Switzer Super Report

Issue 198, 27 June 2013

Same, same but different

Well what a night for Queenslanders. I'm sure Kevin Rudd didn't get much sleep last night and to be honest, I'm shaking my head a little at what's happened to the Labor Party.

However, I still think Abbott will get up in September, or whenever the election now is, which won't mean too much for SMSFers and definitely nothing bad. We have a quick look at the possible impact in our Report today.

Also in the *Switzer Super Report*, Barrie Dunstan examines the kind of companies you should be considering in this market and James Dunn picks up his theme of stocks that are set to benefit from a falling Australian dollar.

Sincerely,

Peter Switzer

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About last night...

by Penny Pryor

The Australian Labor Party has appointed Kevin Rudd, for the second time, in a move that it hopes will stop a landslide election defeat. But what, if anything, will it mean for superannuation policy?

Superannuation impact

The answer to that question is: probably nothing. But it may decrease the chances of a Coalition government.

Switzer expert Paul Rickard says: "The chances of Labor being returned, though unlikely, may have improved. Although we felt the 'tax on pension incomes' was dead (this was announced on 5 April, but never legislated) – there may be a chance that this is revisited."

And if the election date is delayed till the latest possible date – i.e. late November, Parliament will get another sitting.

"Perhaps legislation is then introduced for this tax on pension income," Rickard says.

"Shorten will survive, and given the cabinet changes, may even end up with a promotion. There could be a new minister responsible for superannuation.

"Notwithstanding the points above, the most likely outcome is a new Government later this year and no further changes to superannuation in the intervening period," Rickard explains.

At least one of the government's superannuation policies – The Tax Laws Amendment (Fairer Taxation of Excess Concessional Contributions) Bill 2013 and Superannuation (Excess Concessional Contributions Charge) Imposition Bill 2013 – has already been passed.

This legislation, which was announced in April, means individuals will no longer be harshly penalised for exceeding the concessional contribution limits for superannuation and will have the opportunity to withdraw excess contributions made by mistake. It is effective from 1 July.

Economic impact

Of course any impact on business confidence and the economy will have a flow on effect to superannuation through the markets.

"A possible implication of this leadership change, is that it could reduce the business confidence and investment bounce that I was expecting after the election," Peter Switzer says.

"I have always thought a landslide victory to the Coalition would be received well by business and financial market investors – both local and importantly international – which would help our SMSF's bottom lines.

"Though I still expect a Coalition victory, I believe Rudd will win back some bewildered and lost Labor voters, and this will shore up the Party as a more effective opposition, which could be good for Parliament."

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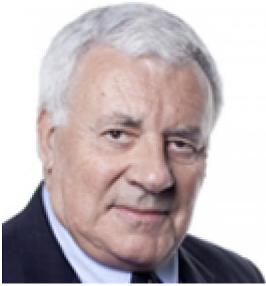

What now for stock selection?

by Barrie Dunstan

Long term SMSF investors probably knew instinctively the recent downdraught in world stock markets caused by the overdone reaction to news on the US Federal Reserve's plans, was almost certainly a buying, not a selling, signal. This was accentuated by some market commentators' doubts about China's economy.

There were some subtle differences, however, in the market climate: the upward pressure on the US dollar and the downturn in the Australian currency. This may mean some changes in local investors' strategy if, as many suspect, the exchange rate shift temporarily makes overseas investors sellers rather than buyers of Australian stocks. In addition, the China factor has cast a temporary pall over major resource stocks.

Focus on stock picking

For long-term investors, the new circumstances merely reinforce the need to concentrate on selecting local stocks, which provide safe, growing income. In short, this is a time to look again at selecting the right stocks, rather than an asset allocation decision to reduce exposure to the stock market.

