Switzer Super Report

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Merry Christmas!

A reader recently asked me why I would support Peter Thornhill's article in the Switzer Super Report that said shares aren't risky investments, so today I give you my two bob's worth.

I'd also like to extend a warm welcome to Tom Elliot, who today joins the Switzer Super Report with his monthly takeover target activity video. Make sure to take a look. Plus, Ron Bewley examines the Industrials sector and, as always, tells you how he's playing it, and James Dunn takes a look at the best performing consumer discretionary stocks and whether they belong in your SMSF.

Also, this will be the last report out before Christmas and we'll return on Thursday next week. Wishing you all a very Merry Christmas!

Sincerely,

Peter Switzer

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36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

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Why dividends make good stocks safer

by Peter Switzer

There are two investment rules you cannot break if you are to run your own investments inside a self-managed super fund. The first is you need a great investment strategy and the second rule is you have to stick to your strategy unless your circumstances change.

Jack Bogle, the US legend of finance, who created a 'little' business called Vanguard, has often said: "Buy right and sit tight!" Stockbrokers hate this advice because it undermines how they make money – having clients that chop and change trying to buy right and 'sell right' – but that is a difficult game.

Lots of fund managers do this or try to do this and this is why the majority of them don't beat the S&P/ASX 200 index.

A few weeks back, I supported an article by Peter Thornhill who argued Ken Henry was wrong trying to push people too heavily into bonds and out of stocks. Peter and I don't like non-dividend paying stocks because we play safe with stocks a stick.

It means when cyclicals go mad along with the stock market, our returns will look conservative, but we are trying to take out the big swings in stocks that can decimate your capital and deliver a collapse of dividends.

A subscriber – M. Lai – disagreed with us saying that dividends fall too when a big market crash happens, but I say yes – but some don't fall by much.

Stable dividends

Thornhill's retirement portfolio is all dividend stocks and he keeps a cash buffer for any bad year or two to make up for when dividends fall by a bit, but good companies' dividends, especially if you hold 20-30 of them don't fall by much.

Let's look at CBA over 2000-2012, which had two market crashes – one from 2000-2002 and the global financial crisis from 2007-2009.

In 2001, the annual dividend was $1.33; 2002 was $1.43, then $1.51, $1.64, $1.89, $2.06, $2.37, $2.62, $2.66, $2.75, $3.02 and in 2011 it was $3.25. It always went up and Westpac had a similar story except for 2009.

Let's look at Westpac from 2007-2011. Its dividend went like this: $1.31, $1.42, $1.16, $1.39 and in 2011 it was $1.56. Sure 2009 was disappointing, but there was a quick comeback.

In fact over the toughest years since the Great Depression, Westpac started paying dividends in 2007 or $1.31 and averaged a dividend of $1.37 over the five years.

Share prices vs dividends

The case is proven that good companies sustain good dividends and the dividends don't collapse like share prices. Let's look at Westpac's share price over 2007-2011.

In 2007, Westpac's average share price was $27 and the dividend was $1.31 or 5%. When the price fell to $17 on average, the dividend rose to $1.42 or 8.3%.

If someone had dollar-cost averaged and bought Westpac at $17, they would have offset a lot of their capital losses, but most people got scared and rushed to term deposits.

During that time, I was arguing that good stocks for long-term investors were great value. Media personalities interviewing me would then ask what stocks people should buy. I have to admit, I was not

sure about many companies, but I always said to buy the banks, which were regarded as some of the safest in the world.

Buy right and stick tight, and let me add – don't be afraid to buy when markets panic and all stocks – good and bad – fall. But you can wait for a turnaround in the trend of panic before jumping in. I must admit this is tricky, but as long as you are buying right, then it's OK.

Worth a million

A New Yorker, Anne Scheiber, who retired from the Internal Revenue Service (IRS) in 1943, lived to 101 years of age mainly on social security and a small pension from her working days. She lived in a rent-controlled apartment in a bad part of town and went to the New York Public Library to read the Wall Street Journal. She had few material possessions and died pretty poor-looking.

However, when her will was read out, the Yeshiva University was left $22 million! History showed she had bought great American brand name companies, re-invested her dividends and her $5,000 savings she had when she left the IRS certainly snowballed!

Scheiber had a great investment strategy and she stuck to it.

