



Double-whammy

The Australian stock market has followed Wall Street lower today, with a double-whammy of news. Overnight, the Federal Reserve announced it will start to taper QE and today we received weak Chinese manufacturing data. Now all we have to do is time the buying opportunity to perfection!

Also in today's Switzer Super Report, with the Japanese equity market one of the best performers in recent times, JP Goldman looks at whether Abenomics is sustainable in the long run and James Dunn tries to add spice to a boring topic - A-REITs - to show why boring can be good! Plus, Gavin Madson looks at rising bond yields.



Sincerely,

Peter Switzer

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Highway to the buying zone – Fed tapers QE and China data disappoints

by Peter Switzer

The US central bank boss — Federal Reserve chairman, Ben Bernanke — talked to the market in typical central banker ways — hints, winks and generalities — but effectively said he will taper back the third round of quantitative easing (QE3) some time this year and, in all likelihood, end it next year.

He also implied that official interest rates would not go up until 2015. He gave the US economy a tick for the progress of its recovery and gave the US Congress a bit of curry for putting budgetary restraints on the course of economic growth.

Remember, if the US grows more quickly, the Fed can stop pumping \$85 billion a month into the economy and then turn off the life-support called QE3.

In case you missed it, the Dow dropped 206.04 points or 1.35% to 15,112.19 while the S&P 500 lost 22.88 points or 1.39% to finish at 1628.93.

This market sell-off is an overreaction but we're living in volatile times, with the Dow actually putting on seven days in a row of triple-digit moves!

Our local market reaction is really over-the-top — down around 2% by lunchtime, but it was not helped by more weak manufacturing data from China. However, this only reinforces my argument that we are in a buying zone for stocks and we now have to time it to perfection.

Don't worry, the Yanks won't stay down for long because their economy is improving and we will follow suit, but in the interim period, share prices will dip some more.

I will let you know when I'm a buyer. I've been writing about and waiting for this sell-off since March, so I'll have to bite the bullet soon. You'll be the first to know.

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Webjet flying higher in Oz. Can it soar in Asia?

by Roger Montgomery

One of the more successful investment themes in the Australian market in recent years has been internet companies. Over time, the best internet businesses have demonstrated an impressive capacity to generate free cash flows from a limited asset base, and to steadily grow those cash flows with minimal additional capex.

Some of the most sought-after internet businesses are the ones that are able to establish a leadership position and exploit network effects – a virtuous circle whereby visitors are attracted to a site because of its comprehensive advertiser base, and advertisers are attracted because of the large volume of visitors. Classified advertising sites like Seek, REA Group and Carsales.com are good examples.

The performance of some internet businesses, however, has significantly lagged others. For example, while the share price for REA Group is up around 60% year to date (YTD), the share price for Webjet Limited (WEB) is essentially flat for the same period. With WEB now trading on relatively undemanding earnings multiples by internet business standards, it is appropriate to ask whether WEB now represents a value opportunity.

To buy or not to buy?

In terms of financial performance, WEB ticks a lot of boxes. Revenue and earnings have been rising strongly for many years, ROE has been trending up, and cash flows have been very healthy. As a result, WEB's balance sheet has grown to a material net cash position. Guidance for FY13 also indicates a continuation of strong double digit earnings growth.

If WEB can sustain this trajectory, then the current share price will look like good value in retrospect. However, there are some issues to consider.

Stock Chart for Webjet Ltd (WEB)



Firstly, network effects are perhaps not as robust in WEB's core market. Compared with the number of new cars on Carsales.com or the number of employers on Seek.com, the number of airlines that Webjet can offer its users is relatively limited. This means that it is not as difficult for users to access the same information from alternative sources, and WEB's market power is correspondingly limited. This may not be a major issue, however.

Including its accommodation business, WEB claims to be the largest online travel business in Australia and New Zealand, and as mentioned previously, its economic performance to date has been very good.

Domestic growth limitations

Another issue is the long-term sustainability of growth. The Australian market is finite, and the migration of travel business from traditional retailers to online can only go so far. Accordingly, WEB

arguably needs to deal with a domestic growth ceiling by finding and successfully developing international growth options.

