Switzer Super Report

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Rate cuts not over

The Reserve Bank held fire and left the cash rate at 2.75% this week, but it's implying it's ready and willing to cut again. So why wait? In today's newsletter, JP Goldman explains that although the Australian dollar has fallen, it's still well above average and the RBA won't have ruled out further rate cuts yet. And while on a falling Aussie dollar, James Dunn analyses what five funds investing overseas have to offer and tells us the difference between hedged and unhedged.

Also, Roger Montgomery reveals how he decides when, and when not, to invest, plus reveals the 127 companies that have reported downgrades. And in this week's My SMSF Joanne Stuhmcke talks about her strategy and approach to DIY super.

Plus, in the question of the week, we look at whether it's possible to sell shares before EOFY to get a capital loss, then buy them back.

Sincerely,

Peter

Peter Switzer

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International exposure – five funds that invest overseas

by James Dunn

With the Australian dollar ($A) having spent most of the past two years valued above the greenback, Australians have had a godsend of an opportunity to diversify their investments overseas, without the currency penalty that has usually applied.

Australians have been able to buy into overseas assets virtually at a one-for-one currency basis.

Recent ructions on the foreign exchange market have re-introduced the currency 'loading' for Australians investing abroad, but at 95–96 US cents to the $A, it is still a fairly favourable transaction in terms of what has most often been the case – given that the argument for international diversification does not go away, even with the strong home bias that the dividend franking system guarantees.

There is always currency risk in investing in another currency. Investors can choose to hedge their investment – that is, run it in the foreign currency, so that currency fluctuations do not affect the returns – or leave it unhedged (that is, in $A). Hedging will help you if the $A rises, but it's better to be unhedged if the $A is falling.

However, many investors do not see this exposure as 'currency risk' at all: they want to remain unhedged, for the possibility that the currency could boost their returns. These investors see foreign currency exposure as effectively another level of diversification.

When investing overseas, you've got to be thinking long-term – at least ten years. With that in mind, *Switzer Super Report* has looked at a group of funds that offer great prospects of doing a really good job investing overseas. The principle here is not to focus so much on the return comparisons, but to go on what the manager offers you.

Platinum International Fund

Platinum, the funds management house founded by Kerr Neilson in 1994, has been a hugely successful Australian funds manager. The flagship International Fund, a $7.6 billion fund, has delivered investors 12.1% a year since inception in 1995. The $3.5 billion Platinum Asia Fund, established in 2003, is up 15.6% a year. There is also a European Fund, a Japan Fund, an International Brands Fund, an International Health Care Fund and an International Technology Fund.

Platinum is usually pigeon-holed as a "value" fund, meaning that it buys stocks it thinks are trading well below intrinsic value, but this description doesn't tell the whole story. Platinum's team are stock-pickers, but they think with a macro-economic 'thematic' perspective. The Platinum team, now led by co-founder Andrew Clifford, resists easy classification: it is almost an absolute-return hedge fund. The Platinum team sees the world as their oyster, they will buy stocks from anywhere, any industry, whether large-cap or small-cap, they are prepared to sell short, and to move heavily into cash if they can't find value at any particular time.

Platinum actively manages its currency exposure, being prepared to take positions for profit. The International Fund has shown disappointing performance recently, but the longer-term track record is outstanding, and investors prepared to give this fund a decade to work for them are unlikely to be disappointed.

Magellan Global Fund

Established in 2007, the $2.9 billion Magellan Global Fund is managed by a team led by Hamish Douglass, rightly considered an excellent investor. The key to the Magellan strategy is to be positioned in the stocks that will be the major beneficiaries of the one billion new consumers that will emerge in the major developing markets of the world, in particular China and India, over the next 15 years. Magellan buys the stocks that produce the goods and services that these consumers will buy. This means it buys global stocks that have big chunks of their revenue coming from developing economies. For example, its top portfolio holdings at present are Danone, eBay, Google, Lowe's, Microsoft, Target, Tesco, Wells Fargo and Yum! Brands. Consumer defensive is the largest sector, at 23.8% of the fund, with financials at 15.3% and mass-market retail at 14.6%. The fund is concentrated, holding about 30 stocks.