The changes in markets, however, do underline how new conditions can alter the emphasis on stock selection. In the changed circumstances, companies exposed to the world markets (especially the US) now have an extra attraction. Companies earning a large part of their income from the US, like the now separate News Corp stocks, insurer QBE, share registry and corporate servicer Computershare, and blood serum group CSL, all look more interesting if the $A continues to weaken against the $US.

There is still the need for income stocks, so the usual stalwarts – the banks, Telstra, Wesfarmers, Woolworths – will remain in favour, since the overseas worries don't appear to alter their appeal. In fact, if bond interest rates keep rising as a result of the potential change in the Fed's approach, this merely reinforces the need to seek good yields on shares.

While these stocks have retreated sharply since May, the banks are still between 25% (NAB) and 36% (Westpac) above their financial year lows at recent prices, while Telstra is still about 25% above its low a year ago. The banks are now yielding between 5.2% and 6.5% and Telstra 6.0% – without the gains from dividend imputation.

Value proposition

Among stocks re-emerging because of the US recovery and exchange rates, Amcor is still about 45% above its year low and CSL and QBE are now selling at around 60% and 50% respectively above their lows. All this demonstrates the benefits of buying good stocks when they are temporarily out of favour.

Investors also shouldn't overlook the attractions of leading property stocks, with most of the major REITs forecast to edge up distributions to maintain yields of 5% to 6%, albeit without the advantages of imputation credits.

The scares over China are spooking some investors in resource stocks and leaders BHP and Rio Tinto were pushed back to around their 2012-13 low points.

In general, investors with a long-term portfolio can ignore the wild swings in the market's mood to concentrate on blue chips, which still offer after-tax returns twice that of bank term deposits – plus the ability to provide a hedge against rising inflation.

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Treasury Wine Estates, CSR, Incitec Pivot to benefit from low $A

by James Dunn

Seven weeks ago, the Australian dollar was sitting at US$1.03, in that lofty above-parity (to the US$) perch that it had occupied for 18 months.

Since then, the dollar has given up more than 10 cents, cramping the style of Australian tourists and online shoppers – the people whose perspective always seemed to dominate when the Aussie's long period of ascendancy against the greenback was reported on the evening news.

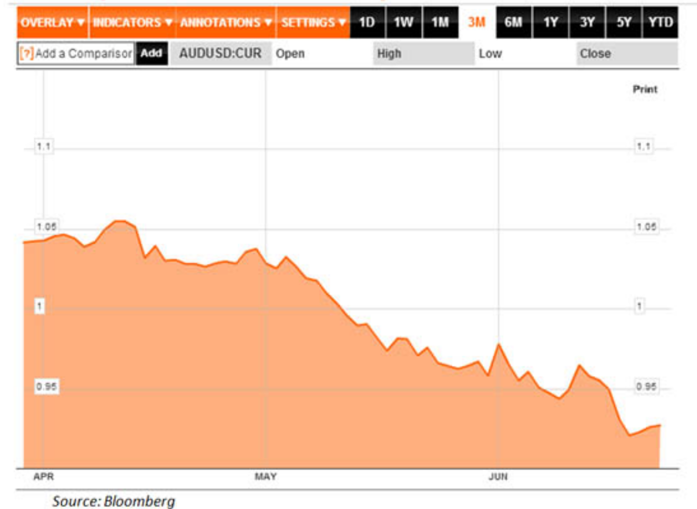
But the falling A$ – and the prospect of even lower exchange rates, perhaps with an eight in front – has had brokers dusting off their models to examine the exchange-rate "sensitivity" of company earnings: where for every US cent that the $A falls, some company's earnings rise by X%.

While currency movements are rarely a one-way street, and the exchange rate should not be looked at in isolation, there are definitely companies that benefit more than others from a falling A$.

Reporting in USD

The companies most enjoying the lower A$ are those that actually report their financial results in US$, including BHP Billiton, Rio Tinto, Fortescue Metals Group, CSL, Woodside Petroleum, News Corporation, QBE Insurance, Oil Search, Brambles, Computershare, James Hardie and ResMed. The weaker A$ helps boost their earnings.