Initially, WEB sought to achieve this via joint ventures and organic growth in Asia. However, after experiencing slow progress with this approach, in December 2012, WEB acquired Zuji for \$25 million cash, and with it the number one online travel position in Singapore and Hong Kong.

Internet penetration and the online migration is less advanced in Asia than in some markets, and if Zuji can maintain a leadership position in key markets as the industry matures in the region, the value of the business could grow very substantially. However, this may not be straightforward. Many others have also recognised the potential upside, and competition in online travel in Asia has become vigorous. Competitors including Expedia, Agoda, hotels.com and Priceline all have similar objectives to Zuji.

Rather than relying on first mover advantages, in Asia, WEB may need to find ways to gain an edge over capable and well-resourced challengers. At this stage, it is difficult to be certain how it will do this, but management skill, understanding of the relevant markets, and depth of resources all seem likely to play a role in deciding the outcome.

Call for concern

For the time being, we see reasons to be concerned on this front. Our analysis of internet traffic and search volumes suggest that some of the competitors named above may have outpaced Zuji in the most recent half year. Recall that the online world tends to be winner-takes-all, and the loss of market leadership would be a significant setback.

Time will reveal whether WEB and Zuji can translate success in Australia into success internationally. In the meantime, potential investors should pay close attention to management's commentary at the full year result; to better understand the strategy being followed in Asia, and for signs that the strategy is working. If Zuji is losing ground, WEB's growth prospects and valuation may need to be revised downwards.

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When boring is good – A-REITs in focus

by James Dunn

This is a boring article, about a boring sector. But boring is good.

Boring is just fine in the context of the Australian real estate investment trusts (A-REITs).

The A-REITs simply collect rent from their tenants, and pass most of it on to their unit holders. With their distribution yields running at about 6.5%, the trusts are finding plenty of favour in a low-interest rate environment, from global as well as Australian investors.

For a while there – pre-GFC – the REIT sector wasn't boring. Many of the trusts had branched out into other income streams, for example, property development and syndication; they had used the cheap debt on offer to quadruple their average gearing level, to close to 45%; they were using some of that debt to offer investors payouts more than they generated in income; and they were expanding overseas.

It was heady times, but the reckoning on the market when the debt bubble exploded was savage.

Cleaning up

Australia's REIT managers have cleaned up their act. Asset sales and capital raisings have pulled the average gearing level down from 43% in 2007 to 27%. At the same time, the average overseas exposure has fallen from 38% to 18%. Payouts are also firmly back in conservative territory, at just over 80% on average, as managers look to put away a bit of money to work on their businesses.

Given the yields on offer, the cleaning-up of the sector resulted in strong investor support. Over the year to 31 March 2013, the A-REIT category returned 30.7% in total returns, nearly one-third better than the

overall share market return. From large discounts to their net tangible assets (NTA) valuation, the A-REIT sector moved in many cases to premiums.

That is OK – many investors are prepared to pay a price premium for the yields offered, both in terms of absolute and relative level of yield, plus the reliability of the income. But there was little room for the sector to improve – until now.

The REIT sector fell by about 7% in May, and is down about 10% from its recent peaks, offering just a touch more value. In terms of trading close to NTA valuation, the A-REIT sector looks fairly valued at present. With some of the 2012-13 froth having come out of the sector's pricing, it looks just that touch more sustainable.

Given where interest rates are now, forecast FY14 distribution yields at around the 6.5% mark still look fairly attractive. Combined with a generally more stable fundamental structure, investors are right to look at the sector with renewed interest.

Arguably, as they cleaned up their act, the trusts became too conservative. There is some room for them to re-gear the balance sheet: they are paying about 5.5% now for debt, which they can use to buy an asset yielding 7%. Right away, that gap is working for unit holders.

Plenty of competition

Having largely pulled back from overseas, there is plenty of competition for the A-REITs from foreign investors and Australian super funds for high-quality assets – but even with that, they will not be looking to move back to Europe or the US.

