Switzer Super Report

Issue 168, 14 March 2013

The bull still has some steam in it

The Australian ASX/S&P 200 continues to bump around just under the 5100 mark and while it isn't immediately following the Dow Jones to new heights, I still know we're in the midst of a rally and investors shouldn't get cold feet just yet, if ever.

Today, Geoff Wilson of Wilson Asset Management agrees with me, and explains why the odds are in favour of earnings supporting the run-up in stocks.

A CEO's attitude and opinion of their performance can tell investors a lot about a company. As can the market's opinion of whether a CEO is worth a large payout. Today, Roger Montgomery looks at two of our favourite 'gurus' - Warren Buffett and Marius Kloppers.

Sincerely,

Peter Switzer

Inside this Issue

Great expectations: Kloppers versus Buffett
by Roger Montgomery
04

02 **Shop till you drop – David Jones, Ten, News set for a rebound?**
by JP Goldman

04 **Great expectations: Kloppers versus Buffett**
by Roger Montgomery

06 **Fundie's favourite – Platypus Asset Management on Acrux**
by Jelena Stevanovic

08 **How long will the bull run?**
by Geoff Wilson

11 **Time to buy a house – investors jump in**
by Penny Pryor

13 **Trauma or disability insurance – act before July 2014**
by Tony Negline

15 **Question of the week – stocks for dividend and growth**
by Paul Rickard

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.

JP Goldman

Shop till you drop – David Jones, Ten, News set for a rebound?

by JP Goldman

While high dividend-yielding financials have so far captured the spotlight in the strong rise in the share market since mid-last year, it may surprise some investors to know that one of the other better performing sectors has been one of the most challenged since the global financial crisis: consumer discretionary.

This sector was further buoyed by news this week that consumer sentiment was on the rise. The Westpac-Melbourne Institute measure of consumer confidence was up 2% in March after a solid 7.7% gain in February.

Consumer discretionary is one of the most cyclically sensitive sectors in the market, and especially attuned to consumer spending. The sector covers major media firms such as News Corporation, Fairfax, Seven West Media and the Ten Network. It also includes leading department stores David Jones and Myers, together with specialty retailers like JB Hi-Fi, The Reject Shop and Flight Centre. Gaming firms like Crown, Tatts and Tabcorp are also included.

Households hold back

Thanks to falling interest rates, rising asset prices, strong employment growth and credit liberalisation, consumer spending powered the Australian economy in the two decades prior to the global financial crisis. Since the GFC hit in mid-2008, however, household spending has never quite been the same.

The savage sell-off in equity prices and modest decline in house prices saw households begin to worry for the first time about the high levels of debt they were carrying. Consumer confidence slumped and the household saving rate surged to around 10% – or to levels prevailing before the debt-fuelled explosion in house prices in the decade to 2005.

As if that weren't enough, traditional retailers and media companies have faced increasingly tough competition from online upstarts, thanks to the wider take up of high-speed internet services.

From the mid-1990s to around mid-2008, real consumer spending grew at an annual rate of around 4%. Since then, consumer spending growth has slowed to around a 3% pace – and was close to flat in the second half of last year. Forward earnings for the sector have been on a downhill slide since mid-2006.

Yet get this: over the past 26 weeks, the S&P/ASX 200 index has lifted by 18.4%, led by a 26.4% gain in the financials (excluding listed property). The next best sector has been healthcare, rising by 23.4% – but the consumer discretionary sector was not far behind, rising by 23.0%. Over the past three months, consumer discretionary has been the best performing sector, lifting by 19.2%.

Sentiment shifts

Why the turnaround? Obviously a rising tide helps lift all boats, and the sector has not been immune to the recovery in market sentiment since mid-2012. As for the market overall, attractive valuations have also played a role. At its nadir in late 2011, the consumer discretionary sector traded at a price-to-forward earnings ratio of only 9.6 – compared to a long-run average of 16. By mid-2012, the PE ratio had recovered to around 13 (though largely due to falling earnings, not rising prices) but that was still below average.

