Switzer Super Report

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Market gains, but for how long?

The Australian stock market has gained over 20% since June, but with negative news such as last night's bad US GDP reading for the December quarter, what's the outlook for February and beyond?

Also in today's Report, Roger Montgomery focuses on The Reject Shop and James Dunn looks at whether A-REITs will continue their stellar performance. JP Goldman analyses the seasonal effect on the market and Andrew Bloore reveals deeming rates have not declined, despite RBA cash rate cuts.

Sincerely,

Peter Switzer

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Stock are up. Great! What's next?

by Peter Switzer

There's no more appropriate time for a market review and outlook statement for the month ahead. The famous January Effect has worked out off the back of a fiscal cliff affected Santa Claus rally and so subscribers and my financial planning clients are asking: "Can this rally last?"

I have two answers. First, for the year and probably 2014 — it sure can! Second, for the month ahead and into the mid-year — I don't know.

I'm not a trader but if I was I'd be selling and taking profit because since mid-2012 we have done unbelievably well. It has been huge!

Since June last year, we're up around 23% on the S&P/ASX 200 and 12.9% since November!

As I said — it has been huge.

Lance Lai from Accountancy Invest, and someone who has been on the money for some time now, agrees with my 2013 view — stocks look the way to go. However, like me, he thinks the big run up since November is screaming out that a pullback must be on the cards.

Bad news to derail the rally?

So, what could be the trigger?

The Yanks got a bad GDP number overnight — negative 0.1% for the annualized reading for the December quarter, after a 3.1% reading in September. However, it was linked to a cut in defence spending, the US election, super storm Sandy and a fall in inventories, which is a good sign that sales are happening and re-stocking will push up GDP in the March quarter.

A bad jobs figure on Friday, which no one expects, could worry the market, but I'm ruling this out.

No, I reckon February could see stocks become volatile — more up and down — because on March 1 automatic across-the-board spending cuts are set to kick in, unless Congress can come with an alternative. Happily, both sides don't like the scheduled cuts but still agreement does not come easy in Washington. They make our mob in Canberra look half-responsible!

The expected argy bargy could unnerve the market, as spending cuts will hurt GDP growth — like they did with the December quarter figures — and then company earnings will be negatively affected, so this could make February a challenge for stocks.

Add this to the fact that stocks have really rocketed and then there will be those who will be anticipating that market maxim — "sell in May and go away" and we have some forces that could put a lid on stock price growth in the short-term.

Also in May, the US Congress has to revisit the debt-ceiling can, which they kicked down the road a few weeks back.

In addition, locally, we have reporting season and, as the economy has slowed and the dollar remains high, I'm not expecting fantastic news there.

Buy during dips

But don't worry too much, as I've been using the strategy to buy stocks on dips — so I have liked dips — and this has worked out nicely for the past three years, and I'm sticking to this for 2013.

One thing I should add. There is a rotation out of term deposits and bonds back into stocks and this could offset fears about the US Congress and debt, which

means the dips could be shallow and, possibly, non-existent if everyone believes that Congress has to find a solution.

We're in historically unusual times and that's where maxims such as "sell in May and go away" can be turned on their head.

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The Reject Shop – a reject or a buy?

by Roger Montgomery

The Reject Shop (TRS) is a discount-variety retailer that has been a standout performer since it listed on the ASX in 2004 and a standout performer for The Montgomery Fund. We know that buying retailers early in their roll out and holding until 80% of the rollout is complete can be a very rewarding investment experience. The shares alone have increased by nearly 800% in less than a decade since listing. Add dividends to the return and you've trounced the broader market. As owners of the Reject Shop and as believers that consumer sentiment in Australia is currently improving, it's worth understanding this business.

As you know, The Montgomery Fund is an investor in businesses rather than a trader of 'stocks' and so rather than chat to you about 'rotation out of defensives into cyclicals', or some other nonsense, we'd rather highlight two past investments made by The Reject Shop to illustrate their impact on the business and the resultant investment returns.

