Switzer Super Report

Issue 154, 24 January 2013

Stocks to rise?

Predictions for the local market have ranged from a 10% gain to 40%. We should at least beat 5,000. Today, I address concerns about the market in 2013 and explain why stocks are a dead set goer.

Also in the newsletter, Gavin Madson explains how to earn higher returns for funds 'trapped' offshore by the strong Aussie dollar. James Dunn puts AGL and Origin head to head. Andrew Bloore completes his super system improvement wish list, and Ron Bewley reviews the consumer staples sector.

Sincerely,

Peter Switzer

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Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
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Stocks in 2013 a dead set goer!

by Peter Switzer

The plethora of questions from subscribers is so significant I thought it was time I formally addressed the underlying concern about stocks in 2013.

One subscriber cashed out ahead of the fiscal cliff ballyhoo because he was off overseas on holidays and now wants to know if he should pile back in or wait for a buy-in opportunity.

Another is a potential retiree who is thinking of staying on at work to cash in on the expected run up of stocks, but he wants my thumbs up on the idea.

Now as a financial adviser, what follows cannot be taken as advice as I don't know the individual circumstances of my subscribers, but let's just regard it as "enlightened personal investment education". And I will answer the questions in terms of how I'm investing for 2013.

Stocks to break through 5,000

As a starting point I reckon the local S&P/ASX 200 index will break through the 5,000-level some time this year and I wouldn't be surprised if it went as high as 5,200 but this is only a guess.

I think a 10% pick up is a shoe in and there are the likes of one-time bear, Matt Kidman of WAM, who would not be surprised if a 20% return bobbed up.

Last year, research ace, Phil Ruthven of IBISWorld said it's highly possible we could see a bounce back year on the market of 40%, but I won't be associated with such massive calls.

I'm hoping for 10% but wouldn't be surprised to see a total return of 20% including dividends.

I suspect there will be a testing of this rally around March when the debt ceiling issue becomes big news in America, but I see these issues as solvable and even the Republicans have recently agreed to accept a higher debt ceiling.

Out of the blue

However, I never underestimate what comes from left-field, but for 2013 with the US and China recoveries looking very believable, money supply being stretched from Europe to the USA to now Japan, with interest rates so low which will make stocks look very appealing, and Mario Draghi, the ECB boss, telling us to look out for a positive contagion, I have to punt on stocks.

Two good years

Deep down I see two good years for stocks and after that I will be checking where term deposit rates are, but for the moment I'm a stocks guy.

This week I hosted a conference where John Noonan, the senior analyst with Thomson Reuters, who is a conservative market expert and who is not long stocks right now, said he thinks our index will beat 5,000 this year.

Given we are around 4,790, that's a 210-point gain or a 4.4% rise. If we throw in dividends, we could easily gain over 10% in stocks next year. If we crack 5,200, that would be an 8.6% rise, and if we throw in 5% for dividends, there's 13.8%. And if you're in retirement with the no tax zone, we're talking a 15% plus gain for the year.

In response

For my subscriber who wants to work on and build up his super, I think his inclination to roll the dice on super and the stock market makes sense.

As for my cashed out subscriber, timing the market for a correction around May, hoping for the old "sell in May and go away" might pay off but this generality does not always work out. This could be an odd ball year and so getting in and staying in might be the best bet but it's a gamble and being a timing tipster can be fraught with danger.

I think it's a dead set goer stocks will rise this year, but on whether the market will have a big fall to create a great buying opportunity, I can only give a definite maybe.

