Switzer Super Report

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Right of reply

In today's *Switzer Super Report*, we chat with Graham 'Richo' Richardson about his newly established SMSF. Check out what he's doing with his $1 million fund below.

Also today, James Dunn breaks down the upcoming iSelect IPO and has some exclusive information on just how much the company is looking to raise and how much shareholders might be expected to pay. JP Goldman asks how low can the Aussie dollar go, and we revisit some EOFY tax deduction issues in an article by Jo Heighway.

Don't forget our Twitter handles @switzersuper and @PaulRickard17.

Sincerely,

Peter Switzer

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Response on BHP – watch out for schadenfreude

by Roger Montgomery

As investors, one enters into a disagreement every time one buys a share. Indeed the seller of those shares disagrees with the buyer 100% and this is reflected in the fact they have taken the opposite position in the trade. So it's important therefore to never feel threatened or personally offended when someone disagrees with your assessment. After all that is what makes a market. Allowing emotional immaturity to pervade any discussions about stocks only reveals that one is emotionally immature.

Investors shouldn't mind conjecture and disagreement.

Add BI to the list

This week Peter and his team invited me, several times, to respond to a BHP "insider" who disagrees with us about our view on BHP – a view we have held now for some time. Add this "insider" to the list of everyone who has ever traded shares with us. They all disagreed.

In the time we have been articulating our dislike for BHP shares, their price has fallen from circa $40 to a low of circa $30 and very close to our estimated intrinsic value. But it is over the longer-run that share prices reflect business performance and BHP shares have produced no capital gain for investors since 2007. I'll talk about why in a moment.

Stocks rise and fall daily and in the short run BHP's share price could rise as the Australian dollar falls or as Andrew McKenzie cuts costs. But in the long-run Andrew McKenzie must confront the same fact that his predecessors all faced; that BHP and its peers are price-takers in an industry that cannot escape cyclical oversupply and excess capacity.

Source: Bloomberg

In any event, we aren't employed to correctly pick the short-term direction of prices of stocks we do not intend to own. We are required to preserve our clients funds first and grow them second.

If the outlook is sufficiently unclear for a company, we'll simply avoid that company and not pretend we have some unique insight that the other 50 analysts covering BHP for Australia's biggest brokers and fund managers don't have.

If you think BHP is a great business, we won't be standing in your way. You would however have made significantly more money investing in any number of other businesses since 2007 and our view at Montgomery is that remains the case in the future.

What we don't like

We are also less enamored with BHP's $110 million improvement in earnings from every one-cent decline in the Australian dollar, than we are concerned by the company's capacity to record "exceptional", or so-called "one-off" losses of $1.4 billion in a six-month period, as occurred most recently. It will

take a lot of one-cent declines in the Australian dollar to make up for all the one-off losses and writedowns.

The company is currently forecast to earn $16.5 billion in 2014. Leaving aside the fact that analysts producing these forecasts have absolutely no idea what commodity prices will be tomorrow, let alone in 2014, the current forecast is the same as the reported earnings of the company seven years ago.

Despite no growth in profit in seven years, $28 billion dollars of additional equity has been retained and raised to fund this "growth" and borrowings have increased from $15 billion to $27.6 billion. If your analysis of the economics of this business is that this is high quality, well, you have reached a different conclusion to us because we don't believe the very long-term economics of this business can dramatically change. I will however change my view the moment Warren Buffett turns up on our shores and bids for BHP.

Given the deceleration in the mining boom is playing out precisely as we have expected, given the dramatic decline in Australian resource company capital and maintenance expenditure and given China needs to 'adjust' to its massive overcapacity in everything "from ships to solar" we are delighted for others to buy BHP for its yield and we wish them every success.

Other mining plays and roadkill

We have never purchased BHP, but we did have exposure to the mining boom through an almost 20% exposure to mining services companies. We did however take profits and we sold out of all of our Montgomery [Private] Fund exposure to mining services in April 2012 – more than year ago, thus recording gains, while saving our investors from subsequent declines of 40%-60% and more. We already feel as though we got it right and have moved on. Studying the roadkill after running it over is not something we have had the time or the inclination to do. Investing in the roadkill is even less likely to employ our resources.

