Switzer Super Report

Issue 158, 7 February 2013

Can you handle the truth?

I recently received a question from a Switzer TV viewer about why I wasn't showing a particular set of stock market numbers. In today's note, I show the numbers I believe in.

Also in the Switzer Super Report, James Dunn looks at InvoCare in detail and Ron Bewley assesses the pulse of the healthcare sector. Also, Andrew Bloore outlines the rules for personal super contributions by the self-employed and Gavin Madson looks at RMBS.

Sincerely,

Peter Switzer

Inside this Issue

Profiting from death and taxes. Is InvoCare a buy?
by James Dunn
04

02 **Give me some truth**
by Peter Switzer
The numbers to believe in.

04 **Profiting from death and taxes. Is InvoCare a buy?**
by James Dunn
A stock to consider?

06 **All in the timing – tax deductions for personal contributions into super by the self-employed**
by Andrew Bloore
What you need to know.

08 **Assessing the pulse of the healthcare sector – getting expensive, but still some value in Cochlear**
by Ron Bewley
Seven different stocks.

10 **Investing directly in property through your SMSF? Here is an alternative – RMBS**
by Gavin Madson
An alternative

12 **Question of the week – Westpac Capital Notes – gross yield vs. net yield**
by Paul Rickard
How does it work?

switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

Important information: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. For this reason, any individual should, before acting, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice.

Give me some truth

by Peter Switzer

A disgruntled bear but loyal viewer, Jon, thinks I won't show some figures because I presume it would embarrass me, as someone who has been bullish on stocks even before 9 March 2009 when stocks turned up after the GFC crash.

Let's look at the numbers and Jon's point:

"Today the ASX is down 25 points. We're up 48 points in 40 months but today lost 52.08% of our 40-month period in one day. The ASX 200 index on 15 October 2009 was 4859 and today it's 4882."

He goaded me with: "These figures are correct so why not show them?"

But then he got personal with this:

"You're telling your viewers the best case scenario, not the truth. You are in the same boat as 'Juliar' Gillard."

That hurt, and he is the one who spelt Julia as 'Juliar'.

A lesson

OK Jon, you've had your say and now it's time for my reply, and this is a lesson I want to share with everyone because I not only want to teach you something, but also others.

The *Switzer TV* programme started after the market crashed and let's assume that a lot of fully invested people lost 50%, and so they needed a 100% gain just to break even.

By late 2008, after Lehman Brothers was allowed to fail, everyone was running to cash — they were scared and ignored Warren Buffet's maxim to be "greedy when everyone is fearful".

Challenger was flogging annuities to the frightened, and the over zealous, like Clifford Bennett, were telling people by early March 2009 that the worst was over. He rang the bell on my show and I was an accessory before the fact!

My goal for the Switzer Super Report

My goal on my TV show was always to encourage a full understanding about investing, be it in stocks, bonds, property, or whatever. The same goal applies to the *Switzer Super Report* for self-managed super fund trustees. I get the best minds on the subject. I decode them and make them entertaining so my viewers or subscribers can invest more successfully.

Since 9 March, stocks are up about 60%. Add in dividends of around 20% and anyone who stuck with stocks could have made up 80% of what was lost in the GFC crash.

If I'd played Jon's more negative game, like most media commentators and market gurus, I would have recommended term deposits, and the best return over four years would have been about 25%!

So someone who ignored my bullish inclinations would be down 75% on the GFC!

Last year I worked out where the stock market should be if it had risen 10% a year instead of the 20% plus rises we saw in 2004, '05, '06 and 07.

It took us to around 4,400, which was where the market was at the time. You see, we get carried away with the boom and gloom, but my message is to buy quality companies, chase dividends primarily, enjoy the capital gain, but don't stress out too much when there's capital loss. As Buffett points out, it is time to buy good stocks at great prices.

With good companies, they will come good.

Jon, I'm not afraid of the truth, but I don't like people bagging me after they selectively choose numbers to suit their argument.