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How to earn higher returns on 'trapped' offshore funds with two Australian banks

by Gavin Madson

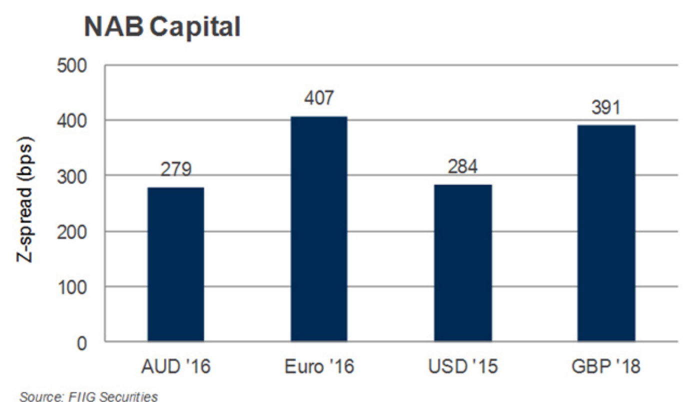
With central banks globally looking to keep rates lower for longer, it can be difficult for investors with funds 'trapped' overseas by the high exchange rate to find a decent return. Here I'll show two examples of where you can earn higher comparative returns than you can in Australia from names you're familiar with.

I often hear clients talk about how they have money 'trapped' overseas earning low returns from term deposits in low interest rate environments like the US and the UK. They'd like to bring their money home however the strong Australian dollar makes that difficult, so, as a result, the cash is stuck earning term deposit rates in some case as low as 0.25%. They would like to earn more on their money, but with equity markets remaining volatile and offering low returns in jurisdictions like Europe, they'd like an alternative.

The nature of the bond market, and in particular for the large issuers like financial institutions, is that issuers need to raise funds in several markets, not just their home country. So names that you're familiar with, and that you may already own, may also offer a fixed income alternative in other jurisdictions and, in many cases, may offer a better comparative return.

NAB Tier 1 hybrids

An example of this is National Australia Bank, which issues a number of Tier 1 hybrids globally. While they have differing maturities, the underlying credit risk across the jurisdictions remains the same. The Australian dollar issue with a 2016 maturity is offering a z-spread* of 279 basis points (bps), the comparable Euro denominated issue, also maturing in 2016, is offering a z-spread of 407bps! That's an extra 1.28% simply because analysts in Europe don't know who is National Australia Bank. NAB also has similar offers in US dollars and Pound Sterling. A spread of 407bps is certainly more impressive than the deposit rates on offer in Europe at the moment.

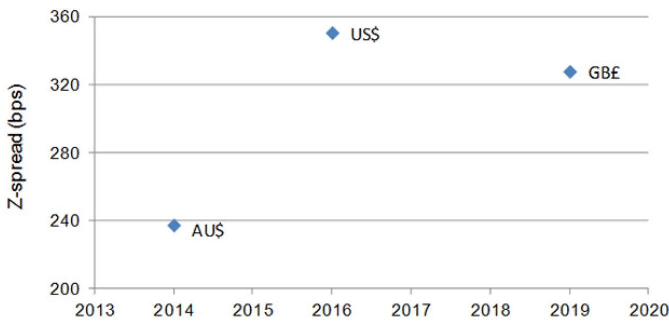


**z-spread is often used to compare issues across different jurisdictions as it takes into account the relevant treasury curve for the particular currency, allowing investors to compare apples with oranges.*

The Rabobank Tier 1 issues

This feature isn't unique to the NAB Tier 1 issue. Another example is Rabobank, which has a number of Tier 1 issues of various maturities. It's worth nothing that the Australian dollar issue is the shortest maturity, but I feel the extra return on offer in the US dollar and pound issues more than compensates investors.

Again, the US and Pound Sterling issues provide investors with the option to earn strong returns from a very low risk issuer. These spread differentials are unlikely to remain an ongoing feature and we'd expect to see some convergence as global markets settle down. Conveniently, this is likely to coincide with reversion of the Australian dollar exchange rate giving investors the opportunity to earn better returns in the short to medium term while waiting for the opportunity to repatriate funds.