In order to achieve its (entirely justified) popularity in the market, the company has made critical investments over the years in order to build (and protect) what we believe have been sound competitive advantages.

Capital investments are generally designed to increase the earnings potential of a business, be it through lower costs or increased sales, but they can also be a necessary requirement to protect a company from significant loss.

All about the brand

The Reject Shop has managed to build a successful market position as a result of high brand awareness, which it leveraged with an unrivalled distribution network that is highly automated. In 2009, the company spent a reported $6 million to convert to SAP infrastructure, which integrated its merchandising, finance, management, IT, marketing, logistics and property departments. That's no small achievement! The investment has allowed the company to critically track its stock, allowing for efficient inventory management, and has also provided the scalability to increase its store count from its current number of 247 to a target of 400 (it's 61% of the way there).

Sometimes sound allocation of capital also provides the ability to take advantage of unanticipated opportunities too. Business success also comes from a little bit of good fortune and timing. One direct outcome from this investment has been the ability for The Reject Shop to nimbly respond to the recent failure of a rival. Retail Adventures, which sold homewares, apparel, stationery and groceries under the Sam's Warehouse, Go-Lo, Chickenfeed and Crazy Clarke's stores, went into voluntary administration in October 2012. By November, management at The Reject Shop announced an increase to their store rollout projections to 20 openings in the second half of FY2013, after reportedly being able to secure some of the former sites that Retail Adventures occupied. The benefits from large fixed investments are maximized when the business can scale its operations, as greater margins will flow through to the bottom line with any additional turnover.

Emergency response

Fixed investment can also be required to protect the underlying earnings of the business. The Reject Shop has a distribution centre in Ipswich, which was significantly damaged in the Queensland floods of January 2011. The base level of the centre was under several metres of water, resulting in a considerable loss of stock and damage to equipment. The loss of stock loss was covered by insurance, but the

company has struggled to claim lost earnings. While the Ipswich distribution centre was out of operation for nine months, its remaining distribution centre in Melbourne had to carry the shortfall, resulting in higher costs and lower sales. The single DC was ill-equipped to handle the number of stores and its geographical location meant that filling stores with stock was incredibly expensive.

In response to this dramatic event, management prudently determined that a Flood Mitigation Plan was required. Part of the plan was the erection of a Flood Barrier System at a cost of $1.45 million, which would physically protect the site in the event of flooding. Unfortunately, two years on, the state was flooded again, though this time management was prepared to respond. While some stores in Ipswich did close due to localized flooding, there was no damage to the distribution centre, though road and rail closures will temporarily impact stock delivery.

Look at the returns

We prefer to invest in companies that require minimal capital expenditure to maintain and grow earnings. And short-term set backs, that are treated by the market as permanent, provide an opportunity to buy great businesses cheaply. The key consideration for any investment, however, is the ability to generate sufficient returns. The Reject Shop is a prime example of a quality business that is enjoying superior returns on owners equity as a result of prudent investments made in the past. As long as any additional capital investments can preserve (or enhance) its high return on equity, we are quite happy with our investment in the business.

As an investor, you should be seeking companies that generate high rates of return on equity, with little or no debt, and have the ability to maintain those high returns as the companies equity base grows. Essentially, we are after big equity and big returns on equity. Thus far, The Reject Shop is playing our song.

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GFC victims A-REITs to provide encore to stellar 2012 performance?

by James Dunn

Australian real estate investment trusts (A-REITs) were star performers last year, delivering a total return of 32.8% (S&P/ASX 300 A-REIT Accumulation Index) versus the market (S&P/ASX 300 Accumulation Index), on 19.7%.

More important even than performance, though, was the fact that after losing the plot in the GFC, the A-REIT sector is back doing what it is supposed to do – capturing rental cashflows and passing them on to investors.

The REIT sector was one of the biggest victims of the GFC, plunging 55% in 2008 alone: from the peak to the trough, the market value of the A-REITs index slumped by more than 70%.

