How the results season let us down

It's worse than the commentators have been telling you

JAMES KIRBY

Here's the pattern this reporting season.

Every morning the results stream out from the big ASX companies: mostly predictable, but often below expectations and generally uninspiring. Every afternoon the brokers issue reports telling us the season is good enough ... don't believe it.

This is a bad results season. The headline figure says we had 18 per cent lift in profits — but that's a distortion from miners which rebounded from losses. The truth is that without the miners we will be lucky to get 5 per cent after a string of disappointments.

There are two big fears in this market as we approach the end of the calendar year.

The first is a looming market correction in the short term, based on the historical pattern of downturns at this time of the year.

The second is that with the ending of so-called easy money, the earnings of companies are going to have to do the heavy lifting in the months to come. But there is very little evidence that earnings growth is on the way. The consensus for earnings per share growth in the year to June 18 (ex-miners) is again 5 per cent.

That consensus now looks to optimistic. At the half-way mark of this reporting season our biggest companies have let us down and crucially, as far as investor confidence goes, the damage is now done.

In essence there are only a handful of companies that can swing sentiment. This select group approximates the top 10 companies held by the most reliable listed investment company in the market, the Australian Foundation Investment Company.

The top ten holdings at AFIC are the big four banks — ANZ, CBA, NAB and Westpac, BHP, Wesfarmers, Rio, CSL, Telstra, and Transurban. There are a handful of names you might add here — but that line-up would be awfully close the core stock portfolio for any private investor.

Now if we look closer at that AFIC top 10 list, we have only one bank that reported a full year and that was CBA, which managed a modest 4.6 per cent profit lift while the management became in enmeshed in its deepest scandal yet and CEO Ian Narev was shown the door months before the market might have expected his departure.

Telstra — the single most reliable dividend payer in the market — lost its crown at a stroke when CEO Andy Penn announced future dividend cuts and the stock retreated to under $4, where it has remained.

Wesfarmers also offered a lukewarm earnings call: group profits up but Coles profits down. It is clearly facing a period of uncertainty in Britain with an ill-advised expansion and at home with a new CEO Rob Scott, who has a very difficult act to follow replacing Richard Goyder.

CSL — the one stock that usually surprises on the upside — surprised on the downside this time, and the stock has been treading water since.

Yes, the two big miners offered big profits — and profits instead of losses this time. Yet Rio did not match expectations, and while BHP may have tripled its dividend, how can investors take the company seriously when this comes directly after the group cancelled its progressive dividend policy?

Just to round the AFIC list off, Transurban was also disappointing and got hit with a string of downgrades. The toll operator actually had a ninefold increase in profits, joining a tiny group of outperformers but again the outlook (on costs this time) was worse than many expected. No wonder AFIC boss Ross Barker was so cautious at his own results announcements a few weeks ago — he would have known more than most what a dismal round of earnings announcements was coming down the line for his biggest holdings.

Looking forward

If we dare to step outside the household favourites list we see results that have really shot a hole in the side of this year's reporting season.

Where would you like to start? Dominos, a food retailer; BlueScope, a steelmaker; Healthscope, a healthcare specialist; QBE, an insurer — they have little in common thematically except that as a group they gave the distinct impression to all investors that things were going a lot better than they were.

Perhaps, you say, the market may focus on positives going forward — the build-up in confidence, the expanding plans for capital expenditure, the traditional defensive nature of our high-yielding market at 4.3 per cent, on top which you get your franking credits.

Perhaps, too, we should be more optimistic about the perennially impressive Fortescue or Carsales, IOOF or Treasury Wines. All that is true but the future health of ASX leaders is going to be about earnings, not yield.

Brokers are trying to put a brave face on it — they say that across the wider market the downgrades have not been too bad and that the season is just about good enough:

To put this argument in a nutshell, they say that the downgrades to earnings are not as bad as we have had in recent years. But looking ahead from here, the forecast for next year EPS growth (ex miners) is only about 5 per cent — no real change from the figure this year. So where's the much-anticipated earnings expansion?

On an individual stock basis the commentary is more subtle — at Telstra shareholders are told the worst should now be over, at Wesfarmers we are told the good parts (the supermarkets) can carry the whole enterprise. At the miners we are told the cash — but only as special dividends — will flow.

Dominoes, BlueScope and even the perennially disappointing financials such as QBE are just plain misunderstood and will come right ... just wait.

Very little of this commentary is convincing, except perhaps that CSL has been oversold by a market which made predictions for it that were never justified.

All up it suggests every investor should take a very hard look at what they used to regard as core shareholdings, regardless of what their stockbroker might be telling them.

It is not by any means an argument for ETFs or index funds — in fact, this earning season suggests ETFs underpinned by the market leaders will be offering modest returns in the months ahead.

But it is a strong argument for focusing on the very best stocks and not taking the wider notion of a "market" or an "earnings season" as anything that should dictate your investment outcomes.

Same-sex couples already get equal treatment under superannuation laws

MONICA RULE

While the protracted debate over same sex marriage goes to a postal vote the superannuation system sorted all this out — financially — almost a decade ago.