The major exception is Westfield Group, which has largely become the REIT of choice for Australian



investors seeking international exposure, while the Westfield Retail Trust manages the group's Australian and New Zealand assets. Goodman Group is the REIT with the biggest international exposure behind Westfield Group.

But generally speaking, the A-REITs have changed their focus post-GFC from over-gearred overseas-income assets to much lower-risk, Australian-based assets.

Non-rental income streams are still available for those investors that want them – for example, in Stockland Group, Australand, Charter Hall Group and Mirvac Group – but they are less common than they were several years ago.

The REITs are looking at a lower-growth environment and weighing up their strategies. For example, Charter Hall has been raising institutional equity and buying assets, while stablemates Commonwealth Property Office Fund and CFS Retail Property Trust are more focused on value-adding strategies such as re-leasing.

There is a wide range of REITs and different investment drivers for each. For example, broker Citi's best A-REIT picks include Australand (pending its major Singaporean investor selling out), turnaround story Federation Centres, industrial developer and manager Goodman Group, and Stockland. Citi predicts Stockland can generate a total return of 28% over the next year as it benefits from a low-interest-rate driven recovery in new housing markets across Australia.

Citi also likes Westfield Retail Trust and Investa Office Fund. Fellow broker Bank of America Merrill Lynch says CFS Retail, Mirvac, Dexus Property Group, Westfield Retail and Lend Lease are all buys. Goldman Sachs likes the Woolworths spin-off, Shopping Centres Australia.

Macquarie favours Dexus Property, Investa Office, GPT Group and Charter Hall. JP Morgan also likes Dexus, GPT and Mirvac Group in the office sector. Mirvac is particularly strong in the Sydney office market, and recently bought a \$584 million portfolio from GE Real Estate Investments Australia.

When looking at the yields on offer for A-REITs, investors have to remember the need for a quality overlay. For example, there are higher forecast FY14 distribution yields on offer than Westfield Retail's 6.9%, but for the quality and defensive nature of the portfolio, that is about as good as it gets for a yield-oriented investor.

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JP Goldman

Abenomics and the land of the rising equity market

by JP Goldman

It's hard to believe but the long ailing Japanese equity market has been among the best performing in the world since late last year – thanks to a jolt of confidence produced by a raft of radical new reforms under Prime Minister Shinzo Abe, who was elected to office in December last year under a landslide of popular support.

Dubbed “Abenomics”, the new Prime Minister’s vision is that of massive fiscal and monetary stimulus, backed up by radical structural reforms to improve the competitiveness of the economy. To that end, Abe unveiled new fiscal stimulus spending – largely on infrastructure – equal to around \$100 billion, or almost 2% of Japan’s near \$6 trillion economy.

On top of this, newly installed bank of Japan Governor Haruhiko Kuroda – chosen as he was sympathetic to Abe’s aims – announced an explicit 2% inflation target, which he aims to achieve by 2015. To that end, the Bank of Japan (BOJ) has unveiled the mother-of-all monetary stimulus programs, with plans to double the country’s monetary base over two years. That amounts to buying up government bonds – and pumping out cash – equivalent to around one quarter of nominal national output over this period. Relative to GDP, that’s roughly double the monetary stimulus program unveiled by the United States Federal Reserve.

Reality check

The market’s initial reaction was one of jubilation. Up to its recent peak in late May, the Nikkei 225 index has surged by 80% since mid-November last year. The yen dropped 20% in value against the US dollar, and 10-year government bond yield dropped from around 0.8% through last year, to a recent low of 0.44% in April.

Adding to the optimism, Japan recorded fairly strong

4% annualised growth in the March quarter, thanks largely to a bounce back in spending by more confident households.

