Switzer Super Report

Issue 206, 25 July 2013

Boring is best

Charlie Aitken might be on holidays after welcoming another addition to the family, but he made a special trip into our offices for a chat with me in our 'Super Sessions' video, where he talks about what's driving the market and companies set to outperform. It looks like boring is good at the moment, watch the video and read snippets below.

Also in the *Switzer Super Report* today, we're introducing a new "What the brokers say" to keep you in the loop until you get our regular in-depth broker report of a Monday. Find out why Telstra was upgraded and AMP was downgraded earlier this week.

And today Barrie Dunstan shares his thoughts on why SMSFs need to look outside the Big Four + one i.e. Telstra. We know they've served you well but never forget the tenants of diversification.

Sincerely,

Peter Switzer

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36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

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Super Sessions with Charlie Aitken

by Charlie Aitken

Watch the full interview here.

On the ASX 200

I think the reporting season is also going to be pretty good and dividends might surprise on the upside. So broadly, if we're sitting here in a couple of years time, I wouldn't be surprised if the ASX 200 is up around 6000.

On China

Do you really believe a county of 1.4 billion people can generate a GDP number within 17 days of the end of the quarter? It's a bit hard to believe.

On favourite stocks

I think the banks are going to continue to do really well. Telstra is going to continue to do really well. Wesfarmers is going to continue to do really well.

Most of the stocks that I'm highest conviction on are all big industrials that pay 5, 6% fully franked dividends.

On strategy

Broadly though, people are so short-sighted at the moment, the real value in the share market is just being an investor.

If you just hold the right stocks, collect dividends, those dividends grow, and you use those franking credits, I think that strategy will reward you very well in a low interest rate environment over the next few years.

To see everything Charlie had to say in our exclusive interview for Switzer Super Report subscribers, watch the video on Super TV.

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Ignore stocks outside the Big Four + one at your peril

by Barrie Dunstan

The yield theme continues around the share market and, with term deposit and call rates potentially under further downward pressure, SMSF investors can't ignore the attractions of the yield favourites: the banks and Telstra.

But there are several reasons for investors to look beyond a narrow list of stocks – perhaps even to BHP.

The first reason is the concentration of risk, especially with the banks, in such a portfolio. While the potential risks (either individually or collectively) for the banks may be low, the bears are still apt to re-appear, citing the risk of house prices being over-priced and subject to a fall. There have been renewed murmurs from a few overseas hedge funds along these lines.

This scenario is probably very unlikely – but, if the only shares in your portfolio are banks (and you also have some bank hybrids for more yield), such a concentration could produce the occasional sleepless night.

Rising earnings

There is another factor to consider. Sustainable, long-term rising dividend payouts depend on companies maintaining earnings growth. This aspect is particularly important for SMSFs still in the accumulation phase, but also can't be ignored by funds paying out pensions.

Rising earnings should ensure growth in the share price, as well as enable companies to keep increasing dividends. If interest rates are going to remain low for some time, any portfolio will require capital growth to produce even modest returns – say 5.5% to 6% or 3% to 3.5% above inflation.

The banks have had a sterling record of growth in earnings and dividends per share over recent years and are tipped by many brokers to lift distributions this year. But they may have some slight headwinds, with potential pressure on margins from things like demands by regulators or limited growth in the loan market.

Similarly, Telstra, though generally well placed in the national broadband network expansion, still has a relatively narrow margin of earnings above its current dividend rate and any forecast slight rise in dividends in the next two years.

Investors relying on yield from shares need to realise that, in the longer term, such shares can react to moves in interest rates just like bonds and fixed interest securities – and initially the market adjusts yields by lowering market prices. In addition, with current market Price Earnings ratios no more than fair value, an easing in confidence could also affect PE ratios and thus share prices.

Trading on emotions

There's another, behavioural, reason for self-directed investors to watch what shares they hold: most investors have a much greater fear of losses than a love of profits. Allowing this to rule a portfolio will expose investors to what may be a too cautious approach to their longer-term portfolio. This suggests a need for more diversification in share portfolios and a little more emphasis on growth stocks. If, as seems likely, the US market is still in a bullish mood, growth stocks are likely to out-perform over value stocks.

