Switzer Super Report

Issue 208, 1 August 2013

Don't follow the herd

Press reports that the Government might be about to ask the banks to pay a levy for deposit insurance, should be no big deal. Although shares in the banks were down by 1.5%, the *Australian Financial Review* said that the levy would raise less than $1 billion over the forward estimates. All will be revealed tomorrow.

In other news, today is a bumper issue of the *Switzer Super Report*. We have Charlie Aitken explaining why Woodside isn't actually a resources stock and could eventually be a better yield payer than Telstra! Yes - I'm as surprised as you!

In one of our most revealing *My SMSF* stories ever, Xpress Super CEO, Olivia Long, gives some very useful insights into starting out an SMSF with a low account balance and tells us how she more than quadrupled that in six years.

Sincerely,

Peter Switzer

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Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
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Why Woodside is a yield play

by Charlie Aitken

If you own enough banks/TLS etc for sustainable fully-franked dividend yield, an alternative to further increasing exposure in these stocks is WPL. Woodside Petroleum (WPL) is one of only two resource sector members on my high conviction list.

Yes, I can hear you all scream "*you don't buy resource stocks for yield*", but I don't think WPL is a resource stock. I think it's a 'high barrier to entry' industrial manufacturing value-add stock with minimal commodity price exposure (contracted prices) or commodity extraction risk. Now that WPL, under the leadership of Colman & Chaney has sensibly turned off the capex tap and turned on the free cashflow/ dividend payout tap, we can now look forward to "*bank similar fully franked yield*" from WPL.

While WPL's lifted dividend payout ratio guidance got plenty of headlines, what wasn't widely reported is that WPL pays US dollar dividends.

Aussie dollar outlook

We have had some success forecasting the AUD fall this year, sending out numerous warnings and predicting it to have an "*8 handle*" before anyone else did. I continue to believe this is the start of a much more significant AUD bear market, particularly versus the US dollar. I continue to believe that unnatural/weak holders of AUD vastly outweigh any hedge fund shorts, while options and hedging downside protection from importers remains minute. The fact the AUD has fallen 15 US cents with very little resistance confirms the statement above.

The AUD/USD cross remains in a nasty spot. There is over-ownership of the numerator (AUD) and under-ownership of the denominator (USD). This is occurring at a time when the fundamentals of the numerator are worsening and the fundamentals of the denominator are improving.

What happens from here is the RBA continues to cut rates and the FED starts tapering QE. I think that could see the AUD/USD cross hit the long-term technical target of 80 US cents far quicker than anyone currently believes possible. I hope it doesn't happen before January 2014 as I have booked the family US ski trip, but that in itself almost ensures it does!

AUD/USD: target remains 80US cents

Woodside yields

At these current AUD cross rates on consensus numbers for CY2013, WPL yields 6.50% ff (fully franked). For CY14, consensus is a dividend yield of 6.27%ff. P/E's are undemanding at 14.9 times CY13 and 12.6 times CY14.

But here's the more interesting bit, if I am right and the AUD/USD cross drops another 11% to 80US cents, then WPL's prospective dividend yields lift above 7.00%ff, taking it above what any bank or TLS offers for the years ahead.

It's just a thought, but if you are going to buy a resource stock for sustainable fully franked yield, WPL should be it.

I also think the WPL chart looks very promising with the five-year downtrend broken and a technical target of the mid $40s. WPL report 1H 2013 earnings on 21 August.

Go Australia, Charlie.

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My SMSF – CEO of Xpress Super, Olivia Long

by Olivia Long

Age: 36
Other members of your SMSF: I initially set up my SMSF with my mum as I was single and happy to avoid corporate trustee fees. I have subsequently added my husband Mark as a trustee and removed my mum.

How long have you had your SMSF?

Six years.

Why did you start it up?

At just over 30, my balance was just under $50,000, but as a part owner of SuperGuardian my administration was free so I thought why not give it a try. Running my own fund has certainly given me far greater appreciation of the SMSF trustee experience.

How big is it?

My fund is now valued at over $275,000. My husband has decided to keep his superannuation benefits with his corporate super fund (despite the fact I'm getting far better results and keep telling him so).

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

From an administrative perspective, it's easy; I do very little which is great, as I hate paperwork. I do struggle with finding time to sit down and consider investments but finding the time is well worth it. Initially, I established my portfolio with a stockbroker but when a few shares turned sour I decided to DIY.

Are you glad you have it?

Absolutely. Despite starting with a small balance, I have significantly out-performed any other superannuation vehicle in such a short space of time.