In it for the long term

The numbers I believe in are that stocks will return around 10% per annum over a decade. In slight contrast, the likes of Jack Bogle, the founder of Vanguard, works off the idea of a 7% return from shares per annum over a decade, but either way that's the approach I think wealth builders have to take when it comes to shares.

There will be a return of around 7-10% over a decade where possibly three of the years could be shockers.

I argue if you have a consistent investment strategy based on the above expectations, you should do well out of stocks. As Bogle points out, "you should double your money over 10 years".

And that's not a bad return and certainly nothing worth whinging about!

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Profiting from death and taxes. Is InvoCare a buy?

by James Dunn

Every business – and every investor – is looking for the holy grail of a good, reliable, predictable revenue stream, that does not rely on the ups and downs of economic growth.

InvoCare Limited (IVC) has one: death.

IVC is Australia's largest funeral chain operator, with about 26% market share of the $960 million funeral market, and 17% of the cemeteries and crematoriums market.

A basic funeral costs between $6,000 and $8,000, depending on which state you live in and whether it is a cremation or a burial. About 147,000 Australians die each year: this number has been increasing over the last decade, in line with the ageing of the Australian population. At the moment, there is a large population 'cohort' moving into the twilight – in other words, more people are reaching an age at which death is more likely.

That is InvoCare's market.

Big business

IVC operates under the brand names of White Lady and Simplicity (the only two national funeral chains) as well as a suite of regional brands including Guardian Funerals, George Hartnett Funerals, Le Pine Funeral Services, Purslowe Funerals and Blackwell Funerals. The company has more than 150 business locations: the branded businesses all use the combined 'back-office' support function.

In June 2011, it bought Bledisloe Funerals – not a reference to the Wallabies' record against the All Blacks, but New Zealand's largest funeral business. Given that Bledisloe was also number two in the Australian market, owning 14 funeral operators, two crematoriums and a cemetery spread across Queensland, New South Wales, Victoria and Tasmania, the Australian Competition & Consumer Commission (ACCC) looked long and hard at the deal before approving it.

The Bledisloe acquisition launched IVC into New Zealand, Tasmania and regional parts of Queensland. Outside Australia, IVC has operated in Singapore since 2003: it has two brands in that market, Singapore Casket and Simplicity Casket.

IVC was floated by Macquarie in 2003, after the investment bank acquired the business sold by US-based Service Corporation International. Macquarie sold the stock at $1.85 a share: the shares moved smoothly to $7 until the GFC hit, after which IVC slumped to under $5 before resuming its remarkably consistent uptrend. The shares currently trade at $9.74, a record high.

Investors have received a total return of 21% a year over the last three years; 11.5% a year over five years.

Clearly, the stock market loves IVC.

The 2003 prospectus projected $144 million in revenue and a fully franked dividend of 12.8 cents; by 2011 (IVC uses the calendar year as its financial year), revenue was $327.5 million and the dividend was 29.8 cents a share. Operating earnings have increased every year.

Four sources of revenue growth

InvoCare has four sources of revenue growth. First, there is the death rate. The company says that has contributed about one percentage point a year of growth over the last 20 years – but as the population ages, the death rate is expected on its own to contribute 2.7 percentage points a year.

The second source is annual price increases. This is a delicate matter, but InvoCare's businesses are not charities, and their input costs increase all the time. The company spends a lot of money on the design, construction and maintenance of its Memorial Parks and Gardens – which used to be called cemeteries and crematoriums – and is highly innovative in providing tailored services and memorial areas that reflect Australia's multi-cultural makeup.

InvoCare says it has been able to get annual price increases of between 3% –4% a year, because it works hard to create and maintain premium brands and the service expectation that comes with that. In this regard, the funeral business is like any other business: arguably, it may even be easier in this business to create the customer rapport that characterises a premium experience, given the highly sensitive and emotional nature of the service offered.