But even worse than the alarming unit price falls was the effect on the sector's reputation. What had once been a solid defensive sector became even more volatile than the market itself.

Until the GFC hit in 2007, REITs were considered a reliable source of high yields, being required to distribute all their taxable profit to unit holders. Most REITs usually paid out about 90–95% of their profit as distribution, compared to about 60% of the major listed industrial companies' profit going out as dividends.

How it all changed

However, the REIT sector changed significantly over the 2000s: what had been a group of simple landlords passing on rental income to their unit holders, with profit coming from rental income minus expenses, became a much more entrepreneurial sector.

The stapled-security structure, where a share in a property company trades indissolubly with a unit in a property trust, became more common. The stapled securities were able to add earning streams other than mere rent collection; for example, property development, syndication, management and property services.

Market risk

While these non-core activities increased the REITs' non-rental earnings –thought at the time to be a good thing for their investors – the earnings streams they represented were a lot less predictable than rental flows. These non-core activities – and the lower-quality earnings they generated – also increased the REITs' exposure to equity market risk

There was also the effect of financial engineering, fuelled by cheap debt: average gearing across the REITs rose from about 10% in 1995 to 30% in 2001 and then to 43% in 2007.

Arguably worse was the fact that by 2007, the average payout ratio of the sector had risen above 100% of free cash flow: that is, the funds were paying out more than they generated.

Hand in hand with the debt load-up went a flush of overseas expansion: by the time the GFC hit in late 2007, about 37% of the funds' assets were located outside Australia.

The reckoning when the debt bubble exploded in 2007–2008 was painful. Because they were listed – and thus more liquid than other property assets – the REITs took the brunt of panic selling. Those REITs with a large percentage of offshore assets fared the worst.

Return to tradition

But since the dark days of 2008, the Australian REITs have cleaned up their act.

They have rebuilt their balance sheets and reduced debt: average gearing across the sector now stands at 29%, with payout ratios at a far more comfortable 77%. Those that have overseas exposure have sold most of their problem assets: overseas holdings now constitute just 20% of the sector's assets.

On average, about 80% of the REITs' revenues come from passive rent collection from Australian commercial real estate.

The return to a more traditional structure and operation based on rent collection means that most of the REITs offer continuing high and comparatively stable income yields, derived from multi-year leases, to high-quality tenants, often inflation-protected.

This income base should neutralise short-term share market movements – but after the GFC, no investor should consider REITs as stable in a unit price sense. These stocks used to be known as listed property trusts – and "listed" is the operative word. They are not immune to a market slump.

However, the A-REITs have very largely regained the main reason for including them in a portfolio: the diversification benefits, both in terms of a source of return – an alternative or complement to the term deposit/fixed-income holding – and a lessening of overall portfolio risk.

The A-REIT sector is once again a strong candidate for a yield portfolio, with the provisos that the REIT distributions are typically untaxed in the trusts' hands: they do not come with franking credits attached. There is a small tax-advantaged component, arising from tax concessions, such as depreciation allowances and tax-deferred income, which is not as effective in reducing an investor's tax liability as fully franked dividends from shares – and in the SMSF context, does not give any augmentation of the yield to the SMSF in accumulation or pension mode.

Good yields

But given the diversification benefits of exposure to rental from blue-chip tenants of commercial, industrial, retail or office property, there are good yields to be found in the A-REIT sector.

For example, in retail, the 7.4% market consensus yield for FY14 offered by Charter Hall Retail REIT (CQR) and 6.4% FY14 yield for Shopping Centres Australasia Property Group (SCP) are attractive. In office property, the standout exposures are Commonwealth Property Office Fund (CPA), offering 6.4% in FY14, and Investa Office Fund (IOF), projected at 6.3% yield in FY14.

For a diversified exposure, Challenger Diversified Property Group – which has a portfolio spread across office (60%), retail (16%), Australian industrial (19%) and French industrial (6%) – is priced on a projected FY14 yield of 7.2%. Despite the absence of franking, this kind of yield suits SMSF investors well.