Are you pleased with its performance?

I lost nearly 2% in the first year of operation due to a couple of failed companies recommended by my stockbroker. To date, my portfolio is up 42% on cost.

What is your asset allocation?

CASH – **32%**
INTERNATIONAL EQUITIES – **38%**
Xero Ltd (NZ)

LISTED SECURITIES – **30%**

BHP Billiton Ltd
CSL Ltd
Dulux Group Ltd
Resmed Inc Chess Depositary Interests 10:1
Santos Ltd
Westpac Banking Corporation

Shares that have brought the portfolio down

Incitec Pivot Ltd (currently at a loss of 64% on cost)
MEO (currently at a loss of 94.98% on cost)
Orica Ltd (currently at a loss of 28.52%)

What are your favourite investments/stocks and why?

I'll be honest – I'm a mad investor. I have a significant amount of time left until retirement so I can afford to be more aggressive with my strategy. Having been burned by some of the stocks recommended to me, I added BHP and Westpac to my portfolio because I considered them fairly solid investments. However, the most exciting addition to my portfolio has to be Xero Ltd – listed on the New Zealand stock exchange.

Sometimes you just have to know a product and follow your hunch. Xero has launched market leading cloud-based accounting software and I liked it. It was revolutionary, user friendly and I thought blew the competition out of the water. Having built up the cash in my fund during the GFC, I had a large amount ready to invest and I decided to invest a significant amount in Xero (now worth 38% of my portfolio). Definitely a high-risk manoeuvre, but one that has paid off as the stock is currently some 292% up on cost.

However, having said that, my portfolio is now at a level that I need to take it more seriously. I have recently engaged the services of a professional portfolio manager to help me tidy it up. Although I'm happy to take a 'punt' with some of it, I really don't have the time to monitor investment performance that I probably need.

What investments do you have outside of superannuation?

You could say I have a love affair with property. I purchased my first home at age 20 and my first investment property leveraging off that at 22. I then acquired a second investment property at age 24, and have subsequently acquired other properties.

I have shares in SuperGuardian, and use term deposits to maximise cash reserves.

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

Having experienced the fall-out from some of the shares recommended to me by my adviser, I have appointed a Private Portfolio Manager (O'Kane Investment Services) who has a proven track record of outperforming the market to manage part of my portfolio.

I'm using their Absolute Portfolio, which is the most aggressive portfolio and consists of quality stocks, value stocks and cash/income securities only when quality and value opportunities cannot be identified.

The objective of these portfolios is capital growth and income and having no set allocation to cash/income securities. The benchmark portfolio has 100% exposure to stocks.

What I like about private portfolio management is the transparency of the results to date.

Year	Absolute	Benchmark	vs Benchmark
2012/13	31.1%	23%	8.1%
2011/12	0.6%	-5%	5.4%
2010/11	10.9%	12%	-1.4%
2009/10	31.5%	14%	17.8%
2008/09	0.5%	-17%	17.2%
2007/08	-15.4%	-12%	-3.3%
2006/07	29.1%	28%	0.9%
2005/06	18.6%	23%	-4.7%
2004/05	19.5%	26%	-6.3%
2003/04	18.9%	21%	-1.7%
accumulated return	**145.3%**	**113%**	**31.9%**
average return	**14.5%**	**11%**	**3.2%**
standard deviation	**15.4%**	**17%**	

SuperGuardian administers my SMSF, handling all of the administration, providing me daily online reporting to all aspects of my SMSF.

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Blackmores - not quite what the doctor ordered?

by Roger Montgomery

Reporting season begins in earnest next week and some days in August will see up to 90 companies report their results for the period to 30 June. One "market darling" we haven't owned shares in for some time, is the eighty-year old health products business, Blackmores Limited (ASX: BKL). We will be interested to see if Blackmores' results, to be released in late August, shed light on what appear to be significant structural pressures to their business.

Stock Chart for Blackmores Ltd (BKL)

Source: Bloomberg

Acquisition issues

Despite its Asian operations now accounting for 20% of revenue and 26% of group net profit, and the company being a clear beneficiary of the recent fall in the Australian dollar, Blackmores noted in its regular quarterly update a 7% decline in net profit for the nine months to March 2013, compared to the previous corresponding period. This was troubling for a number of reasons.