This story is my Christmas gift to all of our subscribers. Have a great Christmas!

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The outlook for six takeover targets

by Tom Elliot

View attached video »
[This is a transcript of a video report]

There's some very interesting share market situations that we are paying close attention to. Now the first of these is **GrainCorp (GNC)**; it's in our takeover target portfolio. Graincorp has had two bids from US giant Archer Daniels Midland. The GrainCorp board has rejected even the higher bid of $12.20 per share, plus a recent 35 cent per share dividend has been inadequate and materially undervaluing the company. ADM has bought just under 20% of GrainCorp now, so it is very committed to this transaction and I do think that a price of $13 a share is quite attainable in this particular takeover battle. We will have to wait and see.

Another one we're paying close attention to is **Echo Group (EGP)**. There's a couple things going on with this; on the one hand you've got James Packer trying to convince the NSW State Government to give him a second casino licence for Sydney. On the other hand, both Packer's Crown corporation and Malaysia's Genting have applied to the regulators in both NSW and Queensland to increase their respective stakes in Echo to 25%. We've recently reduced our holding of Echo a little bit but I still think there's a bit more to come in this particular situation. Genting in particular I think remains committed to taking a bigger stake in the company.

More recently we've seen some activity in the property trust market; **General Property Trust (GPT)**, which has a near death experience during the global financial crisis has come out swinging. This time it's made a a bid for about three-quarters of the assets of fellow real estate company, Australand. Australand at the moment is yet to respond to the bid, but GPT seems comfortable borrowing billions of dollars and presumably doing equity raising to buy other real estate assets and this must mean they see the market as looking fairly good over the next year or so.

Sundance Resources (SDL), this is one I think people should take away from; Hanlong is the bidder and they do not seem capable of raising the money to go ahead with this bid. Who knows, they might yet do it, but the signs aren't particularly good.

Arrium (ARI) is a stock we've been in and out of a couple of times. We know that a consortium made up of Posco and Noble took a very close interest in this. They made an initial bid of around 75 cent and they lifted it to 88 cents. They've said they've walked away, but I've noticed that the Arrium share price has just gone above 88 cents and I just wonder is Posco and Nobel are still having a close look at this company.

And finally, **Australian Infrastructure Fund (AIX)**; they've released a lot more details on the takeover of their assets by the Future Fund. The timing and the quantum of the payments is very well known now and there's some extra franking credits that it's thrown into the mix and we think that at around $3.16-$3.17 Australian Infrastructure Fund represents an excellent yield-to-maturity or internal-rate-of-return style of investment.

Anyway, Happy Christmas and I look forward to your company again in 2013.

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Do these strong performers belong in an SMSF?

by James Dunn

The difficulties just seem to keep mounting for Australian retailers.

There is the high Australian dollar, which is seeing business sucked offshore by overseas websites. Research firm IBISWorld expects Australian online shopping turnover to grow by 5.1% a year over the next five years (some of it on Australian websites), although this is coming off a low base: NAB estimates that online retail represents only 5% of the local industry's total business.

There is the high cost of doing business in Australia, including some of the highest rents in the world – Westfield's Pitt Street Mall in Sydney CBD is ranked as the second most-expensive retail location in the world – and some of the steepest staff costs in the world, especially on weekends and public holidays.

There is the flurry of big-name overseas competitors that have opened in Australia in recent years, including GAP, Costco, Banana Republic, Zara and Topshop.

And then there is the persistent conservatism of Australian consumers – despite solid wages growth, stabilising house prices and official interest rates that have shed 1.25 percentage points since last Christmas.

Given the fact that Australia's economy – despite a clear bifurcation between the resources sector and the rest of the economy – is growing at a rate that the rest of Australia's OECD peer group of nations can only envy, it is this "glass-half-empty" attitude among Australia's shoppers that is proving to be the retailers' number one problem.

On the latest Australian Bureau of Statistics figures, retail trade was flat in October after rising by 0.5% in September and 0.3% in August. Annual spending growth fell in October from 3.5% to 3.1%.

No wonder the Christmas-New Year sales period is so eagerly awaited by the nation's shopkeepers!

Winners and losers

Since the GFC hit, the retail sector has largely struggled, but there have been pockets of success.