Whether this means investors should start re-looking at resources stocks is another matter. U.S. S&P 500 stocks may be a better ploy than Rio Tinto or BHP, which the market seems to think may be another year away from earnings growth.

Still those investors without any resource stocks – and confident in China not imploding – might consider BHP, which is even looking a little like a value rather than a growth stock. Its current gross yield is 5%, which is tipped to rise (above other growth stocks) and it is on a PE of around 10 times projected earnings in the next couple of years – well below current and prospective ratios for Telstra and some of the banks. Its addition could be a baby step in the direction of a more diversified portfolio.

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Eley Griffiths on STW Communications (SGN)

by Fundies Favourite

How long have you held the stock?

We first started buying STW Communications (ASX Code SGN) in February 2013. It has been well over 10 years since we last owned this stock.

What do you like about it?

Well it appears that their disappointing decade is now likely behind them. The stock had been a perennial underperformer – losing 30% over the 10 years to February 2013 versus the Small Ordinaries Index, which added 66% in the same time frame (both stock and index excluding dividends).

Source: Bloomberg

During this period, the company has put together a diversified media and advertising group and in the process looks to have arrested the return on equity compression that has plagued the group for much of this time. The company correctly foresaw the need to grow outside traditional advertising activities. On a 12 times 2013 PER and offering a 5% fully-franked yield, it is a reasonably priced counter, offering discretionary expenditure exposure – a theme that we, as a group, have been targeting.

How is it better than its competitors?

STW is a well-regarded and experienced force in Australia's marketing and communications space. It has prioritised a push into digital media and these revenues will comprise 30% of total revenues by the end of 2013. At the urging of clients, they recently took the first steps to establish a nascent SE Asia business. Traction has been good at this early stage and management expect the region to contribute up to 10% of group revenues by the end of 2016. The company has recently been winning new accounts, as well as increased spend from existing clients, without conceding operating margins in most cases. A revival in business confidence is within line-of-sight and leverage to any uptick in economic activity should be felt across the group.

What do you like about its management?

The STW model draws heavily upon a deep pool of creative and financial management expertise that spans the group. Senior management are experienced, with CEO Michael Connaghan having ridden through several business cycles before. He has described the current advertising cycle funk as 'not easy' but continues to draw upon his group's diversity as one of its key attributes. Connaghan and Lukas Aviani (chief financial officer) are as an impressive double-act as you will find among listed Australian small companies.

What is your target price?

We do not set target prices, rather we have an investment process that assesses the relative value of each stock in the portfolio on a daily basis.

At what point would you sell it?

When our process suggests it is expensive relative to small cap peers.

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

The stock has contributed significantly since our purchase in February 2013.

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Discretionary sector – FOX and Crown the pick of the bunch

by Ron Bewley

While I have not been fond of this sector for quite some time, I did make some assertions in my last review of this sector on 10 January 2013.

History recap

My conclusions were:

"The News Corp (NWS) recommendation was also very good until the second half of last year. But again, it did improve in the last couple of days."

"Crown Limited (CWN) has the best recommendation but it too has slipped a bit. This looks to be the best of the bunch on recommendations alone."

"The only stock that interests me in this sector is Flight Centre but today does not seem to be the best time to buy – at least according to broker forecasts of target prices, our measure of exuberance, and the strength of the trend."

Remember that my high convictions stocks are the largest stocks by market capitalisation, subject to a consensus recommendation of 2.5 or better (where 1 is a buy and 5 is a sell).

On the money

The essence of my hesitation at the time was that the sector was overpriced by 4.8%. It can be noted from Table 1 that Flight Centre not only turned out to be the best performing large cap stock, it did so with a capital gain of 61.5%! Since News Corp split up its business into FOX and NNC, it is difficult to say what an investor might have done in reaction to the split, but FOX was the second best performer at 46.8%. Crown came in at 16.4%, below the sectors' gain of 22.4% over the same period while the ASX 200 grew by 5.9%.