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2013 off to a flying start – the seasonal effect on the Australia stock market

by JP Goldman

The Australian share market has entered 2013 with solid momentum. After a 3.2% gain in December, the S&P/ASX 200 index is so far up around 5% for the month of January.

It begs the question: does a good January bode well for the rest of the year? And more generally, are there seasonal effects in the market that investors need to be aware of? Maybe it's usual for the market to rally strongly around these times of the year, only to give back some of the gains later?

A market for all seasons?

It's often claimed there are seasonal effects on the market. US investors, for example, are especially nervous around the month of October, as it's often been the month when major historic market crashes have occurred. There's also the old adage of "sell in May and go away", which combined with the alleged "Christmas rally" suggests investors do best buying around the turn of the year, and selling by the middle of the year.

What's the evidence for the Australian market? For starters, let's begin by noting the market usually rises each year. Since 1987, for example, the Australian MSCI index market has gained in 18 of the past 26 years – or a 70% strike rate. Add in dividends, and there have been 20 annual gains, or a 77% strike rate. That should give investors some comfort that negative years – uncomfortable as they are – are very much the exception rather than the rule. What's more, there has been a 60% chance that any one month would produce a positive result.

Does a positive January make much difference? In the 18 positive years since 1987, January has only been positive 60% of the time – or not much different from its average. Statistically, knowing January has been a positive month therefore doesn't significantly increase the probability of the year overall also being positive.

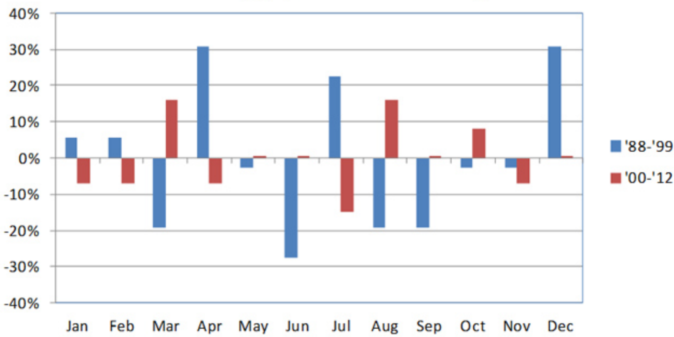
What's more, the average annual gain for the years in which January is positive isn't much different from the average gain in years when January has been negative – since 1987, both have been around 7%.

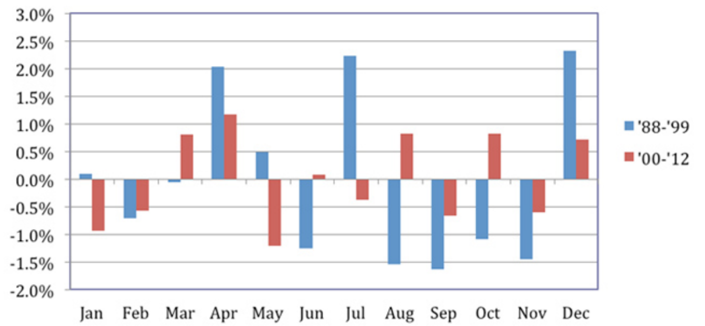
Blurring months

What about seasonality over the year as a whole? In the main, December has tended to be a positive month for the Australian market, along with April and July especially – while June, and the period between August and November has tended to be softer. Tax loss selling ahead of financial year end has been one local factor to weaken the market in June and boost it again in July.

Note, however, these seasonal effects appear to have diminished over time – with month-to- month differences much less apparent in the past decade compared with that before.

Of course, particularly bad years can distort these averages. To reduce the influence of outliers, we can also compare the degree to which certain months generate positive results compared to what would be expected were there no seasonal effects. As noted above, over the past few decades, the probability of a positive return month has been around 60% – though December, April and July tended to produce an above average number of positive results. In the past decade, however, this apparent seasonal effect has also waned.