With the recent recovery in prices, the sector ended February at a forward PE ratio of an above-average 17. That might suggest the sector is fully valued, which would be true if earnings were not expected to recover. However, there are tentative signs of an earnings turnaround. With the reduction in interest

rates over the past year, consumer confidence has started to recover and is now slightly above long-run average levels. Household wealth is improving, with house prices and share prices firming over the past year. Retail sales – while often volatile – were better than expected in January, and some retailers suggest activity levels are picking up.

At the same time, many companies have responded to the challenges in the sector by cutting costs, meaning any pick up in sales could quickly flow through to the bottom line of major media and retailing companies.

According to Thomson Reuters estimates, analysts expect sector earnings to grow by 12% next financial year, after suffering a decline of 13% this financial year. Earnings are then expected to grow by around 10% in 2014-15.

Most major companies in the sector have enjoyed good gains of late. Over the past six months, the best performing stocks have been Seven West Media (80%), JB Hi-Fi (75%) and Myer (56%), while the worst performing have been Billabong (-40%) and GUD Holding (-18%). Even long-blighted Fairfax is up by 50%.

Given the stronger performance of their counterparts to date, News Corp,
David Jones and the Ten Network are examples of companies that might be due for a catch-up.

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.*

Great expectations: Kloppers versus Buffett

by Roger Montgomery

Fund managers are constantly assessing the performance of companies in search of attractive value. While we ultimately come to our own conclusions about the performance of a company, what we find interesting is how management assess their own performance.

There's always going to be a positive bias underlying each CEO's appraisal – it's simply human nature to focus on the good and glaze over the bad. But investors must have a clear idea about the performance they expect of management – it's only in this way that you can determine whether management are acting in your best interests.

Let me illustrate this point by contrasting the assessments of two CEOs from the most recent reporting season. One manager was rather critical of their performance, while the other manager was assessed to have significantly increased shareholder value.

The humble manager

Our first example is a very well known investor and one whom many value investors' investment philosophies have been influenced by. Warren Buffett is a founder of one of the world's largest companies, Berkshire Hathaway. Every year Warren Buffett writes a detailed letter to his shareholders in which he assesses the company's performance and whilst we are not investors in Berkshire Hathaway, we read each letter with a keen interest. Here is an excerpt from Warren Buffett's annual letter for 2012:

"When the partnership I ran took control of Berkshire in 1965, I could never have dreamed that a year in which we had a gain of $24.1 billion would be subpar … But subpar it was. For the ninth time in 48 years, Berkshire's percentage increase in book value was less than the S&P's percentage gain."

Buffett demonstrates that managers are accountable for building shareholder wealth at all times. Buffett's responsibility is to outperform the market, and if he cannot achieve this, then it is cheaper for investors to put their money into an indexed fund. Even though shareholder wealth grew by $24 billion, and even though it was achieved with no additional debt and no capital raisings, Buffett was critical of this performance.

The mighty manager

Let's contrast this with the assessment of our second CEO, who operates far closer to home. Marius Kloppers has been the CEO of BHP Billiton for the past six years, and announced his retirement from the company during this reporting season. The chairman of BHP, Jac Nasser, gave a very positive review of Marius' tenure: "Marius and his team have delivered for shareholders, significantly outperforming our peers in terms of total shareholder returns".

On the surface, it seems like a far more glowing review than Mr Buffett's personal self-assessment. But it is interesting that his performance was gauged relative to his peers rather than to the performance of the market. Many miners have indeed struggled in the post-GFC period, but did Marius Kloppers actually deliver value in total shareholder returns?

When Kloppers started his reign at BHP, the company was generating a profit of $16.6 billion. This financial year, BHP is forecast to generate a profit of $13.8 billion. So analysts are expecting no profit growth between 2007 and 2013. Yet over this period, both the equity contributed by shareholders and the debt taken on have doubled.

Kloppers received a golden farewell that has been widely reported. Upon leaving BHP, he is to receive approximately $75 million in performance bonuses.

To his credit, Marius did forfeit his short-term bonus last year, given the disappointing performance of its shale gas acquisition in the US.

But there has been no mention or suggestion that he will be foregoing this final bonus, which would lead us to assume that he considers the amount reasonable, based on his overall performance. I'm not sure if Berkshire Hathaway shareholders would share the same view.

It's not all relative

Having spent over two decades in the market, I have seen a lot. Selective benchmarking and historical revisionism (managers who call themselves founders when they weren't) are all too common in this world where genuine humility is rare.