Since inception in July 2007, the unhedged fund has returned 7.3% a year, compared to –2.7% a year for the MSCI World Net Total Return Index ($A). While the theme behind the Fund is a popular one – Douglass says the theme is more expensive now, so Magellan owns less of it than it did three years ago – he also says the fund is "positioned where China is changing to," as in a more consumer-driven economy.

Grant Samuel Epoch Global Equity Shareholder Yield Fund

A different approach to Magellan and Platinum (and which sits well between them in a portfolio) is that of Epoch Investment Partners, whose Global Equity Shareholder Yield Fund – offered in Australia through Grant Samuel Funds Management – targets a dividend return of at least 4.5%. Epoch tries to add another 1.5% a year from share buybacks or other capital management, and with 3% from capital growth, Epoch targets a total return of about 9% a year.

The hedged version of the fund ($239 million) has returned 16.5% a year over the past three years, while the unhedged version ($737 million) has generated 9.5% a year. At present, about 70% of inflows are going into the unhedged version, as investors bet on the $A falling.

MFS Global Equity Trust

Another US-based fund, this vehicle is offered in Australia through Equity Trustees. The $4.3 billion fund (hedged and unhedged versions available) invests with a capital-growth focus, and turns over stocks very infrequently, making it tax-efficient for investors. A return of 12.4% over the past three years is a strong validation of the philosophy, although (in common with many longer-lived funds, given the market slumps of the GFC) the ten-year return falls away a bit, to 6.3% a year – which is still well ahead of the MSCI World Net Total Return Index ($A), on 3.5%.

The fund benefits from high-quality stock-picking, with any one stock limited to 5% of the portfolio and exposure to any single industry limited to 25%. The MFS team invests in companies, not countries. It's a high-quality approach.

Fortrend Securities Relative Value Model

The last portfolio is not a managed fund: it is a portfolio chosen by Melbourne-based full-service global broker Fortrend Securities, through its proprietary Relative Value Model (RVM). You won't find the Fortrend RVM in any fund manager surveys or tables: but many Fortrend clients invest in it as a separately managed account (SMA), for 2% a year. At the moment, the $100 million portfolio contains General Motors, Microsoft, Oracle, semi-conductor company Nvidia, healthcare equipment supplier Thermo Fisher, media and entertainment group McGraw-Hill, non-alcoholic beverage group Dr Pepper, truck and busmaker Navistar International and technology manufacturer Honeywell.

Since inception in September 1993, Fortrend's RVM portfolio has gained 12.2% a year, compared to 6.6% a year for the S&P 500 Index. In the last 12 months the portfolio is up 45.5%, versus 27.5% for the S&P 500. Fortrend Securities chief executive Joe Forster says the portfolio is a long-term investor, but there is

no set time frame: for example, it has owned Microsoft for six years, but in March it “flipped” Deutsche Bank after making 22% on the stock in four weeks. Forster says the portfolio looks to invest in sectors of the economy not available on the ASX.

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Weakness from resources sector spreading

by Roger Montgomery

On Peter's show last week, I mentioned that The Montgomery [Private] Fund's cash weighting moved to over 40% a couple of weeks ago as we took profits on stretched valuations among many of the high-quality companies we prefer to invest in.

Since then, share prices for many companies have slumped and naturally, we have since been asked by several subscribers how we go about deciding when to invest and when to step aside.

The role of the fund manager

To begin answering this question, we should start with the understanding that most funds cannot swing so flexibly between cash and shares. The structure of the funds management and financial planning industry has long favoured the idea that the fund manager must stay fully invested and that a research house or asset consultant decides, on behalf of clients, how much to allocate to cash and to shares.

Fortunately, the GFC combined with long-term underperformance has resulted in two trends emerging. The first is a big shift to index funds and index ETFs: as Warren Buffett observed, if you aren't prepared to be a know-something investor, index funds may be the best alternative. For what it is worth, we think it's relatively easy to beat an index over the long run, when the index is based only on size or sector.

The second trend that has emerged is a recognition in the industry that in some cases, the fund manager, who is at the coal face, may be the best person to decide whether to be in cash or shares. As an investor there is no doubt that you want your fund manager to preserve your capital and go to the safety of cash, if he or she was of the strong opinion that the market was at risk of a sharp correction, for example. Up until recently such an option has not been available.