For example, investment bank UBS says a drop of US5c in the value of the A$ could translate to a rise of 11% in the profit of Fortescue Metals, and a 5% jump in earnings a share for more diversified miners BHP Billiton and Rio Tinto. But for the resources companies, commodity prices are more important than the exchange rate: because Fortescue Metals only mines iron ore, a favourable exchange rate does not mean much if a Chinese slowdown were to send iron ore plummeting below US$100 a tonne.



Source: Bloomberg

Offshore revenue

Also benefiting from the A$'s slide are companies with significant percentages of their revenue coming from overseas, such as Amcor, CSR, Cochlear, Treasury Wine Estates, 'New' News Corporation, 21st Century Fox (still trading as News Corporation), Sims Metal Management, Mayne Pharma, Westfield Group, Sonic Healthcare, Henderson Group, Ansell, Adelaide Brighton, GWA, SDI, Navitas, Bega Cheese, Macquarie Atlas Roads, Incitec Pivot and Orica.

It's important to distinguish between companies where A$ fluctuations have a translation effect on earnings (meaning it affects the amount of foreign earnings when repatriated to Australia and reported in A$ terms) and companies where the A$ has a conversion effect, meaning that changes in the A$ actually have a direct effect on cash flow.

A good example of a translation effect is Amcor, which repatriates more in A$ terms when the A$ is weak, but its overseas businesses do not get any more competitive.

Similarly, CSL suffers a translation effect, because 90% of its revenues come from outside Australia. Just as most of its earnings come from the US, so does its cost base and raw material (blood) supply. The level of the A$ does not affect CSL's ability to sell its product relative to its arch-rival Baxter: nor does it damage CSL's markets or strategies or business model.

But when it comes time to report profit, CSL says foreign exchange "headwinds" stripped a potential US$108 million from what became a $US1 billion profit in 2012. The US$/Swiss franc exchange rate is more important to the business' bottom line than the A$/US$ exchange rate: CSL shareholders first need to see the greenback strengthen against the Swiss franc for CSL's earnings to grow.

This is why currency can't be viewed in isolation. Take Computershare, whose 2011 merger of its US operations with Bank of New York-Mellon's Shareowner Services business created by far the most dominant share register operator in the world's largest share market. Computershare also reports in US$, so a weakening A$ boosts earnings. But investors should focus on the actual business: a far bigger boost to Computershare's profits will come from resurgent mergers and acquisitions (M&A) and initial public offering (IPO) activity in the northern hemisphere markets, which is waiting on renewed corporate confidence.

Companies that compete against imports – for example Arrium and ARB Corporation – should gain some respite from a weaker $A, as should those retailers that compete against products bought online from overseas, which is suddenly a less-attractive transaction.

Harvey Norman, JB Hi-Fi, David Jones, Myer and Premier Investments are all in this boat, but again, a lower A$ is not a panacea for them, because it both increases the costs of the goods they have made for them overseas, and makes it easier for the Zaras and the Top Shops of the world to expand into the Australian market.

How to play

The best way to play the currency changes is to concentrate on the companies with some level of business in US$, that will benefit from depreciation in the Australian dollar.

For example, Credit Suisse analysts have been working on the assumption that the A$ will slide as low as 85 US cents over the next 12 months. The investment bank says industrial stocks with US$ exposure will benefit most – but again, investors should not look solely at currency. Credit Suisse looks first at whether a company can be classed as defensive (less exposed to economic growth rate changes) or cyclical (more exposed to economic growth rate changes).

Assuming that the $A reaches 85 cents and stays roughly at that level, Credit Suisse says its best defensive currency-related pick, Treasury Wine Estates, would see its earnings per share rise by 13% in FY14 and by 18% in FY15. Even better, the stock's discounted cash flow valuation would jump by 18.6% in A$ terms.