Thirdly, there is acquisition. In its life on the stock exchange, InvoCare has certainly been a willing buyer of businesses, but for now, the company is concentrating on fully bedding down the Bledisloe acquisition and extracting efficiencies from those businesses.

The fourth revenue source is the investment activity, in which InvoCare invests pre-paid funeral plan payments. These funds are invested conservatively – although with a bias to Australian shares – so revenue growth is not really to be expected from this quarter.

Is it a buy?

So, should you buy it?

IVC has a lot of the characteristics of a utility stock, with high gearing (about 250%), predictable earnings, comfortable interest cover and a relatively high yield. But it has also shown a strong track record of generating earnings growth, and a rising dividend. Fund managers like it, for good reason, as it is a very high-quality stock.

But in a concentrated share market like Australia's, that makes a stock like IVC a crowded trade. It is getting very expensive, at about 21 times expected FY13 earnings and a prospective fully franked dividend yield of 3.8% – 4.1%

For SMSF investors, the expensive price/earnings (P/E) ratio should be balanced against the relatively high yield and the defensive exposure to the growing business of death. Even at $9.74, IVC is offering a prospective FY13 yield to an SMSF in accumulation mode of 4.6% – 5%; and to an SMSF in the pension-paying phase, and untaxed, the full refund of the franking credits takes that to 5.4% –5.9%.

You can do better than that in terms of fully franked yields from Australian shares. But the unique exposure that IVC gives you more than makes up for that. There are only two certainties in this world: the 'taxes' bit you have covered by the franking credits working to augment your yield – IVC allows you to profit from the other certainty.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

All in the timing – tax deductions for personal contributions into super by the self-employed

by Andrew Bloore

Making personal contributions into super can be an effective way to grow your retirement savings. Some individuals may also be eligible to claim a tax deduction for their personal super contributions made to their super fund in the year in which the contribution is made.

You will be eligible to claim a tax deduction if:

- You satisfy the maximum earnings as an employee condition
- You meet the age related conditions
- You made personal contributions to a complying super fund
- You made contributions in order to obtain super benefits for yourself, or for your dependants in the event of your death
- You have written to your super fund and advised them of the amount you intend to claim as a deduction
- Your super fund has acknowledged your notice of intent and agreed to the amount you intend to claim as a tax deduction.

What is the 'maximum earnings as an employee' condition?

You may be able to claim a deduction for personal contributions even if you receive some income as an employee, as long as you satisfy the 'maximum earnings as an employee' condition.

Under this condition, less than 10% of the total of the following must be in respect of your employments activities:

- Your assessable income for the income year
- Your reportable fringe benefits for the income year
- The total of your reportable employer super contributions for the income year.

This is the case regardless of whether your employer has paid super on your behalf.

Example

During the 2011/12 income year, a self-employed doctor earns $100,000 from his medical practice. During that same year, he also worked as an employee in a hospital where his total earnings were $10,000. Since his earnings as an employee were less than 10% of his total earnings of $110,000, he may still be eligible to claim a deduction for personal contributions to his super fund.

What are the age restrictions for claiming a deduction?

If an individual is under 18 years at the end of the income year in which the contribution is made, the deduction can only be claimed if the income was earned as an employee or a business operator during that year. So if the individual earned purely passive income, such as share dividends, they would not be entitled to the deduction for their personal contribution.

For ages 75 years or older, a deduction can only be claimed for the personal contribution that was made before the 28th day of the month following the month in which the individual turned 75.

Notice of intent to claim a deduction

A written notice must be submitted to the super fund in the approved form advising the super fund of the amount the individual intends to claim as a deduction. The notice must be lodged at the earlier of the day the income tax return was lodged for the year the contributions were made, and the end of the income year after the income year in which the contribution was made.

Once the notice is submitted, it cannot be revoked or withdrawn. It can only be varied to the extent that the amount intended to be claimed as a deduction relating to the contribution is to be reduced. This includes reducing the amount to nil.