Firstly, while at the top-line a reported 29% jump in revenue looks like a superb result, readers need to consider that on 2 July, 2012, BKL completed the acquisition of FIT-BioCeuticals, which came with FY11 Earnings Before Interest Tax, Depreciation and Amortisation (EBITDA) of $4.6 million, on revenue of $38 million. Backing this out, we calculate around two thirds of the FY13 sales growth as having been "acquired", and one third – or around 10% – as organic.

Secondly, core net earnings for the nine months to March 2013 would have been down by more than 10%.

We would have expected that the aforementioned $40 million acquisition would have resulted in an immediate boost to underlying profitability, post integration. We will be looking at the FY13 results and associated commentary, to be released in late August, to better grasp the apparent decline of Blackmore's traditional business.

Tough competition

The competitive landscape in Australia has dramatically increased in the form of Swisse, and its very aggressive marketing campaigns. Our assessment is that Swisse is out-spending Blackmores at a 6-1 ratio.

We understand that the entry of Swisse into the Australian market was initially dismissed by Blackmores, and at the time, we wondered aloud whether the incumbent had been underestimating the new kid on the block. We don't think it is any more!

Swisse is using several high profile sporting and acting personalities under the “you’ll feel better on Swisse” slogan. Coupled with lower prices, Blackmores’ traditional positioning appears to be under threat.

Understanding pricing dynamics can reveal a great deal about the competitive advantages in an industry. If Blackmores responds to Swisse by reducing its prices, it would suggest the value of its brand is under pressure, and that there is a structural change within the Australian vitamin industry.

Distribution chain

Traditionally, Blackmores has sold a meaningful portion of its higher-margin products to pharmacies. A lot of Blackmores promotional investment was in training pharmacy assistants, rather than marketing directly to consumers, and there was little to no product discounting.

The rise of the discount pharmacy, combined with the increasing level of complementary medicine sales within supermarkets, is another tier of “structural change” threatening Blackmores’ positioning.

Both of these retail concepts work in selling high volumes on lower margins. Woolworths, Coles and Chemist Warehouse all pursue the Walmart game, whereby suppliers fund the discount in the hope of increased volumes. Chemist Warehouse, for example, often advertises discounts of 50% on certain brands or ranges of products.

Given the long shelf life of the products, a regular user can stock up when there is a sale. In Australia’s highly concentrated retail landscape, the metal of even most traditionally strong brands is being tested.

Outlook

Our assessment is that Blackmores appears strategically stuck between an aggressive competitor and a retail environment that is becoming accustomed to discounting. As one of the most recognised brands in this market, combined with its eighty-year history, Blackmores has historically enjoyed having a trusted brand name and a “market darling” status. However, it appears to us that there has been a structural shift – and we expect margin compression to continue over the medium term.

Over the past decade, the share price of Blackmores has rallied from $6.00 to peak at $36.00 in February 2013. Despite the sharp retreat in share price to its current $26.00, at Montgomery Investment Management we still aren’t sufficiently convinced that BKL is attractive for our own funds.

Buy, Sell, Hold – what the brokers say

by Penny Pryor

So far this week there has been a bit of broker activity around financials with JP Morgan shuffling its Big Four ratings around. The broker rates stocks relative to its sector, so an upgrade for one, usually means a downgrade for another.

In the good books

JP Morgan upgraded Westpac (WBC) from Underweight to Overweight on the back of its underperformance of the bank index by 5% and underperformance of 7% compared to CBA since May. As WBC has the highest capital ratio of the group, another special dividend could be on the cards. JP Morgan is forecasting a full year FY13 dividend of 174 cents.

UBS upgraded medical group Resmed (RMD) to Buy from Neutral as it believes the recent focus on price decline has distracted the market from the reality that earnings drives valuation. The broker says that Resmed could release around 500 basis points of earnings margin over the next 24 months through savings, to offset the price decline.

In what appears to be a contrarian view, Macquarie upgraded Flight Centre (FLT) to Outperform from Neutral. It might be one of the most shorted stocks on the market but Flight Centre continues to increase earnings and contributions from the offshore businesses are lifting. Expectations are for a slow start to the financial year but it still has a strong net cash position. Macquarie based its upgrade on the potential for an increased dividend or growth via acquisitions.

In the not-so-good books

To balance out its upgrade to Westpac, JP Morgan dropped its rating on CBA (CBA) from Overweight to Underweight. Its relatively better performance than rival Westpac is probably due to strong dividend expectations, which are now factored into the price. JP Morgan is forecasting a full year FY13 dividend of 369 cents.