Other defensive beneficiaries would be Amcor, Brambles, Cochlear, ResMed, Sonic Healthcare and Westfield Group.

If investors are prepared to take US-economic-cycle risk, Credit Suisse reckons CSR, Incitec Pivot and James Hardie look best.

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Amcor and Sims Metal the best of a boring bunch

by Ron Bewley

In my last review of the non-mining stocks in the materials sector (7 December 2012), I was lukewarm about all of these stocks. Essentially, none of them is big enough to challenge their mining counterparts for a place to represent the materials sector as high-conviction stocks – and none seemed likely to add some spice as smaller cap stocks. I favoured Amcor (international packaging) over Orica (chemicals and explosives). I did not like the steel companies due to their seeming dependence on government support.

As it turns out from Table 1, Bluescope Steel (44%) did very well and Amcor (21.2%) put in a credible effort. The materials sector as a whole did very poorly (-14.3%) because of the problem that faced the mining stocks. If we compare the capital gains in Table 1 to the gain of 4.6% for the ASX 200 over the same period, four stocks of the top 100 (Bluescope, Amcor, Alumina and James Hardie) and two small cap stocks (Dulux and Fletcher Building) beat the ASX 200.

Table 1: Data on companies in the ASX 200's Materials (Non-mining) sector

Index	Code	Company name	Capital gains	Consensus recs. 16/11/2012	Consensus recs. 21/06/2013
ASX 100	BSL	Bluescope Steel	44.0%	2.22	2.30
	AMC	Amcor	21.2%	2.64	2.60
	AWC	Alumina	7.0%	2.94	3.60
	JHX	James Hardie	5.2%	3.29	3.60
	SGM	Sims Metal Management	3.7%	2.38	2.00
	BLD	Boral	3.0%	3.00	2.90
	ABC	Adelaide Brighton	2.2%	2.64	2.90
	ARI	Arrium	-10.1%	2.60	2.80
	IPL	Incitec Pivot	-12.5%	2.13	2.60
	ORI	Orica	-24.5%	3.50	2.50
Small Caps.	DLX	Deluxgroup	25.7%	2.75	2.80
	FBU	Fletcher Building (ASX)	9.8%	2.60	2.10
	NUF	Nufarm	-24.5%	3.50	2.50
	IMD	Imdex	-33.3%	2.64	3.30

Note: the estimates in the Table are current to the close of business 21st June 2013. They are based on Thomson Reuters Datastream.

The current consensus recommendations for Amcor are still just outside of our comfort zone of a 2.5 (for an overweight call on a scale of 1 for a buy to 5 for a sell) but the recent falls in the dollar and the growing strength of the US may help AMC in coming months. Orica is still out of favour with me, even though its rating has improved substantially. I would like to see it stay a bit better than 2.5 for a while longer.

The recommendation of Sims Metal (SGM) has strengthened to a 2.00 from a 2.38 and continues to attract my interest but not yet my funds.

Turning to Table 2, the materials sector remains very underpriced (my measure of underpricing, exuberance is -17.9%) but all sectors are currently cheap by my measure with the ASX 200 being underpriced by -4.6%. Our capital gains forecast continues to rank the sector as the best prospect (25.1%) over the next 12 months and our capital gains forecast adjusted for exuberance is a whopping 43%.

As the financial year draws to a close, one would expect some turbulence from investors re-arranging their portfolios for the year ahead. On top of that, the tapering of QE is aggravating the situation, but there is an undeniable strength emerging in the US economy and policy makers are at last on top of starting to solve the problems of the European economy. This strength in these real economies can only benefit this non-mining sub-sector.