Risky business

When we looked at our portfolio of high quality businesses, we realised that even though we had no exposure to mining or mining services companies for over a year (they have fallen as much as 60 and 70%), there were still risks present.

The combination of share prices at or above valuations and a resource sector slowdown – that could morph into a more serious wider economic slowdown meant that lofty share prices might not be justifiable. And in any case, the fact that prices were at or above our estimated intrinsic value, the upside was limited and the downside risks were growing.

Many fund managers disagree with our interpretation and that is ok by us. Every time we buy shares, the seller disagrees with us too.

In essence, we are concerned that the 1.5% contribution from mining capital expenditure to our GDP growth rate of 3.1% may be severely curtailed, if the Bureau of Resource and Energy Economics forecast of a 75% decline in capex by 2017 becomes reality.

Company downgrades

And before you decide to believe those who proffer a 'things-are-just-fine' argument, think about the 127 companies one of our brokers tells us have reported downgrades. Make that 128 if we include Cochlear in their list!

Here's their list, in alphabetical order:

Ariadne, Australian Agricultural Company, APN News and Media (second downgrade), ASG Group, Ausdrill

(second downgrade), Ausenco, Australian Power, Bisalloy Steel, Blackmores, Boom logistics (second downgrade), Bradken, Breville, Cabcharge, Cardno (second downgrade), Calibre, Clarius, Clean Seas Tuna, Chandler Mcleod, Chongherr Investments, Coffey, Coventry Group, CPT Global, CSR, DTQ, DWS, Elders, Ellex, Emeco (third downgrade), Engenco, Enero, Fantastic, Fleetwood, Greencap Ltd, Global Construction Services, GR Engineering, GUD Holdings (second downgrade), GWA Group, Hansen Technology, Hills Industries, Hudson Investment, Hunter Hall, Integrated Research, Jumbo Interactive, Konekt, Korvest, K&S Corporation, Lycopodium, Macmahon Holdings (third downgrade), Mastermyne, Matrix Engineering (second downgrade), Melbourne IT, Miclyn (second downgrade), Moko.mobi, Mothercare, Noni-B (second downgrade), Norfolk Group, NRW Holdings, Nuplex, Oakton (third downgrade), Objective Corporation, Peet, Pharmaxis, Platinum, PTB Group, QXQ, Redflex, Reece, Regional Express, Resource Equipment (second downgrade), Ridley, Rubicor, Ruralco, Saferoads, SAI Global, Sedgman (third downgrade), Servcorp, Service Stream, SMS Technology, Steamships Trading, Stokes, Structural Systems, Tel Pacific, Transpacific Group, Transfield (second downgrade), Virgin (second downgrade), VDM Group (second downgrade), Villa World, Vision Eye Institute, Warnambool Cheese & Butter, Watpac, Webjet, WHK Group (second downgrade), WDS Limited, World Reach, Zicom.

The dust storm

We reckon the facts are pointing to economic weakness spreading from the resources sector to the rest of the economy, and from Perth across the Nullarbor to the Eastern Seaboard of Australia. We hear, for example, that a couple of years ago when a Perth-based stockbroker was looking for another mining services analyst, they couldn't find a single person to fill the role. Recently a place became available…and almost 50 mining engineers applied. That dust storm is on its way.

Some fund managers are suggesting you should be looking at the value that is now emerging in the market, particularly in the mining and mining services sector. We thinks that's like being a minnow fishing for food in a bathtub that has had the plug pulled – you run the risk of being sucked down the drain.

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AUD hasn't fallen enough to stop RBA rate cuts…yet

by JP Goldman

The Australian dollar has dropped moderately over the past month or so, from around US$1.05 to the US mid-90c range. It naturally begs the question: has the $A dropped by enough to rule out further interest rates declines?

Indeed, will the weaker $A seriously add to inflation and/or quickly restore competiveness to our hard pressed trade exposed sectors?