Most importantly, we don't expect to get every zig and zag right on every stock and indeed we don't even bother to try. But watch out for those who point out our errors and savour schadenfreude. Such responses reveal a great deal about their emotional intelligence, something successful investors must have a high dose of. It is only when asked that we posit an answer to where things might go, but in reality we simply don't know.

Internally we aren't even thinking about BHP because we cannot be sufficiently confident that BHP will be worth more in 2020 than it is today and so we will invest elsewhere – somewhere where we are confident, like Cochlear and CSL. There are simply businesses with clearer prospects we should be devoting our attention to.

The investor and media obsession with BHP is simply because it is big, and also because BHP is one of the the most inherited stocks owned by the baby boomer generation. But if Google, Yum Brands, Johnson and Johnson, Nestle, eBay, Apple and Microsoft were Australian-listed companies, BHP would be receiving far less attention.

Sadly this week I was not able to devote this column to a stock opportunity that we believe has emerged from the rising US bond yields and declining Australia dollar. Perhaps if we can accept that investors and traders will always disagree, we can free up our time to write about much more useful issues.

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My SMSF - Graham "Richo" Richardson

by Penny Pryor

How long have you had your SMSF?

I've had it for about five months. It took longer to kick in than I actually thought it would.

Why did you start it up?

I got out of a [superannuation] fund a year ago, the fund had just kept losing and you see your money just getting whittled away.

Where did you put your funds in the meantime?

I had it in the bank. About a year ago I emptied the super fund to put a deposit on a home and for various reasons I was able to pay it back [to the bank account].

Are you pleased with its performance?

I've done spectacularly well, without doing anything like acting like a genius. It's up 15% in four months and that doesn't include the dividends. I'm very, very happy with it.

What is your asset allocation?

It's 60% in the bank [cash] and 40% in shares. I think when things become a little clearer [in Europe] I'm thinking I may reverse that ratio. I'm not terribly confident about Europe.

What is it invested in?

I only bought four shares – Telstra, CBA, WBC and ANZ.

Do you use an advisor or any kind of service provider?

It's hard to get good advice, everyone has their own views but you've got to get good advice. In the end a trusted friend who is an accountant, I went to him and talked everything over with him.

There aren't too many people I trust to know what's going on. It's not about trusting them as people; it's about trusting their judgement. Pretty much I did what he [my accountant] suggested. He was the one who suggested those four shares.

How would you describe your investment approach?

I think I've got to stay conservative. I've got half a parliamentary pension, which is a pretty good one, so I know I've got some income no matter what. This million [in my SMSF] is basically it. I've got a five-year-old child, so I've got to build up assets for him, to get through school and university, and I probably won't be alive for all of that.

What are your investment plans for the future?

I like the way this is going and I may well put some more into super. I went out and bought a house with a very big mortgage of $3 million. Apart from that, my only asset is superannuation.

You don't have any international investments?

No, none whatsoever offshore.

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iSelect set to become market darling

by James Dunn

So there was method in the madness.

The carpet-bombing of TV advertisements – initially featuring the bumbling “Mr. iSelect,” but now featuring a far more confident dude smoothly driving the virtual “iSelectron” – were not just meant to drive brand recognition. They were also the precursor to an initial public offering (IPO) of iSelect on the stock exchange.

The health insurance – and car insurance, home loan, broadband, electricity and gas provider – comparison website is gearing up to float on the Australian Securities Exchange (ASX), although there is no prospectus filed with the Australian Securities and Investments Commission (ASIC).

The float is expected to raise $215 million, $100 million in fresh equity and the remainder will be sold down by existing holders. For example, 29% investor Mi9 (the former ninemsn) is selling its stake into the IPO.

iSelect will be welcomed on to the stock market, for the simple reason that there is a dearth of decent small-cap stocks – so much of the sector is involved in mining services, which have been hammered. The company’s marketing presentations so far to brokers and fund managers have generated huge interest, which – given the size of the float, at $215 million – virtually guarantees unsatisfied demand.