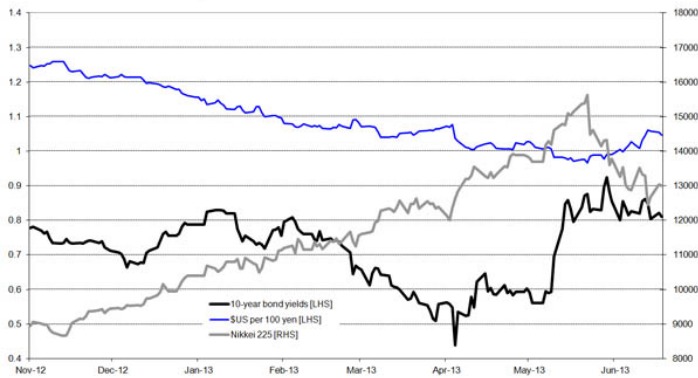
Since around late May, however, somewhat of a reality check has set in. The Nikkei has dropped back 20%, and the yen has strengthened by 5%. Why?

Some correction after such a fierce market move is inevitable. And perhaps staggered by the ferocious market reactions they unleashed, some policy makers have been trying to temper expectations. A few conservative and independently minded Bank of Japan board members, for example, have expressed concerns about the stimulus program and emphasised its “temporary” nature.

Even worse, Abe’s hotly anticipated recent announcement of structural reforms greatly disappointed. Although Japan desperately needs to deregulate its labour market (firms can’t easily fire workers), and improve efficiencies in areas such as health and agriculture, Abe shied away from announcing radical proposals – and instead unveiled a re-run of an old (dubious) policy to create a special economic zone of lighter taxation and regulation. Many are hoping his reticence reflected a concern not to upset voters ahead of a critical upper house election in July, after which his ruling LDP party might have control of both legislative chambers and greater ability to push through controversial new policies.



Japanese Financial Markets



That said, another factor unwinding some of the economic optimism has been the back up in bond yields. Japanese 10-year government bond yields have lifted back to 0.8%, or similar to levels prevailing in mid-2012. In turn, this appears to reflect a lift in inflationary expectations – understandable considering the BOJ’s aims to push inflation higher. This is a reminder that the move to drive up inflation will not be without risk, such as the potential for a surge in bond yields. That would make it more expensive for firms to borrow (at least in nominal terms) and, perhaps most critically, crush the capital value of Japanese bonds that form the vast bulk of tier 1 capital for Japan’s banking sector.

Doubts about Abenomics

Can “Abenomics” work? This economist for one has his doubts. Japan’s main problems are structural rather than cyclical – which don’t seem capable of being solved by merely printing money and building new publically funded bridges. Due to population ageing and objections to more immigration, Japan’s labour force is shrinking. And entrenched vested interests make it hard to achieve productivity-enhancing structural reforms. Lacking any real growth opportunities within the private sector, the risk is that banks simply hoard cash rather than borrow, which would suit firms who see little reason to borrow to fund expansion.

What’s more, with gross public debt already more than 200% of GDP, fiscal pump priming has its limits – and may already be constraining private sector spending due to fears of an eventual lift in taxes. As it is, Japan is still committed to doubling the sales tax to 10% by 2015 to keep the fiscal deficit in check. If

Japan goes ahead with the tax increases, there’s a very good chance it could derail the economy again. But if it doesn’t, its fiscal position risks becoming untenable.

Market rally ahead?

That said, over the short term at least, there’s probably scope for the market optimism to return – especially if the BOJ succeeds in pushing the yen down further, which would boost the competitiveness of its major exports. That will be easier to do if the US economy continues to recover and the Federal Reserve winds down its own stimulus program – potentially pushing up the US dollar.

At around 15 times forward earnings, Japanese equity market valuations remain a touch below their decade average and could lift further – but a sustained market rally over the next two years will require the economy and corporate earnings to pick up also.

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My SMSF – Noel Whittaker

by Super Report Subscriber

Noel Whittaker writes weekly financial columns in publications across the country, has written 20 books and is the recipient of many investment awards. He is a Fellow of CPA Australia, the Taxation Institute, and the Australian Institute of Management. He also manages his own SMSF, and explains his strategy below.

Age: over 65

Other members of the SMSF: Only my wife

Location: Brisbane

What investments do you have outside of superannuation?