Whether you are married, in a de facto relationship or in a same-sex relationship, the superannuation law does not discriminate: Same-sex couples receive equal treatment.

In 2008 the super law was amended to treat everyone as equal regardless of whether they are married, de facto heterosexual couples or same sex. The law extended the definition of "spouse" — which up to that point only included opposite sex partners.

The expanded definition includes another person (whether of the same sex or opposite sex) with whom the person is in a relationship that is registered under a certain state or territory law. It also includes another person who, although not legally married to the person, lives with the person on a genuine domestic basis in a relationship as a couple.

A same-sex couple is treated in the same way to a married or de facto heterosexual with regards to their super entitlements.

Separately, in 2008, the family law was also amended to broaden the definition of "de facto" to include same-sex relationships.

The inclusive nature of the legislation has implications across a range of aspects in super.

Contribution splitting

Same-sex couples are eligible for super splitting which allows a same-sex partner to transfer 85 per cent of their concessional (before tax) contributions into their spouse's super account. This has become more popular since July when the $1.6 million limit was placed on retirement pension accounts. Splitting super between couples allows couples to "even out" their retirement pension accounts and super balances, which may enable them to make further contributions. A member (of any age) can split their contributions with their spouse, as long as the spouse is under the age of 65 and not retired from the workforce.

Couples are all equal under superannuation laws

Contribution tax offset

Same-sex partners can make non-concessional (after-tax) contributions of up to $3000 on behalf of their spouse and be entitled to a maximum tax offset of up to $540 if their spouse's assessable income (including total fringe benefits amounts and reportable employer super contributions) for the financial year is less than $40,000. To be eligible for the full tax offset, the spouse's annual income must not exceed $37,000. The tax offset gradually reduces once the spouse's income exceeds $37,000 and cuts out altogether once the income reaches $40,000.

Running a SMSF

Generally, a person cannot be in a self-managed super fund with another person that they work for, unless the person is a relative of the other person. A curiosity of the current arrangement is that as same-sex couples are considered related, they can be in an SMSF together if one works for the other. Because a same-sex partner is considered a "relative", their SMSF cannot lend money to a member or a relative of a member.

Death benefits

Same-sex couples are eligible for death benefits from their deceased partner's super fund. They do not need to pass special tests confirming that they had an "interdependent" relationship or a financial dependent relationship. This includes the former spouses of same-sex couples.

Breaking up

Same-sex de facto couples in most States and Territories are covered by the Family Law Act 1975 and have the same rights as heterosexual de facto couples in the event of a relationship breakdown for the division of assets and super.

Monica Rule is an SMSF specialist and author of The Self Managed Superannuation Handbook

My wife and I have used superannuation as our primary savings vehicle for retirement. Due to the value of our accumulated superannuation, apart from employer contributions we cannot put anymore into super. Should I consider insurance bonds?

From July 1 this year, individuals who have in excess of $1,600,000 in superannuation are ineligible to make further non-concession (after-tax) contributions to super. I assume you have each exceeded this cap. Note, employer or personal deductible contributions can still be made to your superannuation fund but only up to the concessional contribution cap of $25,000 a financial year.

Notwithstanding this limitation, superannuation remains a very tax-effective way to save for retirement and to receive tax-advantaged income in retirement. The maximum tax payable on earnings within superannuation is 15 per cent when in accumulation mode and 0 per cent when transferred to an account-based pension in retirement. However, there are limits and constraints with superannuation that you need to consider.

To contribute to superannuation an investor needs to meet eligibility rules. This requires the investor to be under the age of 65 or, if aged 65 to 75, they need to satisfy a work test of working 40 hours in a 30-day period within the financial year prior to a contribution being made.

Access to superannuation money is restricted until a "condition of release" is met. This generally means that the investor will not be able to withdraw or use the money until they have reached "preservation age" and have retired or suffered permanent incapacity. Preservation age is 56 for an investor born before July 1, 1961, but increases progressively up to age 60 for those born after July 1, 1964.

An alternative or supplement to investing in superannuation is to invest in insurance bonds or investment bonds. Like superannuation, tax is paid within the insurance bond rather than personally by the investor.

Insurance bonds are attractive investment options for investors with taxable income above $87,000 (whose marginal tax rate is 32.5 per cent or higher) or investors looking for simplicity. Earnings within insurance bonds are automatically reinvested and tax is paid within the bond. The maximum tax paid on the earnings and capital gains within an insurance bond is 30 per cent.

Unlike superannuation, there are no restrictions on accessing the proceeds of an insurance bond. Proceeds can generally be withdrawn within five working days.

Insurance bonds provide a range of investment options to tailor a portfolio to your needs. Investors can usually switch between a range of investment options within a bond without triggering capital gains tax.

If an insurance bond is redeemed after 10 years of establishment, the proceeds are generally tax-free. If the bond is withdrawn within the first eight years, 100 per cent of the growth in the bond is taxable. In year 9 of the bond, two-thirds is taxable. In year 10 of the bond, one-third is taxable. Where the bond is withdrawn within 10 years, the investor receives a 30 per cent tax offset on the taxable growth in recognition of the tax paid within the bond.