And that augurs well for the after-market.

The home of comparison

Established in 2000 as a comparison shopping site for the health insurance market, iSelect has expanded into life insurance (2007), car insurance (2009) home loans (2011), broadband (2011), electricity and gas utilities (2012) and money (2012). iSelect partners with providers of these products, and takes a commission on sales through its website. It calls itself “the home of comparison” for Australian households.

In FY12, 81% of revenue came from health insurance, with life insurance bringing in 7% and car insurance 6.3%. The other business lines are minor contributors at present, but can be expected to grow – that is where “Mr iSelect” will earn his keep.

The share market has been a big fan of the internet sales model of the likes of REA Group (REA), which operates realestate.com.au, employment website Seek (SEK), auto sales website operator Carsales.com (CRZ), and travel sites Webjet (WEB) and Wotif (WTF), but iSelect is not quite the same as this group. As those companies have grown, they have generated large amounts of cash, but iSelect has a cash ‘lag’, because many of its product providers pay it trail commissions over three or four years, rather than upfront revenue – however, the company accounts for this revenue at the time of the sale.

For example, in FY12, iSelect booked a $91.4 million “net present value of future trail commission” as an asset, with actual cash receipts making up 45% of reported revenue. This receivable sits on the balance sheet until it can be converted: in the meantime, the actuarial value of the receivable fluctuates.

In the pro forma documentation circulating among brokers and fund managers, there is $100 million sitting in cash on iSelect’s balance sheet, accompanied by a future trail commission receivable of $85 million.

The actual conversion can be affected by things like lapse rates, mortality rates, inflation, premium increases and government policy. With REA, SEK

and CRZ, this cashflow conversion lag is not a factor. Their EBITDA to operating cash flow conversion is virtually 100% at every reporting.

Closing the cash lag

iSelect recognises this, and is working to restructure its payment ratio between upfront and trailing, looking to sell more product lines that are upfront payment only. In FY12, trailing revenue accounted for 49% of the total: one of the brokers involved in the issue has research in the market projecting that FY13 will see the trailing proportion fall to 39%, and to 38% in FY14.

Even better, revenue is projected to rise from $111.9 million in FY12 to $150.1 million in FY14.

Professional investors will not be unduly fazed by the large trailing revenue component – but they would pay more for a more predictable cash flow. The cash conversion lag makes iSelect relatively difficult to value, and ensures that it will not be given full 'credit' in the price/earnings multiple it is given by the market.

To illustrate, the broker research mentioned earlier values iSelect – at an issue price of $1.85 – at 30 times FY13 earnings and 21 times FY14 earnings (projected net profit of $14.5 million).

In comparison, REA trades on 39 times expected FY13 earnings, and 32 times FY14 earnings. For CRZ, those multiples are 27.2 times and 23.3 times.

The internet stock group are all strong cash-generating businesses, typically converting about 60% to 70% of EBITDA into operating cash flow, enabling them to pay dividends. In contrast, despite reporting strong earnings growth, iSelect has not been able to generate positive operating cash flow over the past three years, let alone pay a dividend.

Strong business model

What brokers and fund managers do like about iSelect is the strong brand recognition that it has established, the proven business model and its "scaleability" into newer business areas. The brand recognition makes iSelect the logical place for consumers to research their options in virtually any service market. Comparison sites are the big winners as branded companies fight in competitive markets.

The only thing spoiling the picture in iSelect's bread-and-butter, the health insurance market, is that it does not have on its site the products of the number one and two players, Bupa and Medibank Private, although the latter sells its cheaper AHM brand through iSelect.

Earlier this year, Bupa Australia settled a misleading and deceptive advertising claim against iSelect: neither it nor Medibank Private likes the commission structure of the comparison sites, arguing that it leads to higher premiums. For its part, iSelect counters that it has increased the size of the health insurance market.