Another financial to come under the broker spotlight was Suncorp (SUN), which was downgraded to Hold from Buy by Deutsche Bank. The broker expects underlying profitability to peak in FY14 and sees downside risks to the sustainability of returns in home insurance.

Low levels of corporate activity remain a downer for share registry business Computershare (CPU), which was downgraded to Neutral from Outperform by Credit Suisse. There might be some upside coming from acquisitions, according to the broker, but it wants to see some signs that the corporate actions cycle is turning before it changes its view.

Citi downgraded Kingsgate (KCN) to Sell from Neutral following its June quarter results as two other brokers – BA Merrill Lynch and Macquarie – maintained their Underperform ratings. The June quarter was pretty much in-line with Citi's expectations, but the lower gold price is beginning to have an impact, and FY14 guidance implies no growth.

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.

Are ETFs the way to invest in bonds?

by Gavin Madson

While ETFs were first introduced to the Australian market in 2001, it was only in March 2012 that we saw the first ETF backed by bonds. At this time iShares (a Blackrock subsidiary) and Russell Investments created a number of ETFs that seek to replicate the returns of various bond indices. iShares has chosen to benchmark to indices from UBS, while Russell's funds are benchmarked to the respective Deutsche Bank indices.

Because of the nature of the Australian bond market, where government, semi-government and senior bonds from the Big Four banks dominate, these funds have the majority of their exposure to these same assets. This is good in that these issuers are very low risk and offer the funds the highest levels of liquidity, enabling them to meet unitholders fund requirements. However, as the funds are exposed almost exclusively to the lowest risk issuers in the market, the returns are also low.

What are the different funds?

Both iShares and Russell offer three funds: iShares offers funds that invest in a mix of all bonds (the composite fund), inflation-linked bonds (the inflation fund) and government bonds (the government fund). Russell offers funds investing in government, semi-government and corporate bonds. They have detailed mandates for each fund, but essentially, you get what's written on the label.

What are the returns?

In general, you expect corporate bonds to offer a higher running yield than government bonds, reflecting the increase in risk (as government bonds are seen as the 'risk free' benchmark in their respective markets) and you would expect to see more movement in the capital value of government bonds (both up and down) as these are the bonds traded in the highest volume by government treasuries around the world, with the capital movement reflecting the overall performance of the economy. The returns are made up of price movements in the units and their distributions.

The best return recorded was from the Russell corporate bond ETF, returning 4.06% for the year ended 30 June 2013, while the worst performer was the UBS inflation bonds fund, returning -1.65% for the year to 30 June 2013.

Bond ETF performance

Fund	Annual return[1]
iShares[1]	
iShares UBS Compostite Bond ETF (IAF.AX)	2.53%
iShares UBS Government Inflation ETF (ILB.AX)	-1.65%
iShares UBS Treasury ETF (IGB.AX)	0.09%
Russell[1]	
Russell Australian Government Bond ETF (RGB.AX)	-1.11%
Russell Australian Semi-government Bond ETF (RSM.AU)	3.77%
Russell Australian Select Corpproate Bond ETF (RCB.AX)	4.06%

Source: Company websites; FIIG Securities

[1] Returns based on iShares and Russell Investments websites (au.ishares.com and russell.com/au respectively) at 31 July 2013. iShares annual return is based on the annualised return for the respective funds since inception as reported on their website, Russell annual return is based on the annual return to 30 June 2013 as reported on their website

Investors looking at gaining exposure to a broad range of bonds would have focussed on the iShares Composite fund and the Russell Select Corporate fund, with Russell coming out on top by 1.53 percentage points: 4.06% for the year versus 2.53%.

Are bond ETFs for you?

Ultimately, the returns on all of these funds are a little disappointing to the naked eye, but the returns reflect the nature of the underlying exposures taken by the funds; ie. a significant exposure to very low risk government, semi-government and senior bank bonds.

They do, however, offer a cheap and easy way for investors to diversify their investment portfolio – something that is under appreciated and not well understood by the Australian investment market. Holding a mix of bank, infrastructure, industrial and small cap shares is NOT a diversified portfolio. The big super funds invest in bonds for a reason, and Australia's burgeoning SMSF market should imitate the professionals and do the same.

An alternative

One of my favourite bonds over the last year has been the Sydney Airport corporate ILB. As a corporate bond, it carries more risk than a government bond, however has an investment grade rating and is supported by a monopoly infrastructure asset. The Sydney Airport ILB (2020 maturity) offered a holding period return (i.e. capital gain plus distributions) of 7.16% for the last financial year, not just a positive return, but a return considerably higher than the ILB ETF.