Discount variety retailer The Reject Shop (TRS) has been a standout, generating a total return of about 7.7% a year over the last five years. The Reject Shop has a business model that suits the times, and has expanded its store network significantly through the GFC. In 2013 the company will augment its expansion by taking over the leases for a number of stores of the failed discount variety retailer, Retail Adventures.

The share price has moved from $12.30 five years ago to $15.14 – via a peak of $18.40 in October 2010 and a trough of $9.12 in September 2011.

At the other end of the retail business, luxury goods retailer Oroton (ORL) has also been a stellar performer, generating a total return of about 21.7% a year over the past five years, and 10.8% a year over the last three years. Oroton's share price has moved nicely from $3.90 at the end of 2007 to $6.95 at present.

Super Retail Group (SUL) – owner of Supercheap Auto, sports retailer Rebel Group and outdoor activities chain BCF (Boating, Camping and Fishing) chain – has also kicked some big goals under pressure, generating a total return of 24.3% a year for the past five years and 29% a year over the past three years.

In contrast, retail icons such as JB Hi-Fi (JBH) and

Harvey Norman (HVN) have struggled, going backwards in total return over both three and five years (Harvey Norman is down a stomach-churning 19% a year over five years and 20.4% a year over three years.) It is in this pair's electronic appliances business specialities – and furniture and bedding for Harvey Norman – that consumer reluctance to spend is most noticeable, although JB Hi-Fi, for example is a far more efficient operator than most of its overseas peers.

The yields

On yield grounds – which concerns SMSFs most pressingly – some stocks in the sector are attractive at first glance, but earnings risk (and thus dividend risk) is very high in this area. For example, JB Hi-Fi is expected by market consensus to pay 65.4 cents a share in dividends in the 2013 financial year, rising to 68.3 cents a share in FY2014.

At $10.24, that prices JBH on a prospective FY2013 nominal yield of 6.35%, and 6.67% for FY2014.

That is starting to get into attractive territory for an SMSF because the FY2013 nominal yield converts to 7.71% for a fund still accumulation, and 9% for a fund in pension mode (and paying no tax.)

The FY2014 yield converts to 8.1% for a fund in accumulation mode and 9.5% on a pension income stream.

Oroton, too, has a hefty 8.16% nominal yield projected by the market consensus for FY2013 on the expected dividend of 56.7 cents, which is expected to fall to 41.1 cents in FY2014, generating, at a share price of $6.95, a yield of 5.91%.

The risks

Why Oroton's projections are all over the place – and why that 8.16% yield should be looked at askance – is that on 30 June 2013, Oroton will lose its exclusive licence agreement with Ralph Lauren Corporation, under which Oroton has distributed Ralph Lauren products in Australia and New Zealand for almost 25 years.

The Ralph Lauren licence (which the parent company is taking back) represents 32 of Oroton's 92 stores, 45% of its sales, and 35% of net profit. The sharemarket showed what it thought of the deal by stripping 25% off the value of the company when it returned to trading after the announcement in August.

It is not as if Oroton is going to subside into oblivion: the company says it will use the freed-up capital to expand its own brand into Asia, and look at opportunities from which it was barred while working with Ralph Lauren. Chief executive Sally Macdonald is considered one of Australia's best retail minds, and the company is arguably the most successful online operator of Australia's listed retailers, generating more than 10% of total sales through this channel.

The bottom line

The problem for an SMSF is that the earnings risk is too high – both at Oroton and JB Hi-Fi – for a fund to try to pick up on these yields. And sadly, neither The Reject Shop nor Super Retail Group, although gun performers, are exactly stand-out yield plays: TRS' expected FY2013 dividend equates to a yield of 2.76%, and while the FY2014 expectation is better, at 4.3% it is not stellar. Likewise, Super Retail is presently priced at a 3.93% yield in FY2013 and 4.71% in FY2014.

The headwinds assailing the retailing sector are not going away: and investors would be gambling to pile in before the effect of the critical Christmas-New Year season on the tills is seen. Sadly, retail is not a sector where SMSFs can invest for yield and sleep at night.

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Industrial stocks showing promise

by Ron Bewley

There are 13 stocks in the Industrials sector of the ASX 100 – ignoring the international drilling company Boart Longyear (BLY) that will exit the top 100 on December 21 after a big price fall.