It is important to assess a company's performance relative to a benchmark and to peers, but above both, the number one focus should be absolute returns. It's no good saying that you have outperformed the market by 1% if in fact the market itself has fallen by 10%. That's like standing on shore watching all the ships in the ocean sinking, and claiming that the captain whose boat is sinking the slowest is the best performer. It's all very well if you are standing on land but not so great if you are on the ship.

With value investing, it's important to see through the short-term fluctuations of a company's results and focus on long-term value creation. Investing is inherently risky, and there will be times of underperformance. But ultimately as investors, you are entrusting your money to management with a view that your overall wealth should increase. This should be your main consideration when assessing the performance of companies in which you have a stake, regardless of how positively management describes their performance.

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.*

Fundie's favourite – Platypus Asset Management on Acrux

by Jelena Stevanovic

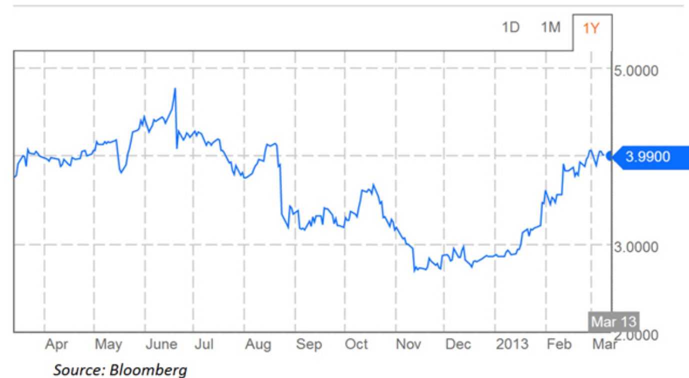
What do you like Acrux (ACR)?

ACR is one of only a few Australian companies in the emerging healthcare sector that has successfully developed and partnered a product and is generating earnings. Most companies in this space tend to list too early and stay in the cash burning, research stage for too long.

ACR's product Axiron, a testosterone replacement therapy, is approved by the US Food and Drug Administration (FDA) and is currently marketed by Eli Lilly in the US market. Lilly has years of experience in sales and marketing of men's health therapies, in particular when it comes to displacing a well-established dominant player and securing a leading market position. Viagra was a clear leader in the erectile dysfunction market until Lilly launched its drug Cialis and claimed that position. In addition, Lilly has sufficient resources to continue to invest into Axiron.

Lilly has already grown Axiron's market share to 13% in the six months following its launch.

In addition, ACR is participating in a very attractive segment of the pharmaceutical market. Men's health, and in particular the testosterone replacement therapy market in the US, has been growing at a 20% plus annual growth rate and is expected to continue to grow in the high teens for a number of years, as disease awareness continues to improve.



Source: Bloomberg

How long have you held ACR?

We initiated our position in February 2013. ACR has been on a watch list for a while but we were waiting for two milestones: (1) the US patent extension to be granted; and (2) for market share growth to return.

How is it better than its competitors?

Axiron is a topical testosterone therapy much like other products on the market; however, unlike Androgel and other topical therapies it is a spray and not a thick gel, and is therefore, easier and quicker to absorb by patients.

In addition, Axiron is applied only to patients' armpits and not to a patient's torso area, thus reducing the risk of accidentally transferring the product onto women or children.

More importantly, Eli Lilly is the most dominant player in men's health with an experienced selling and marketing team (as a result of Cialis' success) and strong track recording in building a leading market position in this segment.

What do you like about its management?

ACR is a rare example of an Australian biotech that has successfully developed a product and is generating earnings.

The success of big Australian healthcare stocks, such as Cochlear (COH) and ResMed (RMD), hasn't been repeated for a while. Most Australian biotech companies tend to list too early and require ongoing shareholder support in funding numerous research and development projects. The research and development phase is very capital intensive and most companies in this sector tend to burn through shareholder capital without ever producing a marketable product.

On the other hand, ACR's management has demonstrated clear focus on maximising shareholder returns. ACR terminated research and development projects that had a more difficult regulatory path ahead of them, and focused the company's resources and attention on developing Axiron. This enabled them to successfully commercialise Axiron, and secure an industry leader as a commercial partner.