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SMSF assets and ownership

by Tony Negline

One area that often trips up SMSF trustees is the ownership of assets.

You need to remember the ownership of your fund's assets must be in the name of all your fund's trustees.

This means if the Smith Super Fund's members are Bob and Mary Smith, who are its individual trustees, then you need to make sure that its assets are owned by Mary and Bob.

In an ideal world they'll be owned by "Robert Smith and Mary Smith As Trustee For the Smith Super Fund". ("As Trustee For" is often shortened to ATF.)

However in some cases – primarily real estate in all States and Territories except Queensland – it's not possible to show the owner on a property's title in this way.

Titles Offices only accept "Robert Smith and Mary Smith" as the owners of the property, either as tenants in common or joint tenants.

This raises a number of problems for SMSF investors. In particular, how do you adequately demonstrate that a particular piece of real estate actually belongs to a super fund?

In addition, how would you stop Bob and Mary from dealing with this property as if it were their own? For example, they might offer the super fund's property as security on a loan. Or they might sell the property and personally pocket the cash.

Some solutions – declarations of trust and caveats

In some cases, it may be possible to execute a Declaration of Trust. That is, a document where Bob and Mary declare that the asset is owned by them as SMSF trustees.

On the face of it, this seems like a sensible idea. However it comes with a catch. The wording of this document is vital because sometimes State or Territory Revenue Offices might argue that by executing this document you have dealt with a property again and impose ad valorem Stamp Duty on the super fund's property for the second time.

The simple message here is that if you want to use a Declaration of Trust, then it would be unwise to try and draft this document yourself or to download a cheap pro-forma document from the Internet.

Another option is to place a caveat over the property. This can sometimes be helpful but there are no guarantees that a mistake won't be finalised with this approach. A caveat only prompts the Titles Office to contact the caveat holder when someone tries to change a property's title. If the caveat holder doesn't come forward within a certain period of time (typically 30 days) then the property's title will be amended accordingly.

Some SMSF investors will want to use a caveat because there has been a change in the membership of their SMSF (which changes the trustees of their fund) and they want to avoid the cost of adjusting a property's title. The new trustees place a caveat over the property so the property hopefully won't be sold without their prior approval.

Leave a "documentation trail"

In reality, what's needed is very good documentation. Sometimes it might suffice to show that a property is owned by a super fund, by demonstrating that it has been included in a super fund's financial accounts for many years.

At the very least, a property's contract of sale needs to clearly state that it's being purchased by the super fund. The deposit and all other outgoings need to be paid for by the super fund.

Copies of all payments (especially cheques and bank statements) and sale documentation should be retained for as long as the property is owned and then possibly longer. This documentation is often needed for Federal tax issues (for example CGT).

This document trail is also needed when a super fund's accounts are audited each year. An SMSF auditor will want to see appropriate documentation. Given the limitations of Declarations of Trust or caveats, this means documents showing the original purchase and annual outgoings for a property are essential.

In my view, the best solution to this problem is to use a corporate trustee specifically set up to be trustee of your super fund. This is not only a simple solution, it is also more cost effective.

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Safe investments

Question of the week

Q: *Is the Centuria Spring Street Fund a safe investment?*

A: The Centuria Spring Street Fund is "safe" in that:

- It is a single purpose fund that owns a commercial building in the heart of the Sydney CBD;
- It has a reputable and experienced manager; and
- It has credible forecasts re return, occupancy plans, re-development prospects.

Like any investment, it carries risk. In this case, risks include:

- It is an unlisted fund. There is no ready market for units in the fund – this is an illiquid investment;
- It relies on an "exit plan" to liquidate the building and return the capital back to the unitholders. There may be no ready buyer for the building when the Fund proposes to sell it – unitholders may end up holding an investment that exceeds their projected holding periods;
- The manager may not be able to improve the occupancy of the building or generate higher rents. The forecast returns may not be delivered.

I would encourage you to read the Product Disclosure Statement carefully – the major risks are described in this document.

Legally, I can't tell you that it is a "safe" investment. However, I can indicate that we wouldn't have carried a report in the Switzer Super Report unless we felt that it was an investment that, in the right circumstances, some of our subscribers may wish to consider.

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Did you know?

We've recorded our latest webinar where our subscribers get to ask myself and Paul Rickard any questions they might have about SMSFs. You can see the video here. And if you like what you see, you can come along to the next one - we hold them at 12.30pm on the last Friday of every month.