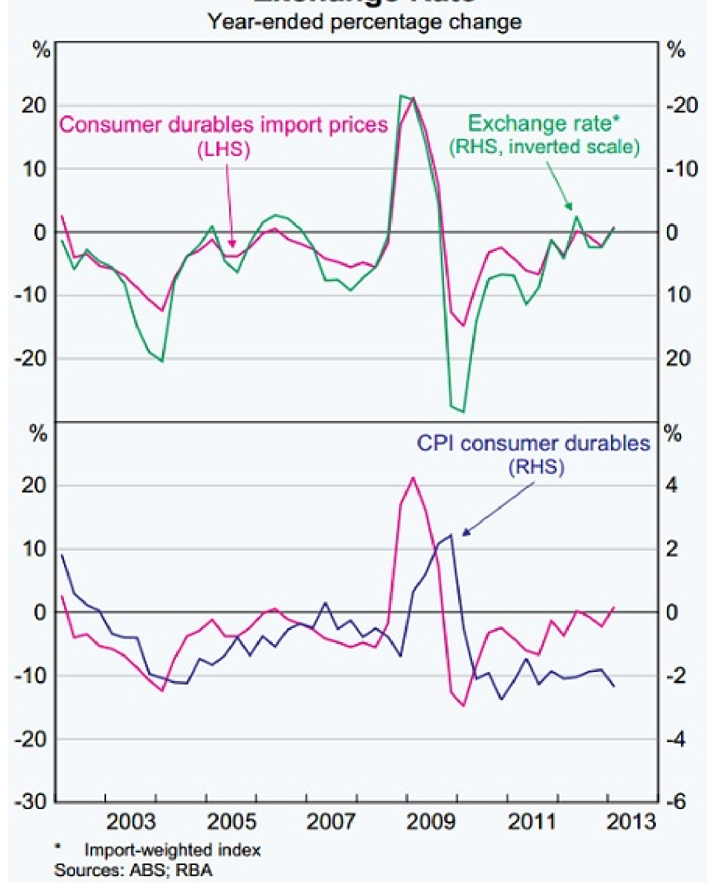
The answer to most of these question is a resounding no – or at least "not yet". After all, the $A has only declined by around 8% so far, and still remains well above its average since the mid-1980s of US75c.

Even on a trade-weighted basis, the $A index is about 25% above its long-run average, and almost 50% above "fair-value" on a purchasing power parity basis – or that which align relative cost levels to those of the United States.

Of course, export prices remain relatively high, but even against this benchmark, the $A is also unusually high – as the Reserve Bank (RBA) was keen to stress in this week's post-meeting policy Statement (at which it left interest rates on hold). So the net effect is that the $A is still hurting competitiveness and imparting a drag on economic growth.

Soft consumer spending

As regards inflation, RBA research suggests the flow through of a weaker currency to consumer prices tends to be quite muted and gradual. Overall, a 10% change in the exchange rate is estimated to produce a 1% change in underlying consumer prices over 3 years, with only one fifth – or 0.2% – of this effect evident after one year. All else constant, that suggests the exchange rate decline to date – if sustained – will boost inflation by less and one quarter of a percentage point over the coming year.



All else, however, is not constant. As also recently noted by the RBA, the price of imported consumer goods has kept falling in recent years even though the $A has been broadly stable – due to improving productivity in retail supply chains and a crimping in profit margins. With consumer spending still fairly subdued, these non-exchange rate forces are likely to continue helping hold down inflation.

More broadly, the softening in the labour market over the past year has already helped slow the rate of wage growth – and with the unemployment rate expected to drift up further, labour cost pressures should also remain a restraining influence on inflation.

Indeed, despite the drop in the exchange rate over the past month, the soft pace of consumer spending and wage growth suggest there's more downside than upside risk to the RBA's inflation forecasts over the remainder of this year. Contrary to strong retail sales reports, for example, the national accounts revealed consumer spending only grew a tepid 0.6% in the March quarter and the household saving rate remained at a relatively high 10.6% of disposable income.

At present, the RBA expects annual underlying inflation to hold at 2.25% by the December quarter – or not far from March quarter levels – and there's a risk it could instead slip a little lower to 2%.

RBA encouragement

Of course, there's also risk the $A could drop further in coming months, especially if the RBA cut interest rates further. But rather than fearing such a drop, it's probably what the RBA is hoping for – so much so it may well cut rates further so as to encourage the currency's decline.

The once counter to this view is if the US economy suddenly gets a lot stronger, such that the Federal Reserve starts to tighten policy more quickly than markets currently expect. This would be a scenario under which the $A could fall ($US rise) even as global growth improves – which would lessen the need for the RBA to cut rates further. At this stage, however, the US economic recovery remains too sluggish to suggest the Fed will take away the punch bowl anytime soon.