ACR management also signed a licensing agreement that secured a very attractive royalty stream. Once Axiron was commercialized, ACR eliminated all unnecessary business costs, including downsizing the executive team, to ensure that virtually all generated operating earnings can be passed onto shareholders in the form of dividends.

What is your target price on ACR?

Our price target on ACR is above $6.

At what point would you sell it?

We will monetise our position when the price exceeds our upper valuation target.

Where do you see the value?

We believe that intellectual property in Axiron, such as the underarm patent, as well as its superior marketing partner, will continue to deliver benefits to ACR shareholders through further market share gains.

Is there anything else you would like to say about company ACR?

Because of its unique structure (ACR is a Pooled Development Fund), unfranked dividends and capital gains are exempt from tax.

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.*

How long will the bull run?

by Geoff Wilson

There is an old saying in the market – never mistake a bull market for genius. Remember, a rising tide lifts all boats. What that means is, keep a cool head in a hot market and don't let your confidence get out of control.

I bring this up now as we are in the midst of a bull market for the first time in several years. The last true bull market finished with the advent of the GFC back in 2007. After the carnage of 2008, the market staged a recovery rally of about 30% in 2009, which ran out of steam at the end of that year and the market has been trading sideways since. Well at least until the end of the last financial year when it began to climb the wall of worry.

This is a term of endearment many professionals use to refer to the early stages of a bull market, when the market starts to move higher against predominantly negative sentiment. This is when the trend followers start to yell at the fundamental investors that the new trend has begun, while the purely fundamental investors sit on the sidelines waiting for evidence that the rally is justified, often too preoccupied with what is happening now, rather than focusing on what will be occurring in six to 12 months! There are plenty of those still saying this rally is unjustified.

Is the rally bull?

Since July 2012, the ASX 200 has rallied around 30%, establishing this run firmly as a true bull market. (Technically, a rally can be called a bull market after a 20% rise).

When bull markets begin, there is usually a shortage of fundamental evidence to support them. This is simply a function of the predictive nature of markets. They look into the future (rather than the historical or contemporary environment) and attempt to price that. Of course, markets are not always correct. As the cynics say, markets have accurately predicted 20 of the last 10 recessions.

Someone once asked me what is it that fuels a true, sustained bull market and my simple answer is earnings per share growth. Short term rallies may be fuelled by a normalisation of sentiment, a cut in interest rates (something we are seeing at extraordinary levels right now) or even a rebalancing of investor capital (something else we are seeing right now) but these catalysts can only sustain a rally for so long. It's earnings growth that drives a true bull market. The ability of a market to rally without getting more expensive can only happen if the earnings per share of its constituents is rising at the same rate as the market.

The ASX 200's long-term average PE is around 13 times. During a period of fear and caution this may fall to 10-11 times, prompting analysts to claim the market is cheap. As sentiment normalises (fear abates) and the market's PE reverts to the mean of 13, a rally of say 20%-30% is possible, but it cannot be sustained without the support of earnings growth. It is unlikely that the market will move to a higher PE level without growth. As a bull market matures and becomes a boom, irrational exuberance drives PE expansion to ever more expensive levels, as markets move well ahead of growth.

The underlying support

We are enjoying (if you are not short) a strong equities rally, fuelled by historically low global interest rates, short covering and a shift by investors back towards equities from the favoured safe haven assets of the last few years. What comes next? We need to see a corresponding improvement in earnings growth from the companies in the market.

At this stage we are seeing limited evidence to

support the new bull market; however the real test will be the results season in August 2013 and January 2014. The strong stock market is predicting a pickup in earnings growth and this will be needed to drive the market higher. In the event earnings disappoint, well the market probably will too.

Many of our stocks have experienced solid rallies already and we remain bullish on the outlook for stocks such as Clime Investment Management Limited (CIW) – a boutique fund manager in a strong growth phase, Cash Converters International (CCV) – retailer of second-hand goods and supplier of financial products, Automotive Holdings Group (AHE) – automotive dealership and logistics group and Hills Holdings (HIL) – an old Adelaide company in the process of a turnaround by former Telstra whiz kid Ted Pretty.