Further, the notice can only be varied before the earlier of the day the income tax return was lodged for the year the contributions were made, and the end of the income year after the income year in which the contribution was made. However if the deduction is not allowable, the notice can be varied after this date to reduce the amount intended to claim as a deduction by the amount that is not allowable.

What to watch out for

Remember that a notice to claim a tax deduction will be considered invalid if your super fund has begun to pay an income stream based in whole or part on the contribution.

This applies regardless of whether a residual amount equal to or in excess of the amount sought as a tax deduction is left in the accumulation account.

This means that if you are planning to commence any kind of pension, ensure that you send your super fund a valid notice of intention to claim any tax deductions for personal super contributions prior to commencing the pension. The super fund must acknowledge the notice, and then it is safe to commence the pension.

If the notice is not submitted and acknowledged prior to commencing the pension, you will lose your eligibility to claim the tax deduction.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Assessing the pulse of the healthcare sector – getting expensive, but still some value in Cochlear

by Ron Bewley

There are only seven stocks in the Healthcare (Health) sector of the ASX 100 – which are listed in the Table – and there are another four in the next 100. Despite being in the same sector, these seven companies are largely quite different in their products/services and markets.

CSL, the plasma company, is by far the biggest – being more than 50% of this sector's top 200 market capitalisation. Resmed has products for sleep disorder; Sonic runs pathology services in Australia and overseas; Ramsay owns hospitals etc; Cochlear is a world famous ear implant producer; Ansell produces health protection products; and Primary runs medical practices and provides pathology and imaging services.

The Health sector may benefit going forward from an ageing population. It is certainly considered by most to be a defensive sector, as evidenced by the performance of many of these stocks through the GFC. However, the dividends are not high by ASX 200 standards and often are not fully franked because of overseas exposure. They also typically trade on high P/E ratios compared to those of the broader index.

Only three stocks meet my '2.5' broker recommendation status ('1' being the highest rating, '5' the lowest – please see my paper on the Market Updates tab of our website www.woodhall.com.au for details). They are CSL, Resmed and Primary – and two of them only just!

CSL, seemingly a very well-run company, has run very hard in price over the last year (+86.9%) and I find it hard not to think CSL has overly benefitted from the flight from cash and bonds into equities. On a personal note, I held CSL throughout the GFC and made a nice profit from it – but it seems I sold (last year) too soon. I sold because I had the sector overpriced by more than 8%. I also sold Sonic at the same time and for the same reason – and that seems to have been a wiser call on my part.

Having been a short-term user of a Resmed product, I cannot understand the business. For someone with bad sleeping patterns, I could not cope with what felt like a diving mask and tube to an aqualung attached to me in bed. The business and stock price have clearly done well (the price perhaps too well at 55.1% for the last 12 months) but I am content not to have invested in it. Primary too has run very hard at 48.7% for the last 12 months.

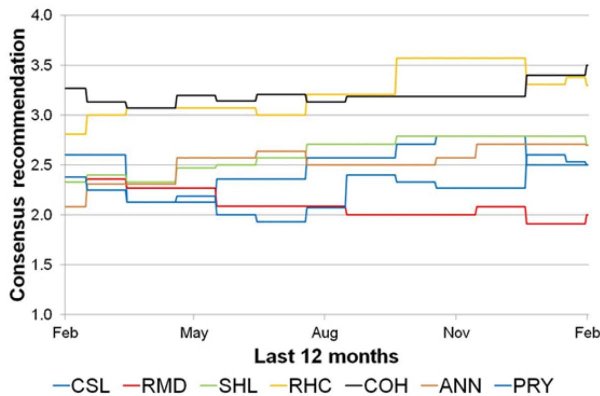
Data on companies in the ASX 100's Health sector

