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Bond investors like Labor's dividend franking cut

by **John Kehoe**

Bond fund managers have backed Labor's proposal to cut the generosity of franking credits, assessing that the shake-up will reduce the tax bias for dividends and encourage retirees to put money into the debt market.

Fixed income portfolio managers said ending refunds of excess franking credits would make shares and hybrids relatively less attractive for low-taxed investors such as self-managed superannuation funds (SMSFs).

Equity investment managers have lashed the policy for hurting owners of shares and hybrid securities, but debt investors anticipate it could nudge SMSFs to consider corporate bonds offering steady interest payments.

FIIG Securities director of education and research Elizabeth Moran said dividend imputation had caused many investors to be over-allocated to higher risk shares and underweight lower volatility bonds.

"One of the things I see quite commonly is people investing in bank shares for the income and franking credits and not being worried about the falling capital value, which is really concerning," she said.

"I do think Labor's dividend imputation proposal is good policy because I think overall we are over-allocated to higher risk assets and there is an inherent danger if you get a big downturn at the wrong time.

"While a bond is lower yielding, the capital preservation is a big part of why you would invest in bonds."

SMSFs had $207.8 billion invested in listed shares and $9.5 billion allocated to debt securities, as of March 2018, according to Australian Taxation office data.

Move can shift investors' mindset

Realm Investment House co-founder Andrew Papageorgiou said limiting franking credits would help change the mindset of equity investors who had pressured company boards into paying franked dividends instead of reinvesting for future growth.

"Franking drives conservatism at a board and management level because people don't back companies to reinvest capital in their own businesses for growth," he said, noting the investor backlash against Insurance Australia Group's move into Asia.

However, Mr Papageorgiou said ending franking refundability was a "bit rough" for retail investors who had invested in bank hybrids, because they were essentially providing an insurance buffer for banks and taxpayers in any future serious economic downturn.

"We need to be fair and reasonable when moving the goalposts," he said.

Domestic shareholders being paid dividends currently receive a refundable tax credit for the 30 per cent domestic corporate tax paid, even if their personal tax rate is zero.

Labor's treasury spokesman Chris Bowen wants to scrap the cash refund of franking credits for low taxed investors like SMSFs, except pensioners, to save the budget about $5 billion a year.

The OECD's *Pensions at a Glance 2017* report notes that for Australia's superannuation funds, equities outweighed bonds by 51.1 per cent to 10.2 per cent, the inverse of most advanced economies which had a greater preference for bonds.

Shares would be 'a little less attractive'

Australian Securitisation Forum chief executive Chris Dalton said ending the refundability of franking credits would make shares a "little less attractive" to SMSFs.

"Combined with changes to negative gearing, at the margin it could start to change the thought process of rebalancing the portfolio away from property and shares to fixed income," he said.

Bill Bovingdon, chief investment officer of Altius Asset Management, a specialist cash and bond manager, said Labor's franking policy could affect asset allocation at the margin, though some retirees may restructure their financial affairs to minimise the impact.

"It will have a marginal impact to take the gloss of shares and particularly hybrids for the cohort who do currently get a net refund," Mr Bovingdon said.

Petition to stop change

A Plato Investment Management survey of 1400 clients, mainly SMSFs, found 81 per cent of respondents said they would reduce exposure to Australian shares in response to Labor's imputation policy. Of that, some 46 per cent said they would increase exposure to global shares, but only 7 per cent said they would increase exposure to fixed income or cash.

"So it seems like our investors won't be putting too much into cash or debt – probably because current interest rates are so low," said Plato managing director Don Hamson.

The Australian Stock Report (ASR) has launched an online petition aimed at stopping Labor's planned changes to dividend imputation and says it has more than 14,000 signatures.

"Millions of Australians will lose a significant amount of their investment income if the proposed changes to the franking credit system are implemented," ASR's head of client services Rhys Williams said.

"We want to make sure that investors who rely on franking credits will continue to get that income from their investments. And we can only do that if we can stop the proposed changes."

In his financial system report for the government in 2014, former Future Fund and Commonwealth Bank of Australia chief David Murray said the imputation system had created a bias where individuals and super funds preferred shares and this had hindered the growth of the domestic corporate bond market.