Table 1: Data on companies in the ASX 200's Consumer Discretionary sector

Index	Code	Company name	Capital gains from 4/1/2013 - 22/7/2013	Consensus recs. 4/01/2013	Consensus recs. 22/07/2013
ASX 100	FLT	Flight Centre	61.5%	2.18	2.58
	FOX	Twenty-first Century Fox	46.8%	2.43	1.60
	ALL	Aristocrat Leisure	35.3%	2.93	3.09
	HVN	Harvey Norman	30.9%	3.46	3.33
	MYR	Myer	18.6%	2.79	2.93
	CWN	Crown	16.4%	2.08	2.10
	TAH	Tabcorp	9.4%	3.15	2.75
	DJS	David Jones	7.1%	3.64	3.64
	TTS	Tatts Group	5.4%	3.00	3.17
	EGP	Echo Entertainment	-22.3%	3.15	2.73
	NNC	News Corporation			3.00
Small Caps.	GEM	G8 Education	70.6%	1.50	1.00
	JBH	JB HI-FI	64.5%	3.53	3.00
	REA	REA Group	62.6%	2.56	2.77
	SXL	Southern Cross Media	40.0%	2.64	2.55
	IVC	Invocare	37.1%	2.82	2.82
	NVT	Navitas	32.2%	2.91	3.10
	TME	Trade Me Group	31.6%	3.33	4.00
	PBG	Pacific Brands	28.2%	2.67	2.46
	SUL	Super Retail	23.5%	2.11	2.22
	BRG	Breville	19.7%	1.78	2.50
	AAD	Ardent Leisure	18.6%	2.63	2.50
	SWM	Seven West Media	18.3%	2.00	2.07
	PMV	Premier Investment	15.7%	2.77	2.67
	TRS	The Reject Shop	14.6%	2.73	2.80
	AHE	Automotive Holdings	13.4%	2.29	2.10
	DMP	Domino's Pizza	3.4%	2.57	2.92
	TEN	TEN Network	-3.4%	3.57	3.23
	WTF	Wotif.com	-4.1%	3.15	3.37
	FXJ	Fairfax Media	-6.5%	3.00	3.08
	GUD	GUD Holdings	-22.3%	3.30	2.91
	BBG	Billabong International	-50.6%	2.73	2.70
	FWD	Fleetwood	-57.8%	2.55	3.70

Note: the estimates in the Table are current to the close of business 22nd July 2013. They are based on Thomson Reuters Datastream.

To the future

Since Fight Centre (FLT) has had its rating cut from 2.18 to 2.58, it now is not a buy as a high conviction stock using my methodology, but it would be reasonable to hold onto the stock while monitoring the recommendation going forward.

There are now only two large cap stocks that pass my filters: Twenty-First Century FOX (FOX) and Crown (CWN) – with a strong preference for FOX – but there are seven small cap stocks that have a good recommendation. Of the small cap stocks, G8 Education (GEM) is the stand-out. It has run hard over the last six months but a 'perfect 1' makes it worthy of further consideration.

The sector statistics, presented in Table 2, show that this sector is again overpriced at 3.2%. Its forecast capital gain at 12.6% is just above that for the broader index at 11.6%. While this may not be the best time to buy, the sector is not sufficiently overpriced to be too worried. Dollar-cost averaging might prove to be important. Of course, the dividends for this sector are almost the lowest of all of the sectors. However, the dollar at its new level in the low nineties might be enough to give the sector another boost.

Table 2: ASX 200 sector statistics

Sector	P/E ratio		Forecast	Forecast	Consensus	Exuberance	Market	Adj. cap.
	historical	forward	yield	cap. gain	rec.		cap	Gain
Energy	19.0	15.2	3.7%	25.9%	2.4	2.2%	5.8%	23.8%
Materials	13.5	10.6	3.5%	24.2%	2.2	-10.0%	16.9%	34.2%
Industrials	17.0	14.8	4.3%	13.8%	2.7	-2.9%	5.8%	16.7%
Discretionary	18.7	16.5	2.6%	12.6%	2.3	3.2%	5.7%	9.4%
Staples	17.9	16.6	4.7%	7.8%	3.3	0.2%	8.3%	7.5%
Health	22.9	20.3	2.3%	12.1%	2.7	3.9%	4.8%	8.2%
Financials	13.6	12.8	5.7%	6.4%	2.7	3.3%	38.8%	3.1%
Property	15.1	14.3	5.7%	5.4%	2.7	-0.8%	6.2%	6.3%
IT	19.0	17.1	3.3%	10.3%	2.7	-1.5%	0.6%	11.8%
Telco	16.1	15.6	5.6%	3.3%	3.1	5.5%	5.4%	-2.2%
Utilities	16.4	15.2	5.6%	7.6%	2.6	-0.3%	1.7%	7.9%
ASX 200	15.1	13.5	4.7%	11.6%	2.7	0.9%	100.0%	10.7%