Company name	Ticker	Price	Price Growth over		Price target			Recommended action	12-month forecast		Market cap. Share
			quarter	year	low	median	high		yield	P/E	
CSL	CSL	56.06	18.3%	86.9%	48.31	50.84	61.5	2.5	1.8%	21	54.9%
RESMED	RMD	4.28	8.9%	55.1%	3.56	4.65	5.49	2.0	1.8%	14.7	13.1%
SONIC HEALTHCARE	SHL	13.84	7.9%	23.0%	12.1	13.55	14.55	2.7	4.6%	15.2	8.8%
RAMSAY HEALTH CARE	RHC	29.81	25.6%	59.6%	20.58	23.78	28.12	3.3	2.4%	20.5	7.6%
COCHLEAR	COH	70	-4.3%	20.5%	49.25	63.18	76.4	3.5	3.6%	24.5	4.9%
ANSELL	ANN	17.01	9.7%	12.4%	15.44	15.86	18.43	2.7	2.5%	14.7	3.3%
PRIMARY HEALTH CARE	PRY	4.49	20.4%	48.7%	2.72	4.07	4.85	2.5	3.3%	14.4	2.8%

Note: the estimates in the Table are current to the close of business 6th February 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.

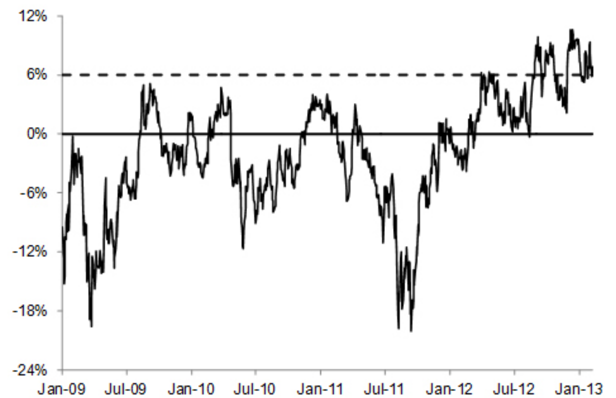
Turning to Chart 1, I plot the recommendations for all of the seven companies and show how these have moved over time. Resmed's trace over time in Chart 1 is the best (with a current recommendation of 2.0) and it has been improving for most of the year. Ramsay and Cochlear have the worst ratings of this group of seven – and the others are clustered together.

Chart 1: Variation in consensus recommendations for selected stocks



Note: the estimates in the Figure are current to the close of business 1st February 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 Health sector



Note: the estimates in the Figure are current to the close of business 6th February 2013. They are based on Thomson Reuters Datastream. Please go to www.woodhall.com.au for more information on the assumptions behind the estimates.

I have owned Cochlear for many years and feel that the brokers could have this one wrong. Its price was about $80 when it chose to recall one of its products last year and the stock price suddenly fell to nearly $50. Since that time, its price returned to over $80 and it did so at very much the same rate as the sector's index. I wonder if it had not needed to recall one of its products, which seems to have been handled very well, would its price have risen from the same rate over the same time but from a base of $80 (to well over $100!). Cochlear reported this week and just missed estimates. As a result, the stock price got hammered. Since the future looks good – with strong growth in Asia – and a bad year behind it because of the cost of the recall, I have a personal buy on this stock in conflict with the brokers – just when I bought more at about $55 just after the recall last year.

From experience, I use +6% overpricing (or exuberance as I prefer to call it) as a trigger for a price correction of about 6% – 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 Health sector behaved as I might have expected until mid 2012 but crossed the 'magic' dotted line of 6% and has largely stayed there. While I do not necessarily expect a large price correction in this sector, I do expect the race has been largely run and a move into resources from defensive sectors will be the theme of 2013. I am still overweight this sector but I was very much so during the bad times.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Investing directly in property through your SMSF? Here is an alternative – RMBS

by Gavin Madson

Recently, there has been a lot of coverage in the broader press about investing directly in property through your SMSF. However, returns from residential property have (on average) been disappointing over the last two years.

RP Data – Rismark in its Home Value Index noted an aggregate decline in home values of -0.4% in 2012, following on from a -2.8% decline in 2011. Gross rental yields on houses for the year were 4.3%. That's 4.3% ***before*** expenses. If you factor in real estate rental fees, insurance, repairs and maintenance, vacancy, etc. the yield falls considerably.