Don't worry, be happy

More formal statistical tests also don't find much evidence of significant seasonal effects – the different average performances across the calendar months over the past decade or so are not especially unusual given the inherent month-to-month volatility in returns. Indeed, since 2000, the average monthly market gain has been 0.3%, with a standard deviation in monthly performance of 3.7%

All up, this suggests investors need not worry too much about seasonal effects distorting the local market. As would be expected in efficient markets, to the extent seasonal effects may have existed, they appear to have been ironed out over time by savvy traders. While the positive start to the year need not give us any more confidence that the coming year will be positive, it does suggest the gains of late at least reflect underlying demand rather than seasonal quirks, which could unwind soon.

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Centrelink deeming rates remain unchanged despite RBA cash rate cuts

by Andrew Bloore

The recent changes to the Reserve Bank of Australia's (RBA) official cash rate, while good news for home owners and those holding debts, has also led to a relatively un-discussed negative for pensioners. The deeming rates as per Centrelink have not changed in line with the official cash rate, meaning as inflation increases the cost of living for individuals, the deposit rates on cash have fallen, leaving pensioners in a worse off position.

What is deeming?

Deeming is a simple set of social security rules that are used to assess income from financial assets. Under the pension income test and allowance income test, any income you get from financial investments is assessed under these rules.

Under these rules, Centrelink assumes financial assets are earning a certain amount of income, regardless of the income they actually earn.

The current rates

Currently a deeming rate of 3% applies to the first:

- $45,400 of a single customer's total financial investments
- $75,600 of a pensioner couple's total financial investments
- $37,800 of total financial investments for each member of an allowee couple.

A deeming rate of 4.5% then applies to financial investments above these amounts. The thresholds at which the higher deeming rate begins to apply are indexed in line with the CPI in July each year.

Deemed income is added to a recipient's assessable income from all other sources, and the total amount is then used to calculate the rate of income support payment under the income test.

How deeming works?

Jack and Jill are both age pension recipients, with a combined total of $95,000 in financial investments.

Calculation

The table below shows the deemed income calculation.

How deemed income is used

The total deemed income of $3,141, is added to any income Jack and Jill have from other sources to calculate how much they can be paid under the income test.

Actual income received from Jack and Jill's total financial assets, if deposited into a cash management account with a 3% annual rate of return, is only $2,850. Jack and Jill are therefore worse off under Centrelink's current deeming rate, as the actual income received is less than the deemed income.

Can the lack of action by the government to review the current deeming rates be seen as a continuous and much needed cash grab, and, if it is, what strategies can be put in place?

One strategy may be to put as much as you can in superannuation and start an income stream, which may be more beneficial as it provides a discounted amount of income being assessed.

Step	Action	$
1	**Determine the value of total financial assets**	**$95,000**
2	Is the total of the financial assets less than the threshold ($75,600)? • If YES, multiply the value by 3% to obtain the total deemed income • If No, multiply the threshold by 3% • Result = 3% x $75,600	$2,268
3	Determine the unused value amount • Value of total financial assets • Less threshold • Result =$95,000 - $75,600	$19,400
4	Multiply the unused value amount by 4.5% • Result above threshold amount	$873
5	Determine the total deemed income • Add the below threshold amount and the above threshold amount $2,268 + $873 • Result = total deemed income	$3,141

The next RBA board meeting is on 5 February 2013, which may add more pressure on the government to review the deeming rates, if the RBA cash rate is cut again. A cut to the deeming rate would give an increased pension, which will soften the blow for retirees.

It is recommended that specific advice be sought regarding your level of income and assets and the potential impact on any social security entitlements. It is important to notify Centrelink of any changes in personal circumstances, as this may have an impact on the level of benefits you are in receipt of.

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Did you know?

I spoke with Matt Kidman, director at Wilson Asset Management, to get his take on the market and economy for 2013. Find out why he has changed from a bear to a bull, and what he's investing in right now.