Table 2: ASX 200 sector statistics

Sector	P/E ratio historical	P/E ratio forward	Forecast yield	Forecast cap. Gain	Consensus rec.	Exuberance	Market cap.	Adj. cap. Gain
Energy	17.4	14.6	4.0%	20.4%	2.4	-3.9%	5.8%	24.3%
Materials	12.6	9.8	3.7%	25.1%	2.1	-17.9%	16.9%	43.0%
Industrials	15.6	13.5	4.5%	14.9%	2.7	-7.4%	5.9%	22.3%
Discretionary	16.8	14.4	2.9%	15.1%	2.4	-2.0%	5.1%	17.1%
Staples	17.4	16.0	4.8%	8.5%	3.2	-2.9%	8.5%	11.4%
Health	21.6	19.2	2.4%	12.1%	2.7	-1.2%	4.8%	13.3%
Financials	12.9	12.1	6.0%	6.3%	2.7	-1.8%	38.8%	8.1%
Property	14.9	14.2	5.7%	5.1%	2.7	-2.5%	6.5%	7.5%
IT	19.1	17.1	3.4%	11.1%	2.7	-1.4%	0.7%	12.5%
Telco	14.9	14.5	6.0%	3.1%	3.1	-0.8%	5.3%	4.0%
Utilities	15.8	14.6	5.8%	7.5%	2.5	-5.5%	1.8%	13.0%
ASX 200	14.3	12.7	4.9%	11.6%	2.6	-4.6%	100.0%	16.2%

Note: the estimates in the Figure are current to the close of business 7th June 2013. They are based on Thomson Reuters Datastream and Woodhall Investment Research's analysis of that data.

The falling dollar creates some issues because of the uncertainty it brings to planning but, if it settles down to a figure well below parity, the lower dollar might also benefit some of the non-mining materials stocks. However, I still favour other parts of the ASX 200 – in particular, the big miners in the broader materials sector and the big banks, until the market fully absorbs the tapering talk and the China credit squeeze.

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Gen Y and the case for an SMSF

by Penny Pryor

Brendan Wheeler is a trauma sales support representative, and although just 26, is planning on starting up a self-managed superannuation fund when he has sufficient funds, some time in his early to mid thirties.

"It's a great way to control your future…being able to direct your funds into specific asset classes," he says.

He also has a very healthy attitude towards superannuation in general.

"And not that I'm necessarily retiring tomorrow but if I can do things today that are going to help that process later on, and set up [good] systems and habits today, that is going to make it a hell of a lot easier when it comes to that time."

So despite the stereotypes around Generation Y that suggest they are all after instant gratification, some obviously have their eye on the future as well.

The 2012 SMSF Professionals' Association of Australia (SPAA) study of the sector found that recently more Gen Ys and Gen Xs are looking at DIY super.

"In recent years, the SMSF vehicle has begun to attract a younger demographic. Some 13.7% of Generation X respondents (aged 31-45 years) and 10.0% of Generation Y respondents, intend to establish an SMSF within the next two years, compared to 10.5% of Baby Boomers," that survey found.

So are there benefits to setting up an SMSF if you're under 40 or even 30?

Pros

Let's start with an analysis of the benefits of an SMSF for anybody. These include more control over your superannuation, flexibility to invest in a greater range of investments and reduced cost. The third one, reduced cost, is understood to apply on sizeable superannuation balances i.e. a balance of a size that many under 30 may not have accumulated. However the first two apply to people of any age.

"I think it consolidates all your super earlier," Graeme Colley, director technical and professional standards, SMSF Professionals' Association of Australia, says of starting up an SMSF under 30.

"I think they see that they are able to control those investments," he says.

SMSFs are also attractive to young business owners.

"Many of them [the younger SMSF trustees] may be small business people who, from what we understand, are getting into investments that relate to their business," Colley says.

Louise Biti, director and founder of Strategy Steps, says that it engages people early on with their retirement savings, which can only be a good thing.

"I think the benefit for younger people is it starts getting them more interested in super from a younger age," she says.