So if property investment is to make sense, investors are obviously forecasting large capital gains on their property. Yet few are predicting significant house price increases in the short to medium term.

The overlooked story

What is also often overlooked in the property capital gain "story" are the costs incurred in order to achieve any capital gain. While a property survey may show a house price increase from $400,000 to $450,000, it does not take into account the cost of stamp duty, the real estate agent fees, the capital costs of any improvements, legal fees etc.

Taking a step back, the capital gain 'story' is based on the assumption of a capital gain! The NAB quarterly Australian Residential Property Survey (for December 2012) forecasts modest growth of 1.5% through to the end of 2013, with a similar gain forecast for 2014 – hardly the sort of capital gain needed to offset the low ***net*** running yields provided by property. With interest rates already at historically low levels, there are not too many independent commentators suggesting a housing boom will happen any time soon.

There is also the question of if you're investing in property via your super fund, are you intending to sell the property to realise the capital gain? Or do you simply plan on using it as a steady stream of income? If the latter, is a gross return of 4.3% really producing a strong enough income for your retirement?

An alternative through RMBS

So what is the alternative if your want to have a property exposure in your SMSF but want potentially higher income returns? RMBS (Residential Mortgage Backed Securities) are a type of debt security secured by a pool of home loans.

Typically, home loans are illiquid and private in nature, however by combining them into a large and diversified pool and then breaking the combined pool into smaller, marketable classes, the RMBS become attractive to investors who would otherwise be unable to take exposure to the underlying sector.

The concept of breaking the pool into varying classes of securities allows investors with specific risk appetites to target the appropriate class, and thus returns they are seeking. In this way, the classes act not unlike a normal company capital structure, where investors with the lowest risk appetite target the senior bonds (or in the case of RMBS, the highest tranches) and those with a higher risk appetite target the lower ranked capital, like hybrids or equity (or in the case of RMBS, the lowest ranking tranches).

What's on offer? Taking a risk adverse view of the Australian housing sector, an investor in high quality AA-rated RMBS can currently achieve returns around 7.5%. This is a relatively low risk 'tranche' of RMBS. The less 'bearish' you are with the Australian housing sector, the more risky the 'tranche' (lower rated) you may choose to invest in and, subsequently, the higher the return on offer.

If you want to hold exposure to residential property in your SMSF, RMBS may well provide a better alternative and better still, there'll be no calls from your tenants to fix the plumbing!

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Question of the week – Westpac Capital Notes – gross yield vs. net yield

by Paul Rickard

Q. *In relation to the Westpac Capital Notes, how does the gross yield of 6.15% p.a. translate to a net yield of 4.31% p.a? What am I missing?*

A. Thanks for the question.

Like many of these hybrid securities, the distribution (or dividend) is quoted on a gross basis (i.e. a margin of 3.20% plus the 90-day bank bill). With the 90-day bank bill at around 2.95%, this implies a gross distribution of 6.15% p.a. (3.20% + 2.95% = 6.15%).

However, the dividend is paid on a net basis. The actual amount you receive in cash is the gross distribution multiplied by 0.70 (where 0.70 is 1 – Company Tax Rate).

So, the cash amount is 6.15 multiplied by 0.70 = 4.31

The dividend is, of course, fully franked.

Essentially, Westpac "takes back" the benefit of the franking credit by reducing the cash paid (i.e. multiplying it by 0.70).

That said, it is still correct to compare it to other investments on a gross basis, as they don't receive any post tax benefits from the imputation credits. Hence, a term deposit paying 4.3% (with no tax benefits) can be compared to this Westpac Capital Note paying 6.15%.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Did you know?

Last night on my Switzer programme on the Sky News Business Channel, I caught up with the opposition Treasury spokesperson, Joe Hockey, to talk about the Government's planned changes to superannuation, and what a Coalition Government would do differently.