Note: the estimates in the Figure are current to the close of business 22nd July 2013. They are based on Thomson Reuters Datastream and Woodhall Investment Research's analysis of that data.

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Buy, Sell, Hold – what the brokers say

by Penny Pryor

The big financial services giant AMP (AMP) fell out of favour with brokers at the millionaires' factory early this week, with Macquarie downgrading it from Neutral to Underperform. The broker cited the announcement by Reinsurance Group of America on expected increased costs for claims liabilities in Australia, which will have an impact on the biggest life insurer in Australia i.e. AMP. As Macquarie believes this, along with AMP's increased claims and lapse experiences, is no longer reflected in the share price, the broker decided to downgrade.

Orica (ORI) was downgraded to Neutral from Outperform by Credit Suisse and Macquarie, and Neutral from Buy by UBS, after the company issued a revised earnings guidance late last week which flagged a 10% fall in profit compared to last year. The company cited three factors for the revised guidance, including weaker global market conditions, high optimisation costs associated with the integration of the ground support business, and issues with the Indonesian business.

Boart Longyear (BLY) was downgraded to Neutral from Outperform by Credit Suisse, after the company announced another earnings downgrade, and all that that was gold did not glitter for Kingsgate Mining (KCN) which was downgraded by Macquarie to Underperform from Neutral. After it issued a new mine plan for its South Australian Challenger mine, Macquarie now thinks that at current prices it is not cash flow positive.

The first upgrade didn't happen till midweek when BA-Merrill Lynch upgraded everybody's favourite telecommunications giant, Telstra (TLS), to Buy from Underperform. It appears Greg Fraser of Kimber capital (see his Monday article here) isn't the only analyst confident about the company's mobile and data performance forecasts, with BA-Merrill Lynch also citing ongoing earnings upgrades in mobiles that should support, or improve, current trading multiples.

JP Morgan downgraded Virgin Australia Holdings (VAH) to Neutral from Outperform on the back of the fall in the Aussie dollar, which has made fuel for the airline company more expensive.

Oil Search (OSH) issued its quarterly report to June 2013 and while six brokers maintained their current ratings – four Buys or Outperforms and two Neutrals – Credit Suisse downgraded it to Neutral from Outperform as second quarter production was slightly below its expectations.

The above was compiled from reports on the FNArena database, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.

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Everything old is new again

by Tony Negline

There's never a dull moment in the realm of retirement planning. Just when you thought everything might settle down, up pops some Government policy changes, which cause anyone still working and older than 60 to re-think their strategies. This time it might be a good outcome. The increase in the concessional contributions cap to $35,000 from $25,000 for older workers makes a transition to retirement pension strategy more viable.

The bare facts

Let's look at an example (summarised in the table below).

John Simpson is 61 and wants to work full-time for another five to 10 years. He receives a salary package of $120,000 per annum. His employer allows him to salary sacrifice as much of his salary as he wants. He and his wife own their home and have one adult child still at home. They need $50,000 a year after tax to live on. His salary package includes his employer's compulsory super contributions.

Assume that right now his employer contributes the minimum required this financial year (9.25% in 2013/14). This means that John would receive a salary of $109,840 and super contributions of $10,160.

Based on the 2013-14 income tax rates, John will be paying $30,236 tax on his income, including the Medicare Levy (assuming he has no income or access to tax deductions or offsets). Effectively, his after-tax income is just over $79,604.

Total tax, including tax on his super contributions and super earnings, is $39,110. John also has $700,000 in superannuation assets.

The strategy

He decides to take all his salary as superannuation contributions and to convert his superannuation assets to a pension and to take his income requirements tax-free.