Source: FIIG Securities

Other offshore hybrids

I've chosen to highlight just two issues today, but there are many others: the other Big 4 banks all have offshore issues; energy companies Origin and Santos both have offshore hybrids, which are offering better comparative returns than their Australian equivalents; large international issuers like Swiss Re and AXA have issues offering similar spread differentials.

There's no need to settle on low returns from your offshore funds. These issues offer strong returns for comparatively low risk issues and should be a prime consideration for investors who either have offshore funds, or access to offshore funds.

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Battle royale: AGL vs. Origin – which won't shock you?

by James Dunn

Last week we looked at gas, and the export outlook for LNG. This week we're going back down the pipe, to the business of supplying energy to households, where it's a battle royale between arch-rivals, the big diversified utilities AGL Energy (AGK) and Origin Energy (ORG).

As it happens, Origin has a finger in the LNG exports pie, too, but we'll get to that later.

Origin clocks in as Australia's largest integrated energy company, with four million customers and a 33% market share. Its portfolio of base-load, intermediate and peaking electricity plants has a capacity of 6,000MW and a 13% market share. Origin also owns 53% of Contact Energy, New Zealand 's second-largest integrated energy company, and 37.5% of the Australia-Pacific LNG (APLNG) project being built in Gladstone in Queensland.

AGL Energy is the number two retailer of electricity and gas, with more than 3.5 million retail customers in the eastern and southern Australian states, giving it a 27% market share. It also generates about 6,000 MW of electricity.

For history buffs, AGL was founded as The Australian Gas Light Company in the first year of the reign of Queen Victoria – in 1837 – and lit the first gas street light in Sydney in 1841. It is one of the oldest companies listed on the ASX, with an original listing on January 1, 1871.

In contrast, Origin Energy was established in 2000, when Boral spun off its energy business from its building and construction materials business. As is often the way with such things, selling off the energy business just before the China boom caused a shortage of energy around the world, looks an awful decision now: the division that Boral did not want has grown into a company worth $13.3 billion, compared to Boral itself, at $3.7 billion.

For AGL, retail electricity generates about 40% of revenue, wholesale electricity about 25% and gas about 15%. In operating profit terms, wholesale energy produces the lion's share, at 61%, while the retail business contributes about 37%.

At Origin, the energy markets division generates by far the lion's share of operating earnings, more than 69%, with exploration and production and Contact Energy both producing about 14.5%, and the remainder attributable to APLNG.

Highly defensive stocks

The main investment attraction for both AGL and Origin is familiar to anyone who has ever played Monopoly: the cash flows utilities derive from providing essential services to households. The revenue and earnings flows from electricity and gas are considered highly defensive.

But those cash flows are also politically sensitive when prices rise, as has happened in both electricity and gas, for a range of reasons, including the carbon tax, the subsidies flowing from the government's renewable energy target (RET) and the impact of rising gas exports from Australia on domestic prices. (International gas prices are about double what Australian households pay at present: the more gas Australia exports, the closer the domestic price must rise to the international price.)

Both AGL and Origin have fallen foul of state regulators in Queensland and South Australia, which have acted to regulate down retail prices and thus limit the retailers' margins. Both companies have downgraded their profit guidance for the current financial year, and wound back marketing and discounting activities in those states.

If the New South Wales government pricing regulator, the Independent Pricing and Regulatory Tribunal (IPART), were to follow the lead of its Queensland and South Australian counterparts, the impact on both companies' earnings would be material. For example, AGL has applied to IPART to lift gas prices by 10.4% in 2013-14. IPART's decision is due in May.

(AGL's long-term gas purchase contracts from gas producers are expiring over the next few years, leaving it fully exposed to the anticipated surge in gas prices.)

What's the difference?

Still, the pair's earnings from electricity generation and retailing should continue to prove defensive. Now let's look at what sets them apart.

