic equities can improve the overall expected return. However, the issue for investors is that this does come at the expense of portfolio diversification.

As we move more heavily towards one asset class, we start to lose the benefits of imperfect correlations between asset classes—an important factor in portfolio construction. So, although a balanced investor can improve the expected return of his or her portfolio by increasing their allocation to domestic equities, in so doing, they take on a disproportionate amount of risk. Putting it another way, an investor who skews towards domestic equities in an attempt to benefit from franking credits simply ends up taking on more risk at the portfolio level. This outcome could be achieved in a more efficient way. One way is to reduce exposure towards defensive assets and skew towards growth assets (which includes both domestic and international equities) in a more diversified and disciplined way.

Domestic equities are not the only beneficiary of franking credits

Domestic equities are not the only asset class where franking forms part of the investment decision. Hybrid securities also make payments with franking credits attached. Unlike domestic equities, which forms an asset class or sub-asset class in its own right, hybrids are typically considered to be part of the domestic credit sub-asset class. Such a concentrated cluster of securities does not lend itself well to making up a large part of a well-diversified portfolio—but there is still a case for increasing exposure to hybrids if franking credits can be fully utilised.

An allocation to hybrids should be made within the credit sub-asset class

In this case, the argument revolves around allocating more to hybrids within the credit sub-asset class rather than allocating more to credit as a whole, which would have a material impact on risk. We find that taking this approach modestly increases returns across the risk profiles, with a greater impact seen at the lower end of the risk spectrum (such as the Yield model portfolio) where domestic credit weights are highest.

For example, if we assume all of the domestic credit in a Yield SAA is allocated to hybrids (rather than traditional credit) then we expect about a 0.2% return uplift—whereas a Growth SAA investor could expect to generate an additional 0.05% from allocating the domestic credit component to hybrids. In this case, we assume a similar risk profile will be maintained, although we would expect a modest uplift in risk as hybrids are typically moderately higher risk than traditional credit. On the whole, skewing the portfolio towards hybrids at the expense of traditional credit improves the risk-adjusted returns for investors who can fully utilise franking credits. Beyond that, where investors may consider allocating to hybrids at the expense of other fixed income asset classes, we see a deterioration in the risk-return trade-off.

Diversification is at the heart of optimising investment outcomes

While franking credits are a valuable additional source of return (particularly for non-taxpaying investors), we can see that when the risk impact is considered, the numbers don't justify a higher exposure to domestic equities unless you are a Growth or Equity investor.

For investors with a lower risk tolerance (Yield and Balanced), our current SAAs are designed to provide the highest risk-adjusted return—even when franking credits are accounted for (an approximate 50/50 balance between domestic and international equities). However, at the sub-asset class level hybrids are favoured over traditional domestic credit.

For higher risk tolerances (such as Growth), a modest preference of 55% of the equity allocation towards domestic equities is justified, while for single asset class equity investors, a more pronounced skew of 60% is warranted. Again, using hybrids from domestic credit exposure improves the return expectation—but the impact is modest.

Overall, we see that portfolio diversification remains at the heart of optimising expected investment outcomes and we are reminded that looking at the whole picture, i.e. both risk and return, is extremely important.

IMPORTANT NOTE

This document has been prepared by Crestone Wealth Management Limited (ABN 50 005 311 937, AFS Licence No. 231127) (Crestone Wealth Management). The information contained in this document is of a general nature and is provided for information purposes only. It is not intended to constitute advice, nor to influence a person in making a decision in relation to any financial product. To the extent that advice is provided in this document, it is general advice only and has been prepared without taking into account your objectives, financial situation or needs (your Personal Circumstances). Before acting on any such general advice, we recommend that you obtain professional advice and consider the appropriateness of the advice having regard to your Personal Circumstances. If the advice relates to the acquisition, or possible acquisition of a financial product, you should obtain and consider a Product Disclosure Statement (PDS) or other disclosure document relating to the financial product before making any decision about whether to acquire it.

Although the information and opinions contained in this document are based on sources we believe to be reliable, to the extent permitted by law, Crestone Wealth Management and its associated entities do not warrant, represent or guarantee, expressly or impliedly, that the information contained in this document is accurate, complete, reliable or current. The information is subject to change without notice and we are under no obligation to update it. Past performance is not a reliable indicator of future performance. If you intend to rely on the information, you should independently verify and assess the accuracy and completeness and obtain professional advice regarding its suitability for your Personal Circumstances.

Crestone Wealth Management, its associated entities, and any of its or their officers, employees and agents (Crestone Group) may receive commissions and distribution fees relating to any financial products referred to in this document. The Crestone Group may also hold, or have held, interests in any such financial products and may at any time make purchases or sales in them as principal or agent. The Crestone Group may have, or may have had in the past, a relationship with the issuers of financial products referred to in this document. To the extent possible, the Crestone Group accepts no liability for any loss or damage relating to any use or reliance on the information in this document.

This document has been authorised for distribution in Australia only. It is intended for the use of Crestone Wealth Management clients and may not be distributed or reproduced without consent.

© Crestone Wealth Management Limited 2019.