My own home and some investment properties and cash in the bank.

How long have you had your SMSF?

About 25 years.

Why did you start it up?

It enabled me to invest in assets, which were not available through a normal retail fund.

How big is it?

It is substantial.

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

It's extremely easy to manage because all the administration work is done by Superannuation Services Pty LTD, which charge about \$5,000 a year for their services. I am appalled at the fees some of my friends are paying to their accountants. Figures of \$10,000 a year to \$15,000 a year are often quoted to me.

Are you pleased with its performance?

I'm extremely pleased with the performance – it is highly invested in Australian equities and the international side is run by top-flight managers.

What is your asset allocation?

It's about cash 5%, fixed interest like hybrids 10%, direct property through property syndicates 10%, alternative investments 5% and the balance spread evenly between Australian equities and international equities.

What are your favourite investments/stocks and why?

My best stock pick has been Magellan global funds – I bought 55,000 at one dollar \$1 each and now they are \$8 each! And I'm holding on!

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

To keep up to date for all the columns I write, I spend at least an hour every day talking to fund managers and economists. However, I also use the Praemium Choice platform to keep track of all the transactions. I couldn't do without them.

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Interest rate movement unknowns vs. known fixed rate bond returns

by Gavin Madson

Recently, the OECD downgraded the growth forecast for Australia to 2.6% in 2013, from 3.0% just six months ago. The prior forecast made a year ago was 3.7%. Lower growth reinforces our view that interest rates will be lower for longer.

FIIG's economist Dr Stephen Nash expects "a further 0.25% cut to 2.5% to the official cash rate, but if growth starts to moderate in the US, more than expected, the cash rate could fall further". Assuming US growth remains on track, Dr Nash expects the cash rate to remain at 2.5% for the 2014 year.

Bill Evans, Westpac's chief economist, is more pessimistic, "we retain our position that the terminal cash rate will be 2.0%, with single moves in August, late 2013 and early 2014". He expects rates to reach a record low of 2.0%. Admittedly, he made these remarks before Federal Reserve chairman Ben Bernanke's comments last night.

The Reserve Bank (RBA) has clearly left the door open for further easing, with the statement from 4 June 2013 concluding with the following paragraph:

At today's meeting the Board judged that the easier financial conditions now in place will contribute to a strengthening of growth over time, consistent with achieving the inflation target. It decided that the stance of monetary policy remained appropriate for the time being. The Board also judged that the inflation outlook, as currently assessed, may provide some scope for further easing, should that be required to support demand.

QE effect

Against this backdrop of potentially lower RBA cash rates in the short term, long-term interest rates (or yields) have actually risen in recent weeks. This has primarily been due to growing anticipation that

quantitative easing (or QE) is closer to ending in the US. QE is primarily conducted via purchases of long dated US Treasuries and Agency debt. If/when this ends, the simple reduction in demand will see prices fall, and with an inverse relationship between the price of fixed rate bonds and yields, the latter will rise.

While this is a US based dynamic, the effects have been felt in Australia. Before last night's announcement by the US Federal Reserve, the yields on five and 10-year Commonwealth Government bonds had risen by 13 basis points and 17 basis points respectively over the last two weeks, creating better value in long dated fixed rate corporate bonds.

The emphasis of market commentators on dividend yield or share income has meant we've started to focus a little more on running yield (the income you would expect to earn in the next year) given it is more equitable. Think of yield to maturity (income plus the capital gain or loss at maturity) being a worst-case, however known, scenario.

Keep this in mind

Having said that, investors must remember the simple inverse relationship between yield and price and consider if this suits their circumstances. When interest rates fall, the price will increase, however when interest rates rise, the price will fall. The difference however, when compared to most other asset classes, is that on a hold to maturity basis you will get the exact return you expected when you purchased the bond. If this dynamic poses an unwanted risk, investors may be better suited to floating rate or inflation linked bonds, which tend to be less volatile and typically increase in value when interest rates and/or inflation are rising

Table 1 on the following page shows a range of fixed rate bonds with a running yield of 5.4% or more.