AGL's standout difference is its renewable energy portfolio, consisting of wind, hydro, landfill gas and biogas. AGL's installed renewable energy generation capacity comprises around 27% of its generation portfolio. (It also owns the country's single largest emitter of CO2, the Loy Yang A power station in Victoria, but AGL says it will use the cash generated by Loy Yang – which came with the largest brown-coal mine in Australia, but also $2.25 billion worth of carbon tax subsidies and free carbon permits – to invest further in its renewables projects.)

Origin's difference is coal seam gas (CSG), which it has produced in Queensland for the last 12 years. AGL is also involved in CSG, but Origin is turning CSG into a source of export income through its 37.5% stake in the $23 billion APLNG joint venture, based at Gladstone in Queensland. (Origin intends to lower this stake to 30%.)

Origin's partners in APLNG are the project's operator ConocoPhillips (37.5%) and Sinopec, one of China's largest petroleum products suppliers and crude oil and natural gas producers (25%). The project will convert CSG to LNG based on Australia's largest CSG 2P reserves base, to supply both domestic contracts and export contracts with two of Asia's largest energy companies, Sinopec and Kansai Electric Power Company of Japan. The project's first LNG exports are scheduled to start in mid-2015.

How's the yield?

On yield grounds, at $16.63, AGL is priced on market consensus at a 4.2% fully franked yield in FY13, rising to 4.3% in FY14. To an SMSF in accumulation mode, that is equivalent to 5.1% in FY13 and 5.2% in FY14. In pension mode, the equivalent yields to an SMSF would be 6% in FY143 and 6.1% in FY14.

Origin is yielding just a touch lighter, at 4.1% in FY13 based on a share price of $12.21,and the same in FY14. Fully franked, that is equivalent to 5% for an SMSF on the 15% accumulation tax rate and 5.9% for an SMSF in pension mode.

These yield figures do not take into account the earnings stream from APLNG. The market appears to be factoring in cost pressures at that may not eventuate, given that APLNG started later than the other projects. Profit growth in the energy retail business is under-pinned by regulated price rises, and the APLNG 'kicker' could well push this stock in front of AGL over the medium-term. But if renewable energy interests you more than CSG exports, AGL provides a nice solid yield in the meantime.

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Tips to improve the super system the federal government shouldn't overlook

by Andrew Bloore

A Federal election must be held by November 30 this year so now's the opportunity to outline a wish list for some improvements to the super and retirement system for both parties to consider in their upcoming election promises.

Self managed super funds: intergenerational transfer of assets

Increasing the number of members from the current maximum of four would allow financial advisers to plan more effectively for the intergenerational transfer of assets.

For example, transferring real property normally results in capital gains tax and stamp duty. A solution could be to hold real property in a family superannuation fund, where both parents and children are members.

By holding the property in a family superannuation fund with the parents and their adult children as members, as the parents cease working and contributing to the fund subsequently commencing pensions, their children's SG contributions into the fund result in a change in the respective proportion of account balances, and consequently the ownership of the underlying assets.

Ultimately the parent's accounts will be completely eroded by pension payments and the assets of the fund will be represented entirely by the member accounts of the next generation. The property will have effectively been transferred from one generation to the next, in circumstances unlikely to give rise to CGT or stamp duty.

Abolish superannuation 'death tax'

At the moment, death taxes and rules around inheritance are complicated and, in some cases, unfair. For example, if someone was to pass away and their superannuation was left to a non-tax dependant, that superannuation money would be taxed at 15% plus Medicare in the hands of the beneficiary — a so-called death tax. Whereas, if it was left to a tax dependant, someone who was financially dependent on the deceased at the time of death, then the super benefits would be received by that beneficiary tax free.

Financial advisors are already looking at ways to assist non-tax dependants eliminate this tax, such as paying a pre-death ETP or recycling super components.

A person over age 60 who meets a condition of release may withdraw super and make a pre-death benefit payment to a non-tax dependant, such as an adult child. Tax-effective gifts can also be made to grandchildren (generally not permissible under super law). Another opportunity is where someone is terminally ill and an amount is cashed out tax-free directly to a non-tax dependant or via the deceased's will. For example, where a client is being cared for by a sibling but does not meet the interdependency relationship definition.