Initial strength expected

In the final analysis, iSelect lives or dies on its ability to attract traffic to its website and call centre, and generate sales across all its product lines. iSelect has become a very well-known brand, with high customer loyalty, and a major path to market for the product lines it sells.

The market is going to love iSelect, because of the scaling-back of broker and fund manager applications, but once listed, the stock has to be valued appropriately. The discounted multiple gives it a bit of room for improvement, but it has to improve its cashflow conversion. As an SMSF investor, if you manage to get hold of some, given that there is no dividend on offer, it's probably best to sell into the initial strength and then let the professional investors sift through the working capital cycle and assess what it is really worth.

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JP Goldman

How low can the Aussie Dollar go?

by JP Goldman

A number of factors help explain the fall back in the Australian dollar in recent weeks, and there's an increasingly good chance the Aussie could finally be breaking to the downside, after an extended two-year period of trading just above parity to the US dollar.

The drivers

The Reserve Bank of Australia surprised markets by cutting the official cash rate to 2.75% earlier this month, and has indicated it still has "scope" to cut interest rates further, given our currently low rate of inflation and likely below-trend pace of economic growth this year.

Confirmation in the May Budget by the Gillard Government that they won't be able to achieve a budget surplus this year – in fact, the deficit over the next two years will be higher than markets expected – has also raised international question marks over our reputation for sound fiscal management.

Continued concerns over the Chinese economy and the drop back in spot iron ore have also helped. Indeed, as I argued some weeks ago, seasonal trends suggest iron ore prices could weaken over the coming quarter at least, which should further undermine strength in the Aussie. Either way, iron ore prices are clearly past their peak, with both the Treasury and RBA predicting further weakness in prices over the next few years due to slowing Chinese demand and expansion in global iron ore supply.

Last but not least, the US economy continues to improve, which has increased speculation the Fed Reserve will ease its monetary stimulus – which has lifted the US dollar at the expense of other currencies such as the Aussie.

Good news for some sectors

If the $A is heading lower, it will be goods news for many trade-exposed sectors of the economy struggling under the weight of the high currency – not least of which is the mining sector.

Indeed, if the Aussie suffers a decent fall, it would have profound implications across the economy. Investors should note that it would help breathe life into the earnings outlook for the Australian equity market overall – given it's top heavy with exporters rather than importers – as a falling $A boosts the $A value of profits earned overseas.

By improving competitiveness, it would also help revive still depressed business sentiment in the manufacturing, tourism and educational export sectors. And it might cause miners to think twice before mothballing more expansion projects.

On the downside, however, a weaker $A means the RBA would be less inclined to cut interest rates again this year – which would be less supportive for the housing sector. And a particularly large fall in the Australian dollar could boost the price of imported household goods, unnerve consumer sentiment and dent consumer spending – which would not be especially great news for the consumer discretionary

sector.

In short, a lower $A – provided the fall is not too far too fast – should be of net economic benefit and positive for the share market, and tend to favour the mining and industrial sectors over financials, housing and retailing.

Fall has its limits

That said, it's unlikely the $A will drop too far in a hurry – and it may well disappoint those hoping for a major boost to competitiveness. After all, even if the RBA cuts interest rates again – to 2.5% – they will still be attractive for foreign investors compared to the near-zero rates in most other developed regions such as Europe, Japan and the United States.

And despite the recent budget deficit blowout, net public debt is still very low by international standards, suggesting we're still a good credit risk. Iron ore prices could weaken further this year, but possibly hold above the lows of last year, as China steel producers learn to better manage their inventory cycle and less efficient Chinese iron ore producers exit the market.

Last but not least, despite recent heightened fears, the US Federal Reserve seems unlikely to announce a scaling back of its stimulus program anytime soon, as it still regards America's economic recovery as too fragile – particularly given the sharp automatic tightening in US fiscal policy in recent months. Similarly, Japan has announced a massive new money printing campaign, some of which will find its way into high-yielding Australian dollars.