The drivers for the Industrials sector are many and varied. There are a number of mining services companies listed on the ASX, but only Monadelphous makes the top 100 list and my list of 13 stocks. If you've been following my earlier articles in this series, you may recall that in my review of the Energy sector I chose to reallocate Worley Parsons from Energy to Industrials, but its rating of 2.6 precludes my selection of it at this time.

Only six of the 13 stocks in the table below (PDF readers, please see the last page of this article) have a recommendation (less than or equal to 2.5 – remember, the lower, the better) sufficient to warrant my consideration for including them in a high conviction portfolio. The largest, Brambles, which runs an international distribution network of pallets and plastic containers, fails to make my list. So the three biggest stocks by market capitalisation with a sufficiently good rating are: Transurban (TCL), Aurizon (AZJ) and Asciano (AIO).

There is a paper on www.woodhall.com.au under 'Market Updates' that illustrates my methodology and provides more detail on the statistics I use.

The top stocks

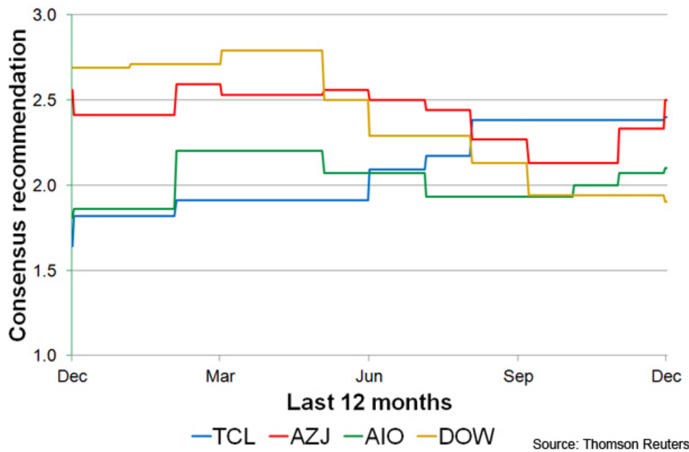
Transurban is an infrastructure company that owns motorways in Australia. Hence, price growth is not usually expected to be particularly strong, but the dividends are quite reasonable at 5.4%. Aurizon is a rail freight company based in Queensland and Asciano is involved in rail and port services. Downer EDI (DOW) is a much smaller company involved in engineering and infrastructure services, but it does have the best rating (1.9) of the 13 stocks in the top 100.

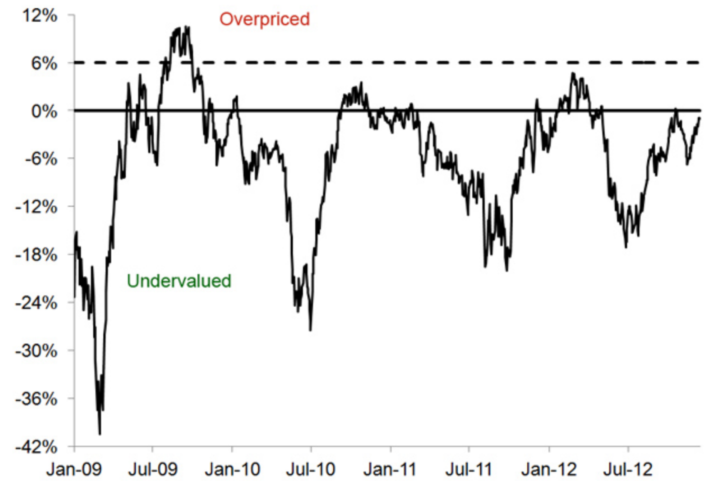
The sector as a whole looked quite promising at the beginning of the year, but it took a beating when the doom and gloom story about China emerged in mid-2012. It has always been my opinion that the China story was massively overdone and the prices of many stocks in this sector have improved markedly in the last few months. These wild price fluctuations have had a major impact on the relative market capitalisations. As a result, it might be worth considering other stocks outside the current biggest three with acceptable ratings.

My current forecast for capital gains for the Industrials sector over the next 12 months is a very respectable 14.5% with a forecast dividend yield of 4.6%.

I would never own an airline for so many reasons and so Qantas is not on my list – even though its rating is quite good (2.3); but SEEK (2.5), an internet employment services company, seems to have some merit.