Another benefit is the ability to tailor insurance. A mainstream fund is legally obliged to include insurance of some sort, and from late last year SMSFs are also now required to at least consider insurance as part of their investment strategy. However the policies offered may not give you maximum coverage. With an SMSF you can tailor the insurance, within some parameters, to get better coverage. Although premiums will be at market rates,

you will get a tax deduction for them.

"If you've got your own SMSF you've got much more flexibility to shop around and find the policy that's best for you," Biti says.

And if you're a couple under 30, you may well find that by consolidating your superannuation, you could come up with a balance that's not far off the magic number for a cost-effective SMSF – $200,000.

Cons

The obvious con is the cost if you have a small balance. Many SMSF establishment fees and some ongoing fees are flat, which means the less you have the more expensive it will be.

However Biti points out that due to technological advancements, fees may not be as expensive as they once were. "There has been a lot of developments in different platforms … so I don't know that [cost] is such a big issue anymore," she says.

Even so, the start-up plus ongoing costs on a $25,000 superannuation balance will be quite sizeable.

Colley says it should take around six to eight years for someone to build up a decent sized balance, contributing up to their maximum contribution limits.

Mortgage versus superannuation

There are mixed views around whether it is better to pay off a mortgage or focus on your superannuation i.e. an SMSF. Colley cites research by Griffith University academic and superannuation specialist, Professor Michael Drew, that shows it's much better to focus on building up your superannuation earlier, to insulate yourself from volatility.

"If you haven't got a mortgage I think the option of paying rent and saving in super can be a very effective one, particularly because of all the benefits in super and then in retirement, you can chose to buy something," Biti says.

Many young people, put off by the cost and the choice of being tied down to one location, may in fact chose not to buy a home. They may chose to buy property to invest, rather than live in, and even use their SMSF to do that.

Gen Y Brendan Wheeler says buying a property in an SMSF is something he would consider, but only after getting some good advice.

"It would be potentially something I would look at," he says.

"I would have to assess it at that point, if the maths add up and it works out to be a good investment."

Conclusion

If you are in the middle of paying down a sizeable mortgage, you may want to focus on paying that off first.

But if you're under 35 and have a decent sized superannuation balance – which doesn't necessarily have to be more than $200,000 – or at least the prospect of adding substantially to your superannuation in the near future, an interest in superannuation and the preference for controlling your own investments, then by all means an SMSF may be for you.

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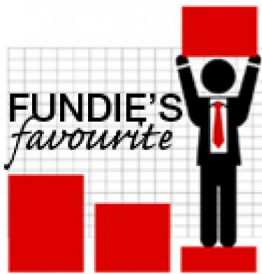

Australian Ethical Investment on Stratasys

by Fundies Favourite

Nathan Lim

How long have you held Stratasys?

We've held Stratasys (NASDAQ:SSYS) since 9 August 2012.

What do you like about it?

Additive manufacturing (colloquially known as 3D printing) has been characterised as the second industrial revolution. The ability to completely reinvent manufacturing, and its associated impacts on supply chains and business processes, attracted AEI to this stock. Through a combination of strong organic growth and strategic acquisitions (most recently MakerBot which now secures Stratasys' position in both the commercial and retail market), the company has the potential to maintain double-digit growth rates for several years. Ultimately, its growing installed base of printers will create a large pool of recurring revenue, through the sale of consumables when growth inevitability slows.

Stratasys' impact on how we do everyday things is already evident in Australia. Stratasys distributes its printers in Australia through Tasman Machinery, which counts Royal Perth Hospital (RPH) as a customer. RPH has purchased two additive manufacturing machines, which they use for surgical planning tools used during pelvic reconstruction and scoliotic spine correction. The machines are also used in cranial reconstruction to ensure the implant fits correctly before surgery even begins.

How is it better than its competitors?

Stratasys has the largest installed base amongst commercial users. In the retail/hobbyist segment, with the MakerBot acquisition, Stratasys is in the top three.

What do you like about its management?

