Switzer Super Report

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It's all about the core

We're still in the midst of earnings season, but you'd have to be living under a rock not to know that, or paying too much attention to that other race that's going on. Today, Charlie Aitken explains why NAB and Suncorp are two financials that he is very much enamoured with.

Also in today''s *Switzer Super Report*, Paul Rickard takes a look at the ASIC ''crackdown'' and Barrie Dunstan explains the importance of sticking to a strategy in tough times.

Ron Bewley's review of the health sector looks at the darlings there, but his favourite is still Cochlear, read below to find out why.

Sincerely,

Peter Switzer

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NAB and Suncorp – dog starts wagging tail

by Charlie Aitken

NAB and SUN remain core members of my high conviction buy list. Both stocks this week confirmed they are continuing along the road to market redemption, which I believe will translate to further P/E expansion and share price gains. My confidence in dividend growth is also enhanced and I think the total returns generated by both stocks from here will be pleasing.

National Australia Bank

A year is a long time in banking. It was less than 12 months ago that NAB shares were under $24.00 (while still cum the final dividend) after analysts downgraded the stock for the poor UK performance. I think we described NAB back then as "the best risk adjusted large cap buy since TLS at $2.60".

Fast forward to today and the only comment worth focusing on from NAB's trading update on Tuesday was the following:

"In the UK, we continue to deliver against the strategy we outlined in April 2012. Progress on simplification of our UK banking business has been pleasing, with efficiency benefits ahead of plan. We have also achieved further run-off in the UK Commercial Real Estate portfolio, with the current balance of £4.4 billion down £1.2 billion, since its transfer to National Australia Bank Limited in October 2012."

I remember saying to NAB CEO Cameron Clyne at a Christmas drinks party last year, a day after the *AFR* named him in the "*top 10 CEO's likely to be sacked in 2013*", that if he got the UK business off the headlines, the P/E discount to the oligopoly peers would take care of itself and the financial press would move on to kick another corpse. We both agreed it "wasn't rocket science", had another beer, raising our glass to hopefully better times ahead in 2013.

For all the press and analyst criticism/corpse kicking of Clyne, he has succeeded in getting the UK business off the headlines, and NAB's P/E discount to its peers is narrowing at pace, as it becomes more obvious to all that the UK noose is coming off NAB's share price.

As far as I can tell, most research on banks simply extrapolates the present. If I look forward two years, I can see a scenario where no bank analyst even mentions the UK for NAB, or if they do it's in passing.

That is a very important call, because the UK tail has been wagging the entire NAB share price dog for the best part of five years. Now I believe the domestic, 18% ROE, oligopoly bank will drive the share price, as the UK P/E discount to the domestic peers evaporates.

A new darling

Imagine this scenario: the UK becomes a non-issue for NAB, domestic business confidence picks up post the election, consumer and household confidence improves with ultra-low cash rates for an extended period, domestic bad and doubtful debts (BDD) remain benign and unemployment peaks below expectations. Under that scenario, NAB will be testing all-time highs around $44.00 in a few years' time.

And I believe that is increasingly becoming a base case scenario, not a "what if" scenario. Today, I think we are only part way through the NAB re-rating. It has moved from wildly cheap to now cheap.

I really want to stay the course in NAB, until it achieves a domestic bank sector multiple. The dividend yield plus franking credits alone pays me adequately to take that risk. FY14 dividend lifts to 198c fully franked, putting NAB today on a prospective 6.3% yield.

Earnings Forecast

Year end 30 September	2012	2013e	2014e	2015e
NPAT (reported) (A$m)	4,082	5,579	6,375	7,030
NPAT (adjusted) (A$m)	5,433	5,924	6,375	7,030
EPS (adjusted) (cps)	241	252	266	289
EPS growth (%)	-4%	4%	6%	8%
PER (x)	13.1	12.5	11.9	10.9
P/Book (x)	1.7	1.6	1.5	1.4
P/NTA (x)	2.0	1.9	1.8	1.6
Dividend (cps)	180	187	198	213
Yield (%)	5.7%	5.9%	6.3%	6.7%
ROE (%)	14.2%	14.8%	14.9%	15.4%
NIM (%)	2.10%	2.02%	1.99%	1.96%
Franking (%)	100%	100%	100%	100%

SOURCE: BELL POTTER SECURITIES ESTIMATES

NAB remains a high conviction buy. A price target of $35.91 is generated on 13.5 times FY14 EPS, while our slightly increased (+2%) FY14 dividend forecast, leads to the 5.00% fully-franked yield target on NAB being lifted to $39.60. On that basis, in the year ahead, it's fair to predict NAB moving into a new higher trading range of $35.00 to $40.00, as the UK discount is shed.

Suncorp

Now to another member of our high conviction list, which has been there since inception. The total returns generated by Suncorp (SUN) continue to outpace the broader ASX200.

Our previous attraction to SUN was as a specialist, contrarian, deep value post "near death" GFC turnaround situation. That turnaround has now broadly occurred, yet the next leg of the SUN story is a growth plus yield story that sees SUN come back onto all investors radars. It's easily forgotten that SUN is an ASX top 20 stock with a $16 billion market cap.