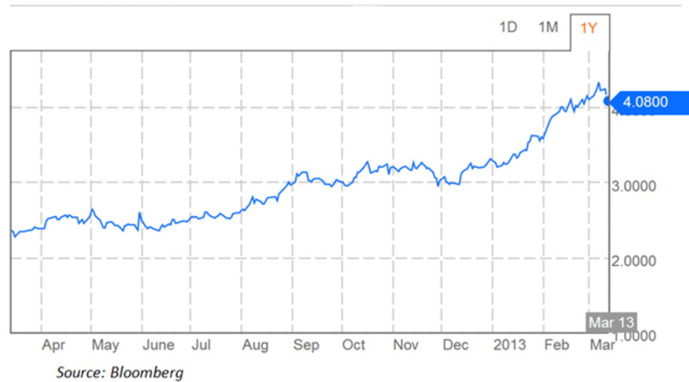
Regardless of the broader market's actions, we at WAM continue to implement our investment process, which has provided solid investment performance over the long term (+18.3% pa since August 1999). I remain confident that the outlook for investors is bright, provided a sound and discipline approach is adopted.

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.*

Stock Chart for CCV

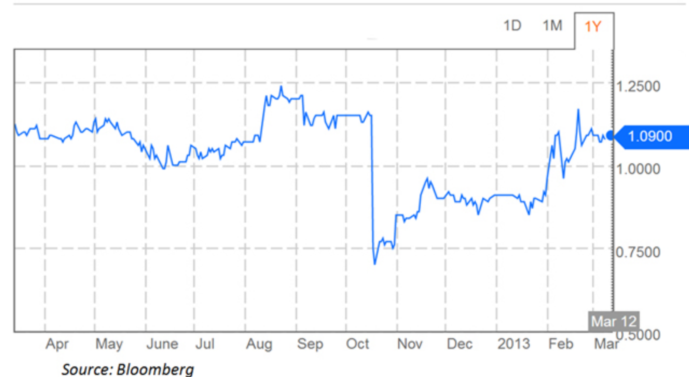
Source: Bloomberg

Stock Chart for AHE



Source: Bloomberg

Stock Chart for HIL



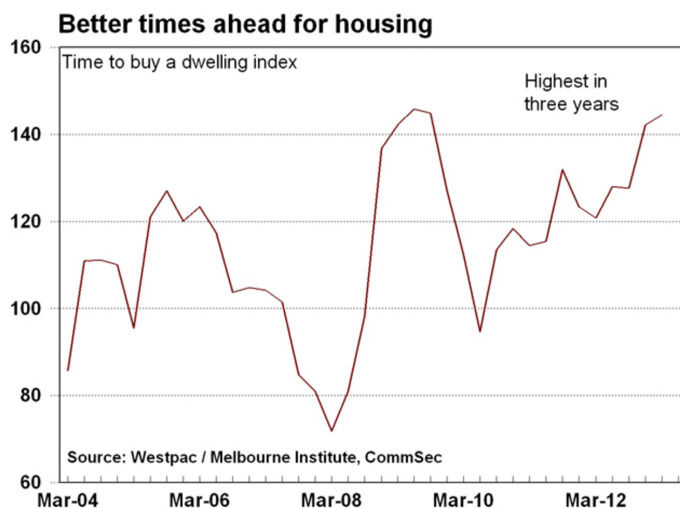
Source: Bloomberg

Time to buy a house – investors jump in

by Penny Pryor

The Westpac-Melbourne Institute 'Time to buy a dwelling' index – a forward indicator of sentiment in the housing market – is now at its highest level in three years as property investors move back into the market.

The index, which is part of the Westpac-Melbourne Institute's consumer sentiment suite of measures, has risen by 1.6% from 142.2 in December to 144.5 in March.



Housing finance data for January, also released yesterday, saw the value of investment loans increase by 4.4% over the month seasonally adjusted, as the value of loans approved for owner-occupied homes rose by just 1.3%.

The number of loans for owner-occupied housing dropped by 1.5% as first home buyers stayed away. In NSW there were only 773 first home buyers in January, the lowest level in 31 years. First home buyers accounted for just 14.9% of all home loans approved in January in Australia.

