Is the dream run of Australia's Big 4 coming to an end?

Michael O'Neill – Portfolio Manager

18 September 2017

The continued success and profitability of Australian banks over the last few decades, as well as recent large capital raisings, means that Australia's big 4 banks are now valued at over $400 billion by market capitalisation and they account for over 26% of the S&P/ASX 300 index. As a result, Australian bank stocks are widely held by many Australians either directly, or through their super funds.

Do Australian Banks warrant such a high weighting in investors' portfolios going forward?

Investors Mutual has, over the past few years, been relatively cautious around investing in the big 4 banks. This article seeks to explain to investors the thinking behind our view.

The foundations for extraordinary growth

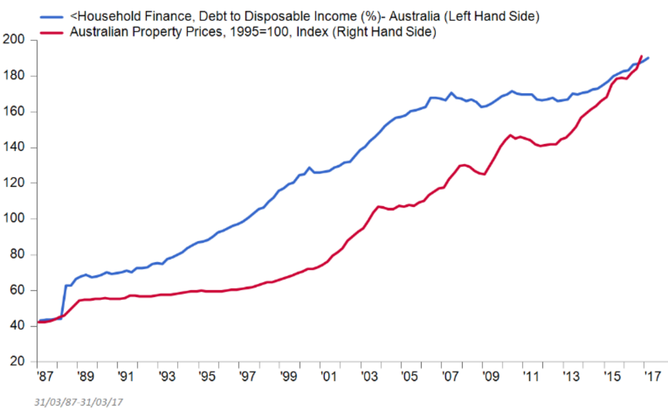
The last three decades have been a dream run for Australia's big 4 banks. Strong earnings growth translated into strong share price appreciation, as well as reliable, fully franked dividends - exactly what all investors were looking for over the long term.

The foundations for this extraordinary run began as far back as the mid 1980's, a time when median house prices were two times disposable income, while household debt to disposable income sat at around 50%. This relatively low level of consumer indebtedness provided a low base from which the banks could grow.

Bank deregulation really kick-started this growth in 1987 (see Chart 1), with the removal of interest rate controls and the reduction of mortgage capital requirements. This deregulation allowed Australian banks to compete more aggressively for home loans and deposits, while at the same time they were required to hold far less capital on their balance sheet to support underperforming loans, relative to other classes of lending like business loans.

This resulted in commercial lending being crowded-out ever since the 1980's by more-profitable residential lending, with double digit growth in this sector helped along by the rise of third-party mortgage brokers like Aussie Home Loans (1992) and RAMS (1995). These and other mortgage brokers provided the big four with an expanded, and far more incentivised distribution capability, which also provided more flexible customer service and document processing – resulting in a far better conversion rate than the banks were achieving through their branch network.

Chart 1: Household debt increases, as property prices climb

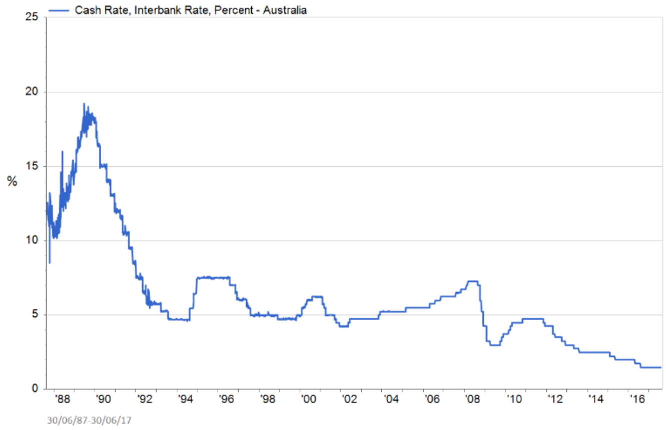


Source: FactSet as at 31 March 2017

The Golden Era

The period from the early 1990's until now has been a dream run for Australia's banks, with uninterrupted economic growth and falling interest rates driving unprecedented demand for residential mortgages. The prolonged fall in interest rates (see Chart 2) allowed consumers to borrow larger amounts, with the resulting boost in residential house prices also generating a huge surge in investors seeking interest-only mortgages.

Chart 2: Interest falling to historical lows



Source: Factset 31 July 2017

On the back of this credit boom, Australian banks have been able to generate record profits and increasing dividends, providing investors with strong share price capital growth and significant, tax-effective income in the form of franked dividends.

This sustained performance over the last 30 years now sees all four banks in the top five largest Australian companies by market capitalisation with the Financials sector weighting of Australia's ASX 300 now more than double the weighting of global banks in the MSCI World Index.

WATCH VIDEO: Portfolio Manager, Michael O'Neill, describes the circumstances that produced the 'Golden Era' for the big 4 banks and what this means for investors.

Chart 3: An extraordinary period of growth

Source: Morningstar 31 May 2017

This concentrated exposure also extends to direct retail investors, with bank stocks widely held by many due to the familiarity that they offer, their historic track record of strong share price performance, and their reliable, tax-effective dividends. The lack of perceived alternatives has also supported demand from retail investors, especially among those in retirement seeking a consistent income stream.

As an example, direct retail investors make up over 50% of the Commonwealth Bank's share register. Given the index concentration of Financials, most Australian investors exposure to Australian banks may be even greater, when you factor in these investors holdings in funds with shareholdings in Australia's Top 20 companies.

Historical drivers are today's risks

Residential mortgages now represent $1.5 trillion of the assets on the balance sheets of the big four who now account for more than 80 per cent of all residential mortgages in Australia. We believe that the big four banks' ability to continue growing this level will be restricted by three key factors:

1. A slowing economy
2. Tighter regulations
3. A new political environment

To read more about these risks and where else investors should be looking, the full article can be found on our website.