All up, while days of the $A trading above parity to the US dollar may be over, it might hold itself above US90c over the coming six months or so at least – which might not be enough of an adjustment to prevent the RBA from cutting interest rates a little further.

The big move in the $A may come when (and if) the US Federal Reserve finally begins to tighten monetary policy and raise interest rates – which is still at least six months to two years away. For investors though, the "risk/reward" play says to stay 'unhedged' with your offshore investments – including global equity funds.

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Where to now for fixed income investors?

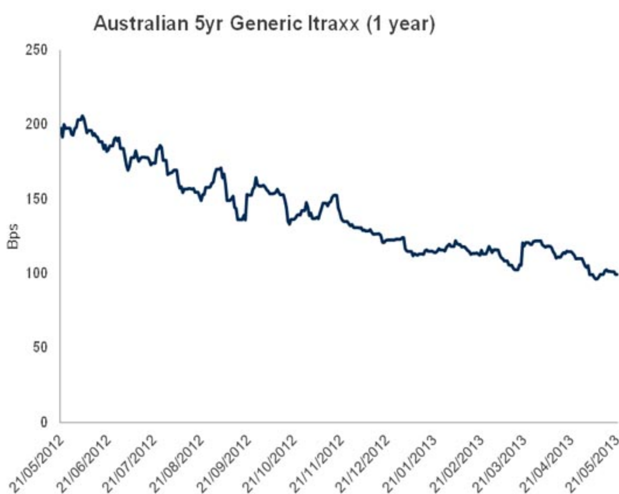
by Gavin Madson

The RBA joined seven other central banks in easing policy this month. The RBA cut the cash rate by 0.25% to 2.75%, revising inflation forecasts lower, and increasing the scope to cut rates again in the future. With the RBA inflation target range being 2% to 3%, another rate cut means investors are effectively getting 0% real returns at the cash rate.

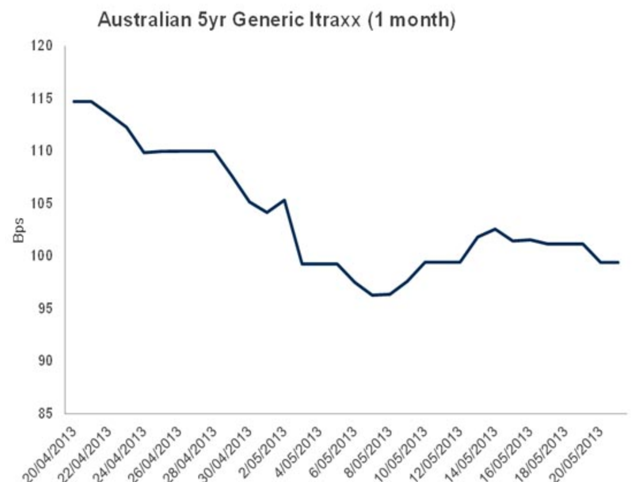
Given favourable market conditions of low base rates and lower credit spreads, issuance activity in the debt capital market continued at a steady pace this month. So far in May, total issuance volume has been $8.6 billion, the second highest year to date, behind the $12.62 billion of issuance undertaken in January, as companies take advantage of favourable borrowing conditions.

The great yield chase

The Australian iTraxx Credit Default Swap (CDS) index tracks the performance of Australian corporates and is an indicator of credit risk for investment grade entities. The lower the spread, the lower the perception of credit risk. The charts below show performance over one month and one year. Over the last month, the Australian iTraxx tightened some 15 basis points and over the last 12 months has tightened just under 100 basis points.