Using this strategy John would save tax by moving his superannuation assets from the accumulation phase (which are taxed at 15%) and moving them to the pension phase (which is taxed at 0%). On $700,000, the tax saving here might be more than $7,350 – assuming a 7% earnings rate in both the accumulation (pre-retirement) and pension phases.

When the concessional contribution cap was $100,000 (during 2007/08 and 2008/09) for those aged over 50, this strategy made a lot of sense for John. With this strategy he would have paid $24,300 tax – a saving of almost $15,000 including the assumed tax saving on his pension assets.

When the concessional cap was reduced to $50,000 for those over 50 in the 09/10, 10/11 and 11/12 financial years, this all or nothing strategy lost its tax effectiveness. In fact, upfront tax in this example would have increased to $40,050.

This strategy became an even better way to pay more tax in 2012/13 when the concessional cap was reduced to $25,000 for all taxpayers.

From 1 July 2013, everything old is new because of two specific changes:

1. The increased concessional contribution cap of $35,000 for those aged at least 59 on 1 July 2013.
2. The taxation of excess concessional contributions at a taxpayer's marginal rate

If John took all his $120,000 salary as super contributions, he would pay $25,922 tax – $5,250 on

the $35,000 and then $20,672 on his excess contributions (assuming he has no other income). This represents a saving of $13,118 after taking into account the tax savings from the pension tax.

The best outcome

There's obviously a fair amount of strategizing to be done by John and his financial advisers to make sure he plans well and doesn't unnecessarily pay too much tax.

Prior to 1 July 2014, some further planning will be necessary for John because of the increased Medicare rate (will be 2%).

In addition, with the Super Guarantee contribution rates increasing each year between now and 1 July 2019, it looks like these strategies will have to be continuously reviewed.

People who are at least 55 but under 60 will also want to revisit their transition to retirement strategies before July 2014 because from that date they'll be eligible for a concessional contribution cap of $35,000. (Their transition to retirement pension won't be tax-free but they will receive a 15% rebate on the taxable component portion of their pension.)

	Current Arrangements	Salary Sacrifice 100% of Package
Salary	$109,840	$0
Income Tax & Medicare	$30,236	$0
Net Salary	$79,604	$0
Transition to Retirement Pension	$0	$50,000
Income Tax & Medicare	$0	$0
Net Income	$79,604	$50,000
Super Fund		
Employer Super Contribution	$10,160	$120,000
Fund earnings not subject to tax	$0	$49,000
Fund Earnings subject to tax	$49,000	$0
Super Fund Tax (inc conts & excess conts tax)	$8,874	$25,922
Net Tax	$39,110	$25,922

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Question of the week – pre-retirement assistance needed

by Questions of the week

Q: *I'm about 18 months off retiring. I currently have $700,000 in an SMSF (50% Australian shares with balance in cash). I have left it in cash for far too long and am now buying more shares. I'm thinking of selling a Sydney investment property, as costs associated with renting seem over the top (probably spend $10,000 on costs out of the $50,000 income plus there is loss of rent between tenants). After I've paid out the mortgage and CGT, I was planning on putting the remainder in my SMSF. Not sure then whether too much in shares and although my focus is playing safe with high dividend quality Australian stocks, I wonder if there's a danger of putting (nearly) all my eggs in one basket.*

A: I don't know whether you have been down this path already or not, however I think you might wish to consider seeing a financial adviser. You are contemplating some fairly key moves – and getting a structured plan around the strategy might be a really good investment.

Prima facie, your SMSF is going to be a pretty tax-effective vehicle to hold your investments. As soon as you turn 60, you can draw a pension tax free – and the investment earnings within the fund are going to be tax free.

Depending on your risk profile, need for income in retirement, assets outside super etc, you will want some sort of balance between shares, property, fixed interest securities etc. This balance is going to have to be particular to you – and probably needs to be modelled. This is one thing a financial adviser would be able to do for you.

In terms of the specific shares, have a look at our 'income oriented' and 'growth oriented' portfolios for some ideas – particularly around the approach to sector weightings. Another alternative is to consider some of the major listed investment companies, such as Argo or AFIC (ASX codes ARG and AFI), and leave the stock selection up to them.

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