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My SMSF – stick to the growth path

by Super Report Subscriber

Joanne Stuhmcke

Vital statistics:
Age: 49.
Profession: Private trader, part-time bookkeeper, investment education writer (currently consult to two not-for-profit organisations).
Family: My husband and I are members of the SMSF, we have two adult children who are not members.
Location: Brisbane.
Investments outside of superannuation: Rental properties, family trust holding Australian shares, portfolio of shares in personal names.

How long have you had your SMSF?

Since 2007.

Why did you start it up?

We started the SMSF because we wanted to have more control over what our super money was invested in. I did some administration work for a financial advisor and learned how to set up an SMSF and what was involved in running one, which gave me the confidence to start out on my own.

How big is it?

Not big enough! Most of our wealth is in equity and in property outside super. I have a staged strategy of selling property and contributing the proceeds to super over a period of five years leading up to retirement, which will get the super fund balance to a level where we can provide for our retirement comfortably.

Is it more or less difficult to manage than you thought it would be?

It is easy to manage as long as you are aware of the responsibilities that you have as a trustee. With just a little bit of effort you can meet them easily and we don't have anything too tricky – no borrowing or property within our SMSF – so it is fairly straightforward.

Are you glad you have it?

Yes, very glad that we have the SMSF. I know exactly where the money is invested and how it is performing at any time.

Are you pleased with its performance?

I wasn't pleased with the performance over the first couple of years. Because it was our 'retirement money' I tended to treat it differently to our other investments and I made mistakes. Over the last two years though, performance has improved. The return is still not as high as the returns I get within the family trust but I am happy with the improvement. Over the last three years the average return has been 12.4%.

What is your asset allocation?

Our intention is to have 90% invested in growth assets and just 10% in cash, but at the moment the SMSF is only 70% invested – 54% in Australian Shares, 13% in Australian listed property trusts and 3% in an international managed fund (which has always performed hopelessly and which we never should have bought!). The remainder is allocated 6% in fixed interest and 24% cash – we are just waiting for some buying opportunities to buy companies at value prices.

My Australian shares are well diversified across a mix of sectors, including some great performing utility and infrastructure stocks and a couple of stocks in the consumer discretionary sector. I did have a couple of banks but I took profits on those just recently, and I'm still holding Wesfarmers (WES) preference shares and Woolworths as well as a couple of smaller growth focused mid-cap stocks. I have been too cautious, though, with my position size. My returns would have been much better if I had trusted myself more and taken the position size my plan allowed for.

What are your favourite investments/stocks and why?

As much as I don't like the accounting associated with listed trusts, my favourite investment has to be APA – it has performed so well. My other favourite is GEM, G8 Education – I like its growth prospects and the chart looks great. Hopefully this market correction will allow me to buy some more.

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

No, I don't use an advisor as I have had some 'expensive' experiences with financial advisors in the past. I work for a local accountant, in fact I do all the practices' SMSF accounting work, so I do all my own accounts so the only service I use is an auditor.

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Question of the week: EOFT share buyback strategy

by Paul Rickard

***Q.** I have several shares with losses. What are the rules if I was to sell them before financial year to get a capital loss, but buy them back at some stage? Is it any different if I was to firstly buy some more and then sell half of them for example? What constitutes a share wash?*

A. Thanks for the question.

If you are in any doubt, you should access the assistance of a qualified accountant or tax professional.

There aren't any specific rules per se, except that any transaction or series of transactions that could involve a "scheme" could potentially run fowl of the general anti-avoidance provisions in Part IVA. The ATO has provided its guidance in Taxation Ruling TR 2008/01, which deals with "wash sales" and is available here.

Generally, it can't be a scheme for the avoidance of tax, there must be separate sale and purchase transactions, and there must be a sufficient time interval such that there is a material financial risk. In an example the ATO considers in the guidance note, it doesn't think that 24 hours is sufficient.

I hope this helps.

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Don't miss this

I recently caught up with champion swimmer Geoff Huegill. After an incredible 2010 Commonwealth Games comeback, he's now a specialist at the Commonwealth Bank. Don't miss his interview on Super TV.