The recent history of the consensus recommendations for TCL, AZJ, AIO and DOW are shown in Chart 1. TCL's rating has been deteriorating for much of the time and this trend is a concern. The ratings for AZJ and AIO have been reasonably stable. DOW's rating has improved strongly, which is why I have added it to my list for consideration.





Source: Thomson Reuters. Note: the estimates in the Figure are current to the close of business 14 December 2012. Please go to www.woodhall.com.au for more information on the assumptions behind the estimates.

The wild fluctuations in stock prices have led to the sharp changes in my measure of mispricing – exuberance – shown in Chart 2. I had the sector very underpriced at around -18% in the middle of 2012 and another good buying opportunity arose in mid-November. I currently have the sector priced at about par, which does not in my methodology, imply that one should not buy, but that there is no 'free kick' to accompany a buy at this point.

I don't currently own any of the stocks from this list, but I did once own some TCL. My current holdings are Boart Longyear (BLY), Bradken (BKN), and Emeco (EHL) – three mining services companies in the ASX 200. All three went down sharply with the sector on the China story, but all three are showing promising signs of recovery. If, as I believe, the world will look a lot stronger in coming months, these stocks prices might ride the wave back up.

Ron Bewley is the Executive Director of Woodhall Investment Research.

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Table: Data on companies in the ASX 100's Industrials sector

Company name	Ticker	Price	Price growth over quarter	Price growth over year	Price target low	Price target median	Price target high	Concensus rec.	No. of brokers	12-month forecast yield	12-month forecast P/E	Market cap. share
BRAMBLES	A:BXB	7.35	8.9%	2.1%	7.07	7.89	9.71	2.6	13	4.1%	16.3	16.4%
TRANSURBAN	A:TCL	6.15	3.0%	8.1%	5.60	6.18	6.50	2.4	15	5.4%	47.5	11.8%
AURIZON	A:AZJ	3.62	6.5%	2.0%	3.40	3.90	4.52	2.5	15	3.3%	16.4	9.6%
SYDNEY AIRPORT	A:SYD	3.47	10.5%	23.9%	2.95	3.15	3.55	3.2	12	6.3%	38.4	6.0%
ASCIANO	A:AIO	4.51	3.2%	-1.7%	4.60	5.20	6.10	2.1	14	2.4%	12.1	5.4%
TOLL HOLDINGS	A:TOL	4.59	-3.4%	2.9%	4.55	4.86	5.15	2.7	13	5.7%	10.7	4.8%
ALS	A:ALQ	9.61	10.2%	-2.5%	8.20	9.15	12.73	2.8	17	4.8%	14.1	4.7%
LEIGHTON	A:LEI	16.82	-1.3%	-14.6%	15.66	18.38	21.90	2.7	16	6.5%	9.4	4.1%
QANTAS AIRWAYS	A:QAN	1.40	12.5%	-8.2%	1.31	1.50	1.88	2.3	13	1.4%	10.3	3.8%
MONADELPHOUS	A:MND	22.50	13.4%	17.7%	18.00	23.50	27.86	2.6	15	6.7%	13.0	2.9%
SEEK	A:SEK	7.05	5.1%	14.3%	6.00	7.23	8.45	2.5	20	3.1%	15.2	2.7%
UGL	A:UGL	10.69	-0.7%	-14.4%	9.50	12.21	13.65	2.8	17	6.9%	10.2	2.7%
DOWNER EDI	A:DOW	3.82	6.1%	17.5%	3.73	4.35	5.02	1.9	17	3.1%	7.7	2.5%

Source: Thomson Reuters. Note: the estimates in the Table are current to the close of business 14 December 2012. The price target is the brokers' forecast of where the stock price is heading, often considered to be in the next 12 months.

Did you know?

The Switzer Super Report will be slowing down a gear over Christmas and the New Year, with two special holiday editions to be delivered to your email inboxes once a week on Thursday over the next two weeks.

Keep an eye out for the report on:
- Thursday 27 December – our final edition for 2012; and
- Thursday 3 January – our first edition for 2013!

There will be no report sent on Monday 24 December or Monday 31 December. We'll return to our normal twice-weekly reports starting Monday 7 January.

From all of us here at the Switzer Super Report, we wish you a very Merry Christmas and a great New Year! Here's to many happy returns in 2013!