Many of the bonds are showing a yield to maturity in excess of 5.5% and a running yield of over 6%.

All prices and yields are a guide only and subject to market availability. FIIG does not make a market in these securities.

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Table 1

Issuer	Sector	Call date	Maturity date	Capital structure	Trading margin	Yield to maturity	Running yield	Capital price	Face value
Dampier Bunbury Pipeline	Infrastructure		11/10/2019	Senior Debt	1.87%	5.45%	5.83%	102.909	\$50,000
Downer Group	Other Corporate		29/11/2018	Senior Debt	2.20%	5.65%	5.72%	100.463	\$50,000
JEM (Southbank)	Other Corporate	28/06/2018	28/06/2020	Senior Debt	1.97%	5.35%	6.28%	105.633	\$50,000
Lend Lease Finance	Property		13/11/2018	Senior Debt	1.66%	5.10%	5.40%	101.873	\$50,000
Lend Lease Finance	Property		13/05/2020	Senior Debt	1.94%	5.60%	5.87%	102.267	\$50,000
Mackay Sugar	Resources		5/04/2018	Senior Debt	3.23%	6.57%	7.06%	102.750	\$50,000
Praeco	Other Corporate	28/07/2020	28/07/2022	Senior Debt	2.83%	6.50%	6.89%	103.587	\$50,000
Qantas	Other Corporate		27/04/2020	Senior Debt	2.24%	5.90%	6.29%	103.348	\$50,000
Silver Chef	Other Corporate		14/09/2018	Senior Debt	3.64%	7.06%	8.00%	106.250	\$50,000
APT Pipelines	Other Corporate		22/07/2020	Senior Debt	1.36%	5.05%	6.68%	115.979	\$100,000
AXA SA	Insurance	26/10/2016		Tier 1	3.19%	6.25%	7.23%	103.750	\$100,000
Swiss Re	Insurance	25/05/2017		Tier 1	2.66%	5.84%	7.19%	106.250	\$100,000

Source: FIIG Securities Ltd

Retail = black, wholesale = red

Prices are accurate as at 4 June 2013



Questions of the week – low dollar stocks and ETFs

by Questions of the week

Question 1

The volume of ASX traded ETF's appears low. Should I have liquidity concerns regarding this investment type?

There are more than 90 ETFs listed on the ASX under the category ETP or Exchange Traded Product.

Most of the action is in the broad based Australian share ETFs like State Street's SPDR (ASX Code STW) or Vanguard's Australian Shares High Yield (VHY), or one of the broad based international shares ETFs such as iShares US S&P 500 (IVV). Liquidity and the spread between the bid and offer in these ETFs is generally quite good.

However, some of the share sector, currency and commodity ETFs have pretty poor liquidity.

I think it is important to consider who issues the ETF. Some of the issuers take more effort than others in promoting liquidity by arranging "market makers" to make markets. When you have strong market makers, you will find deeper markets with narrower spreads – and hence better liquidity.

The ASX puts out an excellent publication each month that details the key characteristics of each ETF, including the fund inflow, management fee, turnover, average liquidity, average bid/offer spread, bid depth etc. I use this as my guide when considering an ETF. The May edition can be found [here](#).

Personally, I stick with the major ETFs – I haven't observed the liquidity to venture further yet.

Question 2

Which businesses will do well with a lower dollar?

Thank you for your question. In fact, Geoff Wilson addressed this question in his article last week. You can read that [here](#).

He outlined a number of companies and industries that look set to benefit from a low Aussie dollar. These included companies with overseas assets (News Corporation, James Hardie Industries), exporters (Australian Agriculture Group, Fortescue Metals Group and Atlas Iron Group) and tourism operators (Arden Leisure, Village Roadshow Limited and wotif.com Holdings).

I hope this helps.

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Did you know?

Running an SMSF can be tricky business and there are many traps trustees can fall into. Joining Peter on the show to find out some of the biggest mistakes an SMSF trustee should avoid is [Sinclair Taylor](#), head of SMSF segment at Westpac's Australian Financial Services Division.