Source: FIIG Securities



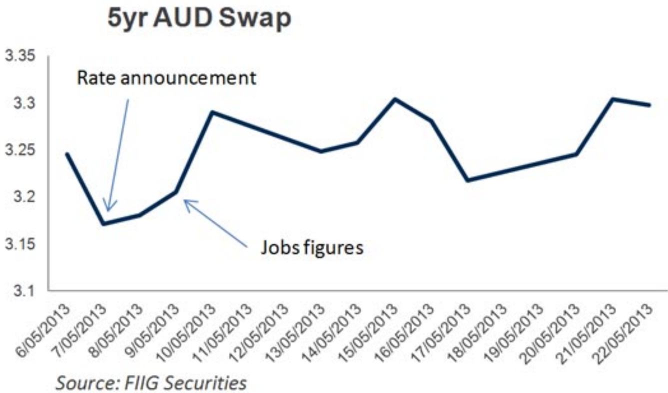
Source: FIIG Securities

This decrease in spread has occurred as investors have 'chased yield' driving the capital prices of bonds up. This chase for yield and decrease in risk perception, has seen bank spreads come in markedly over the last 12 months. The five-year CDS spread on NAB, for instance, has come in from 185 basis points 12 months ago to 72 basis points today. It's still higher than pre-GFC, but bank funding costs have come down, and this is the reason why commentators are now discussing out of cycle rate cuts – banks can afford to sharpen their pencils and chase the loan market. With corporate sentiment remaining subdued, competing for the home loan market is the best chance of growth for the Big Four in the short term.

So where's the value?

With spreads tighter and base rates lower, it is becoming tougher for investors looking to maintain a diversified investment portfolio to achieve solid returns. However, it is worth noting that the cut in the cash rate tends to have more effect on term deposits and short maturity bonds. Longer maturities take their lead from other, longer-term indicators. In the graph below we see the initial drop in the five-year AUD swap rate following the announcement of the rate cut. Two days later solid job figures were announced (a

good sign) and the rate jumped up to above where it was the day before the rate cut (subsequent to this, in the absence of other data, the rate followed US movements as is the norm).



Source: FIIG Securities

So for investors holding fixed income and who are confident that the low interest rate environment is here to stay, the message is to move out of shorter-dated securities and into longer-dated maturities where the base rate can help increase returns. A return in the 5% range may not sound great, but it is double the short-term rates on offer.

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Make the most of SMSF tax deductions

by Jo Heighway

Whether it is common expenses, such as accounting fees and establishment costs, or the more outlandish such as flights, accommodation, laptops and expensive software programs, the simplest way to work out if it is appropriate for your SMSF to pay a particular expense is to ask two questions:

1. Is the payment allowed under your trust deed and the superannuation law?
2. Will the payment be tax deductible?

What does superannuation law say?

Remember the sole purpose test? That is the requirement that any decision you make in relation to your SMSF should be made for the sole purpose of providing retirement benefits to members. Any expense that provides a current benefit to members – say a personal computer, training course or holiday that you want now but can't afford personally – should not be paid from your super fund.

The sole purpose test is sometimes also known as the 'sniff' test! If the expense looks personal or excessive in relation to the size of the fund, it is likely to get some extra attention.

Other rules you need to know:

- Your SMSF can't provide loans or financial assistance to members of the fund or their relatives. If the expense is really a personal expense, don't risk paying it from your fund.
- Any payments between your super fund and yourself or your business must be done on commercial terms (arms-length).
- Be very careful selling anything to your super fund that isn't listed shares or business real property because strict rules apply.
- You can't pay yourself remuneration for your services as a trustee of your SMSF.
- Check your trust deed too, as there should be a clause setting out what expenses are acceptable.

Property, flights and other costs

Can your DIY super fund pay for your flights, accommodation, and associated travel costs to visit an investment property owned by the fund? Yes, it is possible if the visit is necessary for the maintenance of the investment.

However, you will need to keep fantastic records and document any personal component of the trip and apportion the costs. Be prepared for extra scrutiny, especially if the trip is for more than a day or two, is overseas, or to a holiday location.

Does your claim make sense?

The expense should 'make sense' in the context of what types of investments your SMSF holds.

Let's say you've come across a great share-trading course that costs $6,000 and you want your super fund to pay for it.

If you only have a small amount of money in your SMSF invested in no, or only a few, listed shares in blue chip companies, the expense represents a large chunk out of your fund balance. If you have no real intention to become a very active investor in your capacity as trustee, then you really shouldn't contemplate paying an expense like this from your super fund.

