If you can't beat the banks, join 'em

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Instead of putting your money in the bank, why not just buy a bit of it?

David Potts reveals why having a stake in a lender is so much more profitable than being its customer.

We're told the banks are putting profits before jobs, which is fine by me. And that they won't pass on this week's expected rate cut either. Even better.

Treating the bank as your friend rather than the enemy can pay dividends. Lots of them.

A slice of the action

Bank	Dividend	Likely this year	2013-14 forecast
ANZ	$1.40	$1.48	$1.61
Bendigo & Adelaide Bank	60c	60c	64c
Bank of Queensland	54c	69c	79c
Commonwealth Bank	$3.20	$3.39	$3.76
NAB	$1.72	$1.88	$2.09
Westpac	$1.56	$1.6	$1.82

Source: RBS Morgans

So instead of putting money in the bank, it might be better to buy a bit of it. You'll be mates in no time. I can tell you, a shareholder gets paid a lot more than a customer.

In what should have been a bad year, the banks made record profits. Again. That was despite the money they raise to lend becoming more expensive and fewer borrowers.

It just goes to show, there's a lot to be said for all but obliterating the competition.

Dividends are so large - and tipped to get even bigger - that not a few fund managers and financial advisers see the annual pay-out as being worth more than anything the share price is likely to do.

No wonder. If you had bought shares in a bank on Friday, the return from its dividends would be about 7 per cent - way more than it pays savers. But that's only the half of it. The dividends are franked so come with a 30 per cent tax credit - no questions asked.

In fact, for every $100 in dividends you receive, a maximum of another $43 could come your way from the Australian Tax Office. Or should that be $30? No, that's the minimum. On a marginal rate of 30 per cent, you're square and keep all the dividend. Pay no tax (such as retirees over 60 who are drawing down a super pension) and you get the whole dividend, plus the $43.

Technically, the $43 is added to the $100 and then your marginal tax rate is applied. I know, it's convoluted but it seems to work just fine refunding the 30 per cent tax the company has paid, so just grin and share it.

This all adds up to bank shares yielding about 10 per cent a year from the dividends.

Even on the top marginal rate, a bank share yields 5.3 per cent after tax. Compare that with the interest on a term deposit, taxed at your normal marginal rate. You wouldn't get much more than half that.

This might change one day, since the government said it would halve the tax on interest up to $500.

But, what with budget constraints and all, this has been put off to July next year - and who's to say this lot will still be around by then?

Getting double digits on something as safe as a bank sounds too easy but you can get even more on something as safe as Telstra, so maybe you just have to accept that the market is mad.

Then again maybe it doesn't expect the dividends to stay so high, which is why the share prices are so low - only that's not what banking analysts are saying.

On the contrary, unless the debt crisis in Europe drags the world into another recession - ah, of course, that's what's worrying the market - the banks' dividends will rise, not fall. Especially as they're almost self-financing.

Depending on the bank, between 20 per cent and 40 per cent of dividend pay-outs boomerang back into retained earnings. That's some trick. The secret is, that's the proportion of shareholders who take more shares in lieu of the dividend.

That shouldn't be so good for the share price, only the banks have that sewn up. What's not paid out in dividends can earn interest, making higher payments possible later.

Often the reinvestment scheme will also be underwritten, with new shares sold to pay those recalcitrants who insist on their cheque. How's that for sneaky?

Not that the banks' profits are bulletproof. They would be vulnerable to a prolonged economic slump, so there's no denying shares are risky.

However, the head of banking research at Morningstar, David Ellis, thinks the share prices are sustainable.

"There have been negative headlines looking at funding costs, credit growth and the rebound in bad-debt expenses," he says.

"But they [banks] have a number of levers to mitigate the funding-cost effect. If there's a rate cut, I'd expect the major banks to pass on only half of it.

"Credit growth is weak but not disastrous. It's stabilised and improving slightly. And the banks are cutting their cost base. It's hard to see what could cause a cut in dividends," he says.

If nothing else, the high-dividend yields must put a floor under the share price. But the banks are as susceptible to market mood swings as any other stock so if you're going for the dividend yield, it's crucial to have a long horizon so fluctuations in the share price won't matter.

Still, on the dividend alone, after the tax credit, your return is going to be between 8 per cent (Commonwealth Bank shares) and 10 per cent (NAB and Westpac) and is predicted to reach as high as 12 per cent by 2013-14. That's the average return from the sharemarket over the years anyway so any price gains will be a bonus.

There's also the tantalising prospect of a special dividend or buy-back when the new capital rules imposed by the Basel III convention are introduced in a few years because it appears the banks will have more capital than they will know what to do with.

Confusion about exactly what their capital requirement will be has helped depress their share prices.

You've seen how Europe is handling - or, rather, isn't handling - its debt crisis so you can imagine the politicking going on over how the world's banks should best be regulated.

But it seems any regulations won't be so onerous after all. Thanks to their huge new share issues during the global financial crisis - a reminder of how share prices, as well as dividends, can collapse - the banks could have too much capital.

There will also be new liquidity requirements, including a 0.15 per cent annual fee to the Reserve Bank.

While the Basel III rules are "incredibly bank-friendly", according to leading banking analyst, CLSA's Brian Johnson, the trouble is a second part set by the Australian authorities.

"We will never know what the capital requirement will have to be because pillar one is what you see but pillar two is a regulatory overlay that will require a buffer that we never see."

Even so, he expects a couple of years down the track, the banks will have surplus capital, helped by the slow growth in lending.

But the lower lending growth will play on the banks' profitability. Because the market likes colour and movement, the banks will look sluggish next to other stocks.

The chief investment officer at Platypus Asset Management, Don Williams, says the banks' earnings outlook is "terrible".

Yet Platypus has stocked up on bank shares, despite preferring to hold none at all, because of the high yield and the fact they do well in the early stages of a market take-off.

"We'll use them to fund other industrials later," Williams says. Now there's an idea - sit in bank stocks until the market takes off.

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