The merger with Objet last year saw founder and inventor of Fused Deposition Modelling technology Scott Crump move up from the CEO role to the Chairman position. David Reis, Objet's then CEO, became the CEO of the combined group. Keeping both within Stratasys ensures continuity in the business and retains significant IP. Reis successfully ran Objet, so there is every indication that this will continue at Stratasys.

At what point would you sell it?

Stratasys remains a concept stock in our mind. The potential for this technology to disrupt the business of manufacturing and its rapidly growing list of new applications, means it remains difficult to forecast when this period of high growth will end. That said, we are closely watching the financial metrics it reports because Stratasys remains just a business and you still have to manage things like working capital and costs efficiently.

Source: Bloomberg

How much has it added to your overall portfolio over the last 12 months?

We have held it since 9 August 2012 and it has thus far returned 29%.

Where do you see the value?

We defer to our previous comments on when we will sell it. Stratasys is a high-risk play in our portfolio and is sized accordingly. We are continuously weighting the potential upside against how the business is actually tracking.

By Nathan Lim

Nathan Lim is a portfolio manager at Australian Ethical Investment*. He has nearly two decades experience in stockbroking and funds management and joined Australian Ethical in 2010.*

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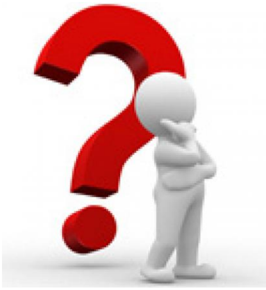


Question of the week – MCG and BOQ outlook

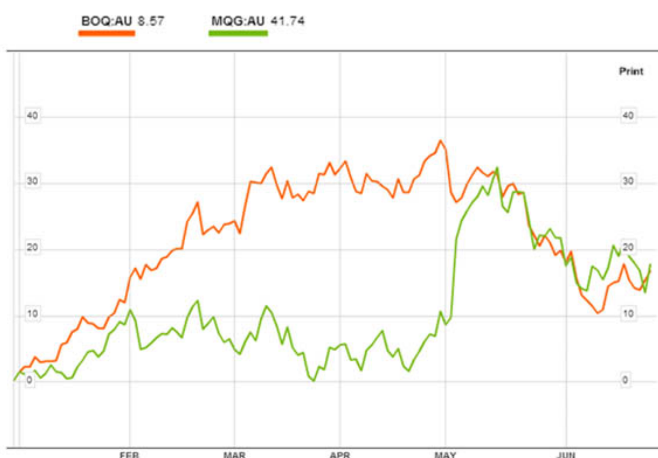
by Questions of the week

***Q:** I hold shares in WBC, ANZ and NAB. What is your opinion on Macquarie Group (MQG) and Bank of Queensland as buys for about a year?*

A: Thanks for the question.

I like Bank of Queensland and think there is quite good upside in the stock. The new management team seems to be making a good go of it, and provided there aren't further write-downs in respect of some of their old commercial property exposures, I can see value around the current levels. Minor and regional banks are probably going to do better in stronger equity markets – and also if the economy starts to make some headway and the demand for credit starts to increase.

According to FNArena, the broker consensus price target for BOQ is currently $9.48 compared to the current price around $8.80. Sentiment is neutral.



Source: Bloomberg

Macquarie is not a group I profess to understand well – so I tend to stay away from the stock. If you don't understand something, don't invest in it. When the stock was trading around $20 and totally out of favour with the market, I could see some reasonable value, particularly on a "worst case" break-up basis. Above $40, I am not sure that it offers that much appeal.

Again, Macquarie is a stock that will do well in strong equity markets. If you really think the global economy is going to accelerate, investment banks such as Macquarie will do well.

The consensus broker price target for Macquarie is $42.13 – just below the current price of around $42.30. Sentiment is marginally positive.

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Did you know?

To follow up on all this talk about a recession, I spoke with associate economist at the Commonwealth Bank, Diana Mousina, on my show on Sky Business TV.