There is generally no limit on how much can be invested in insurance bonds. Future contributions to a bond can be up to 125 cent of the previous year's contribution without restarting the tax-free period.

On death, the proceeds of an insurance bond can be directed to a nominated beneficiary or to your estate. Proceeds are tax-free to all beneficiaries.

Superannuation remains a tax-effective method of funding retirement. However, for those who are restricted in making future contributions to super or have personal marginal tax rates above 30 per cent, insurance bonds or investment bonds are well worth considering.

Visit the Wealth section at www.theaustralian.com.au to send your questions to Andrew Heaven, an AMP financial planner at WealthPartners Financial Solutions.

Local 'pot stocks' run out of puff, as medical cannabis firms have plenty of work still to do

TONY KAYE

Investors in Australia's listed medicinal marijuana stocks know all too well that market highs don't necessarily last.

Many of those who bought into the sector early, before the federal government legislated in March this year to make the prescription of medicinal cannabis legal in Australia, had a chance to treble their investment if they sold quickly.

Among them were shareholders of Zelda Therapeutics — which does research in the use of medicinal cannabis to treat a variety of ailments including sleep disorders, dermatology conditions and cancer — who watched at one stage as the value of their holdings jump close to 500 per cent.

Similarly, investors in MGC Pharmaceuticals, which grows marijuana for medical purposes, and those in Stemcell United, which is focused on plant stem cell biotechnology, experienced gains of more than 400 per cent.

AusCann Group, which has been licensed to manufacture and supply medicinal cannabis and ranks as the biggest local so-called "pot stock", with a current market worth of $150 million, rocketed from an issue price of 20c to a high of 94.5c, just shy of a 400 per cent return. Medlab Clinical, which is developing cannabis-based medicines, Creso Pharmaceuticals, which is researching cannabis and hemp-derived therapeutic products and treatments for humans and pets, and MMJ Phytotech, which makes cannabidiol capsules, were also in the 350 per cent-plus return league.

But after soaring into the stratosphere soon after the change to the Narcotic Drugs Act 1967 to decriminalise the use and supply of medicinal cannabis, the share prices of the dozen or so companies on the ASX associated with the industry seem to have run out of puff.

On average the "pot stocks" are down more than 40 per cent from their peaks, with several down by more than 60 per cent since March. Even still, most are still well up on their listing prices.

In a nutshell, it's still very early days here. In what has been termed by biotechnology analysts as the "green rush", investors in Canada and the US have been pouring billions in capital into listed companies involved in the research and development of marijuana products, including drugs, creams, food, and hydroponics systems. Law changes in both nations have seen a proliferation of listings over recent years.

Now, with more than 300 stocks already listed in North America, the cannabis-associated sector there is on track to achieve a compound annual growth rate of 25 per cent until 2021. By then the market is expected to top $US20.2 billion ($25bn) in value. In April, the first marijuana exchange-traded fund was listed on the Toronto exchange. By comparison, Australia's market is much smaller, with the stocks listed on the ASX collectively only worth about $600m.

The majority, involved in medicinal cannabis research and development, are yet to generate any revenue, let alone turn a profit for their shareholders. And they are competing against scores of other companies overseas, some doing very similar research.

A threat to the industry in the US could be any meddling at the federal level by President Trump and his Attorney-General, Jeff Sessions, who both oppose state laws legalising marijuana use. "I think our stocks may have sold off on the back of that," says Zach Riaz, a director of Banyan Tree Investment Group, adding that profit taking has probably also contributed to the recent pullback.

"I think existing investors who are still there from the IPOs are now waiting for management to successfully execute on their strategy (clinical trial results etc) and other investors are waiting on the sidelines to see what business models will last before they start putting their money into the sector — essentially they want to see a track record," says Riaz.

That's likely to be some way off, given most, if not all, cannabis-related stocks listed on the ASX have a lot of work to do. As such, we can expect the share prices of these stocks to remain volatile and investor turnover to be high.

With all cannabis stocks having different business models, their growth profiles will vary. Some have gone down the path of growing and supplying cannabis, but investors need to consider how government bodies may regulate this supply and what that means for the overall market.

Riaz says that significant deregulation, allowing for the granting of more licences to grow and supply cannabis products, is likely to lead to marijuana becoming a highly commoditised, low-price, high-volume, product. He notes some ASX-listed cannabis businesses have gone down the "regulatory light" path, such as skincare, which is quicker to market, has lower price point products and relatively low capital intensity. "Others are focused on tapping the highly lucrative market of big pharma and are looking to prove marijuana applications in the treatment of diseases such as cancer and epilepsy."

Riaz says this is highly regulated, very capital intensive and requires many years of trials before any revenue may be derived. In other words, a lot can go wrong.

"Investors need to decide which business model offers the best risk/reward," Riaz says, "and while the overall industry appears to have a bright future, as it stands today execution risk at the individual company level is high and investors should regard them as highly speculative."

Tony Kaye is the editor of Eureka Report, which is owned by financial services company InvestSMART. www.investsmart.com.au