More education and planning

The Government could stimulate interest in superannuation by providing more financial education to encourage people to take an active role in investing for their futures. People wishing to locate all their superannuation investments can do so online via the ATO website. But once super monies have been located, they should be reviewed by a financial adviser and an ideal investment plan put in place. This may simply be a consolidation of money but it could involve maintaining some super plans that may have superior benefits in comparison with others.

The Federal Election is the opportune time for politicians to look at their plans for developing the superannuation and retirement system so it becomes self-sufficient and also to look at making changes that will stimulate Australian retirement savings.

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'Bread and butter' stocks – are WOW, WES and others in the staples sector a buy?

by Ron Bewley

There are only six stocks in the Consumer Staples sector of the ASX 100 – which are listed in the table – and there is only one more stock that makes the top 200 sector – that is, Goodman Fielder. I think all these companies are household names so I'll not discuss what they do. Perhaps the only one that needs some explanation is Wesfarmers (WES) – let's refer to it as Coles – as it goes head-to-head with Woolworth's in its supermarket chain – but 'Coles' also has coal and industrial interests!

Sells goods we need, but do we need the stocks?

By its very name, staples, is a sector that produces goods we always need. The bread and butter stocks should not be expected to go through the price cycles that their cousins, Consumer Discretionary, go through – and certainly it's not a sector that might be expected to swing through the big Resource sector cycles.

Coles and Woolworths are about the same size – as can be seen from the last column of the table. And these two companies account for over 80% of the weight for this sector in the top 200. Both pay reasonable dividends – WOW (4.5%) and WES (5.1%) and both have prices that have run hard over the last 12 months (24.0% and 24.6%).

My views (as is usual) are largely reflected in consensus recommendations. None pass my 2.5 rule – and that failure is more or less peculiar to this sector. Possibly brokers have factored in the recent strong run in prices. The two big guns have recommendations better than 3 (a 'hold') – an absolute minimum standard for me to buy in. The other is Metcash – a smaller chain that doesn't excite me.

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

Company name	Ticker	Price	Price growth over		Price target			Recommended action	No. of brokers	12-month forecast		Market cap. share
			quarter	year	low	median	high			yield	P/E	
WOOLWORTHS	WOW	30.88	4.8%	24.0%	22.00	29.17	33.35	2.9	14	4.5%	15.8	41.7%
WESFARMERS	WES	37.69	7.3%	24.6%	31.10	34.98	42.39	2.7	14	5.1%	17.5	41.3%
COCA-COLA AMATIL	CCL	13.45	-1.1%	15.4%	12.00	13.64	14.25	3.2	14	4.5%	17.2	7.2%
METCASH	MTS	3.59	-3.5%	-12.0%	3.00	3.38	4.15	2.9	14	7.5%	11.1	3.3%
TREASURY WINE ESTATES	TWE	4.80	-12.7%	33.7%	3.30	4.30	6.50	3.3	13	3.3%	19.4	3.2%
GRAINCORP	GNC	12.12	36.9%	53.2%	7.35	12.55	13.40	3.3	11	3.5%	16.3	2.4%

Note: the estimates in the Table are current to the close of business 18th January 2013. They are based on Thomson Reuters Datastream. The price target is the brokers' forecast of where the stock price is heading - often considered to be in the next 12 months.

To the charts

Turning to Chart 1, I note that the recommendations for WOW and WES slid in recent months. Before that they were OK. And WES looks better now than WOW. Since these recommendations are not *bad*, the reasonable dividends might be associated with not much growth in capital gains, making a buy seem reasonable – but I'll now turn to this aspect in detail.