If the investments of the fund and your trustee activities clearly indicate the expense is relevant, then go for it.

What can trustees be remunerated for?

While you can't pay yourself remuneration for your services as a trustee, you may be able to be remunerated for non-trustee services, provided:

- You are appropriately qualified and licensed to perform the service;
- The duties or services are performed as part of a business through which you provide the same services to the public; and
- The remuneration is on an arm's-length basis.

A common example of this is an accountant receiving remuneration for preparing the financial statements and tax return of his or her super fund in their normal course of business.

Claiming those all important tax deductions

There are times when an expense may be allowed to be paid by your super fund, but no tax deduction is available. For example, the costs of establishing your super fund, or expenses incurred when the fund is in pension phase and paying 0% tax. In these situations, the fund should still pay the expense, but there will be little or no tax advantage.

There is a tax ruling (TR 93/17) that contains a detailed list of expenses that are deductible to your SMSF including:

- Actuarial costs;
- Accountancy fees;
- Audit fees;
- Updating your trust deed to comply with the SIS Act;
- Trustee fees and premiums under an indemnity insurance policy;
- Costs in connection with the calculation and payment of benefits to members e.g. interest on money borrowed to secure temporary finance for payment of benefits, medical costs in assessing invalidity claims;
- Investment adviser fees;
- Subscriptions to the Switzer Super Report; and
- Other administrative costs incurred in managing the fund.

What you can claim

Expenses that are likely to be deductible include bank charges, brokerage, filing fees, fines, interest paid, life and TPD insurance premiums, valuation and storage costs, property expenses, relevant training courses, subscriptions, administration software such as Class, and depreciation on plant and equipment.

Two of the most beneficial tax deductions available to SMSFs are:

- Exempt current pension income deduction – available for funds paying pensions; and
- Anti-detriment deduction – a very valuable deduction for any fund paying a death benefit.

Hot tips to keep you out of trouble

- Make sure the invoice is made out to the super fund.
- Wherever possible, pay the expense directly from the super fund bank account.
- Watch paying expenses from your own bank account or company bank account as they could be deemed a loan to your fund or a contribution.

My final pieces of advice – don't overdo it, and be patient! Remember your superannuation money is there for your retirement. The less you touch it, the better your retirement will be.

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Question of the week – how can I invest in infrastructure

by Paul Rickard

***Question:** There are quite a few experts on the Switzer program and the Sky Business Channel who advocate spending on infrastructure projects. There is also a huge sum of money being managed by superannuation funds (both nationally and internationally).*

Would you please provide some advice on some of the best ways for an SMSF to invest in infrastructure projects?

Answer: Thanks for the question about the best ways for an SMSF to invest in infrastructure assets.

It is not easy to invest directly as most SMSFs would not qualify as a 'wholesale investor' and would be ineligible to receive any information memorandum. In any event, most projects just aren't interested in small investors.

There are two ways to invest indirectly. Firstly, you can invest in the listed "infrastructure" companies on the ASX. These tend to be single industry focussed (eg. roads, power stations or airports etc), and often have a single or small number of assets.

The listed companies that can be classified as "infrastructure" include: APA Group (APA); Asciano Group (AIO); Australian Infrastructure Fund (AIX); DUET Group (DUE); Envestra Limited (ENV); Infigen Energy (IFN); Macquarie Atlas Roads (MQA); MAP Group (MAP); Qube Holdings Limited (QUB); Redbank Energy Limited (AEJ); SP AusNet (SPN); Spark Infrastructure Group (SKI); Sydney Airport (SYD); and Transurban Group (TCL).

Secondly, many of the major fund managers (AMP, Macquarie, Colonial First State, Magellan etc) have unlisted infrastructure funds.

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Did you know?

I spoke to Clifford Bennett, chief economist at White Crane Group during the week on Switzer TV for his view on the current market situation. Turns out he doesn't think a pullback is on the cards either.