"The first home buyers seem to be staying out of the market, you just have to question whether that is a generational change or a societal change," Craig James, chief economist at CommSec said.

It appears Gen Y's are no longer as keen to get into the property market as their parents, but this means many will be renting for longer and provides a good pool of tenants for investors.

"I think the rental market still remains tight, rents will continue to rise in most of the capital cities market and that will attract investors in," James said.

Definitely time to examine your property portfolio with a view to growing it.

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.*

Trauma or disability insurance – act before July 2014

by Tony Negline

The types of insurances your super fund can buy will change from 1 July 2014.

From this date it won't be possible to purchase new trauma and 'own occupation' disability insurance policies, which have become quite fashionable for SMSFs.

This new rule will be an operating standard for super funds. A failure to comply with these standards will lead to the Australian Taxation Office imposing an administrative penalty of $3,400 for an individual and $17,000 for corporations. If a fund breaches this new rule, the ATO will also be able to seek additional penalties against a fund, for example by removing a fund's complying status, or fines against the trustee.

Trauma problems

Trauma insurance will pay out when you suffer one of a defined range of medical problems. Typically these insurances cover heart attacks, strokes, brain tumours, liver failure and so on.

If your super fund buys trauma insurance, it's quite possible that your fund won't be able to pay that benefit out of the fund because you don't meet a condition of release such as death, or temporary or permanent disablement.

Increasingly, people who suffer medical traumas stop work for a period of time to recuperate, and receive intense medical and other treatments, but after one or two years return to work part-time and then full-time once they're fully recuperated.

If your trust deed allows your fund to purchase a trauma insurance policy, any claim proceeds would be used for at least two purposes. Firstly, some of the proceeds could be used to make notional super contributions for you whilst you aren't working. In addition, some of the policy proceeds could be used to pay temporary disablement benefits to you while you can't work.

To solve the problem of trauma insurance benefits being locked in super funds, I have heard that one large life insurance and fund management organisation recommends transferring the ownership of a trauma insurance policy from the super fund to the fund's member just before a claim is made. On the face of it, this sounds like a sensible suggestion but I suspect capital gains tax may have to be paid by the super fund because at that point it's disposing of a valuable asset.

Act before July 2014

Own occupation disablement insurance will normally pay a benefit when you can't perform your current job. This doesn't mean, however, that you're permanently disabled under the super laws. In simple terms, these laws only allow a permanent invalidity benefit to be paid to you if your super fund trustee decides that you'll never again perform a similar occupation to your current job.

It's possible, therefore, that own occupation disability insurance proceeds can be trapped in your super fund and can't be paid out, because whilst you might not be able to perform your current job, you could perform a similar one. For example if a surgeon injured their hand, they would no longer be able to operate as a surgeon but there are plenty of other occupations they could carry out.

If a person joins your fund before July 2014, then it will be possible to put in place trauma and own occupation disability insurances for them before that date and keep it in place after June 2014. Unfortunately, this change means that July 2014 will become another messy transitional date that

everyone needs to keep in the back of their mind while running their fund.

For now, it would be a useful exercise to review what life insurance policies you currently own in super. If you would like your super fund to own a trauma insurance policy or own occupation disability insurance policy, then you'll need to put this insurance contract in place before July 2014.

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 – stocks for dividend and growth

by Paul Rickard

Q. *I have just started to subscribe to the Switzer Super Report and I am looking for a more up-to-date view on stocks you would buy today – six stocks for dividend and six stocks for growth?*

A. Thanks for the question. I trust you are enjoying the Switzer Super Report.

We published both income and growth oriented portfolios in early January – and while the market has rallied strongly, they remain by and large our recommendations. You can read about their latest performance here.

I am reluctant to identify "six" stocks in either category, because I don't think six stocks provide sufficient diversification.

With these caveats, on the income side, I would be considering the banks (NAB, Westpac and to a lesser extent, CBA), with Telstra, and for sector diversification, AGL and UGL.

For growth, the materials sector (BHP and RIO – although I am very out of step with the market on this), at lower prices in the health sector (CSL and Ramsay), and Woodside and Santos.

I hope this is the information you were after.

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?

On Switzer TV this week David Anderson from Mercer spoke with James Daggar-Nickson on how the Australian superannuation system stacks up internationally.