One of the main planks of my investment strategy is our proprietary measure of exuberance – or market mispricing. Often when I write about a particular sector or stock, it seems to be too late or too early to make an important comment. Chart 2 says it all to me – today. And for anyone interested in such charts and more, I update them all each Saturday on www.woodhall.com.au. I think they're self-explanatory after a brief discussion such as this. I also have a general paper on that site that describes my methodology used in these sector reviews.

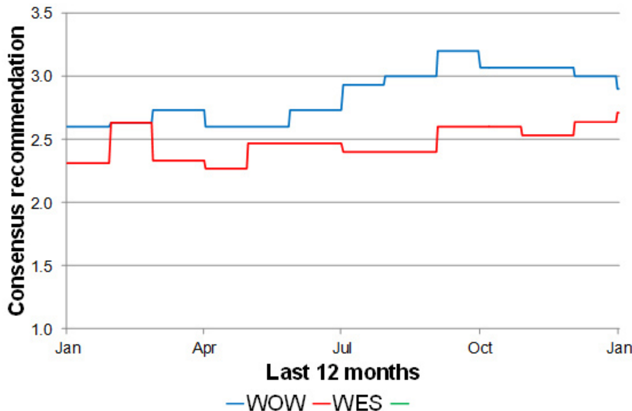
From experience, I use +6% overpricing (or exuberance as I prefer to call it) as a trigger for a price correction of about 6% to 10%, or a prolonged sideways movement in price. I have been monitoring these statistics and related methods for more than eight years and I think they have served me very well.

From Chart 2, I note that the Staples sector crossed the 'magic' dotted line of 6% on 17 August 2012. At this point the sector price had run hard. Exuberance then fell to around 0% (a buying opportunity?) before rebounding. During this time, the price index for the

sector went largely sideways (a bit down) – until about 21 November, when it shot up again. I wouldn't buy either WOW or WES now (the sector is nearly back to +6% exuberance) but I might have been tempted when it was fairly priced by our measure!

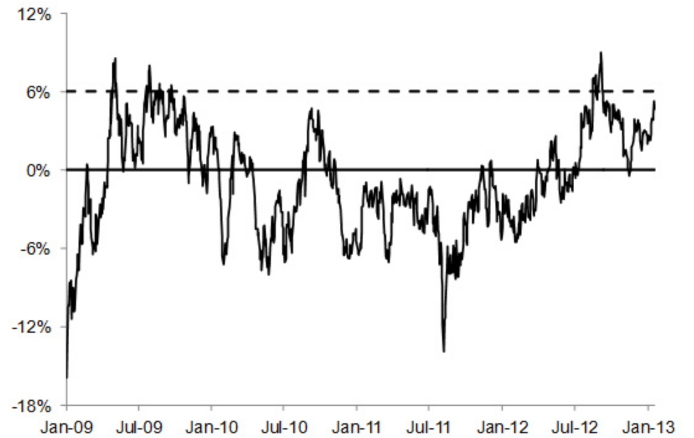
On a personal note – I have never owned a stock from this sector. If I just want dividends I go for Financials. If I just want defensives, I go for Health and Utilities. But I don't think I am necessarily 'normal'. We all should make our own choices. I hope this analysis helps you make decisions that are good for you.

Chart 1: Variation in consensus recommendations for selected stocks



Note: the estimates in the Figure are current to the close of business 18th January 2013. They are based on Thomson Reuters Datastream. The price target is the brokers' forecast of where the stock price is heading - often considered to be in the next 12 months.

Chart 2: Exuberance in the Staples sector



Note: the estimates in the Figure are current to the close of business 18th January 2013. They are based on Thomson Reuters Datastream. Please go to www.woodhall.com.au for more information on the assumptions behind the estimates.

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Did you know?

The ATO now requires trustees of self managed super funds to consider insurance for members as part of the fund's investment strategy. Get all you need to know from Paul Rickard's recent article on the topic.

Don't miss this

Our term deposits page, which lists rates for major banks, regional banks, online banks, credit unions and mutual banks, is updated weekly. Find out the latest rates here.