In terms of future P/E rating for SUN, the good news is, just like the NAB example, SUN is shedding the previous P/E noose around the group neck known as the "non-core bank". The non-core bank will be all but gone by the end of FY14. This is important.

Why is this important? Because the core SUN bank has good assets that we think will continue to grow. In fact, they grew nicely in FY13 to $47.5 billion. What I like is the SUN core bank is basically a QLD and NSW residential mortgage exposure.

In the insurance side of the business, margins continue to increase. This is also good news, driving a $883m general insurance NPAT for FY13.

A yield play

What all this translates to, is all SUN business lines are experiencing top line growth, which is seeing shareholders rewarded in big, fat fully-franked dividends, from their excess franking credit pool.

Earnings Forecast

Year end 30 June	2013	2014e	2015e	2016e
NPAT (reported) (A$m)	491	1,218	1,348	1,491
NPAT (adjusted) (A$m)	576	1,296	1,419	1,546
EPS (adjusted) (A$m)	45	101	110	120
EPS growth (%)	-30%	124%	9%	9%
PER (x)	28.0	12.5	11.4	10.5
P/Book (x)	1.2	1.1	1.1	1.1
P/NTA (x)	2.1	2.0	1.9	1.8
Dividend (cps)	75	73	79	85
Yield (%)	6.0%	5.8%	6.3%	6.7%
ROE (%)	4.1%	9.2%	9.9%	10.4%
ITR margin (%)	13.1%	14.0%	13.9%	13.9%
Franking (%)	100.0%	100.0%	100.0%	100.0%

SOURCE: BELL POTTER SECURITIES ESTIMATES

SUN is currently cum the 20c fully-franked special dividend and 30c fully-franked final dividend. We forecast SUN to pay another 73c of fully-franked ordinary dividends in FY14, with the clear risk of another special dividend. That means if you buy SUN today, you will be entitled to 123c fully franked of dividends, with risk to the upside on that number. On Wednesday's closing price of $12.60, that equates to a 13-month yield of 9.76%, or 13.9% grossed up.

I actually fully agree with SUN's view of themselves, that they are now a yield plus growth stock. That is pretty much exactly the attributes all domestic investors should be seeking, in an ultra-low interest rate environment, where headline growth is hard to find.

I also think management, led by Patrick Snowball,

has done a very admirable job turning this big ship around. I suspect some P/E will be added from this point for management execution.

SUN remains a high-conviction buy with the bottom up, top down and technicals all coming together. The $14.50 price target is also the 5.00% fully-franked FY yield target.

Go Australia, Charlie

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ASIC's "crackdown" on hybrids – more noise?

by Paul Rickard

I always get a little worried when ASIC announces yet another "crackdown" (yes, their words). Two ready possibilities come to mind – either ASIC is late in taking action about some investor scam where the horse has already bolted, or they have got it horribly wrong again. To be fair to ASIC, the ASIC of 2013 has lifted its game considerably and recent innovations, such as the Money Smart website, are to be applauded.

On Tuesday, ASIC announced a "crackdown" in the hybrid securities market. It issued 'Report 365', which details its thinking about the market and the actions it proposes to take.

The hybrid market

According to ASIC, more than $18 billion has been raised by companies between November 2011 and June 2013 through the issue of ASX-listed hybrid securities. These securities combine both 'equity-like' and 'debt-like' characteristics (see Table 1 at end).

Investment in hybrid securities is, according to ASIC, narrowly focussed among a group of 75,000 retail investors. They claim that there is almost no participation by institutional investors, and of the retail investors, two thirds are SMSFs.

What are ASIC's concerns?

ASIC has three primary concerns with the issue of hybrid securities:

- Misleading conduct in the sale of hybrids. This includes inappropriate labelling of hybrids and unwarranted comparison of hybrids to different, less risky products e.g. covered bonds or senior debt;
- Spruiking of the potential higher returns of hybrids, and the brand name or reputation of the issuer, without balancing that with the risks of the product, and
- The complexity of the issues, meaning that some investors don't know what they are getting in to.

What is ASIC proposing?

The regulator says that it has already worked with issuers and their lawyers to improve disclosure in prospectuses (for example, by requiring an 'Investment Overview' and 'About the Security' sections at the start), and has also been active in issuing warnings through the media. In addition, it now proposes to:

- Develop tools that will allow investors to "check their understanding" of hybrid securities;
- Investigate any reports of problematic behaviour by brokers and other distributors;
- Review advertising and promotional material;
- Consider naming conventions for hybrid securities to ensure that they are accurate; and
- Continue to work with issuers and their lawyers to further improve prospectuses.

Of these actions, standardising naming and labelling conventions for hybrid securities and simplifying prospectuses are steps in the right direction. Naming and labelling is an issue, with ASIC noting that recent issues of hybrid securities by the major banks that qualify as 'Additional Tier 1' capital have been variously described as "Capital Notes" and "Convertible Preference Shares". ASIC would like to see them described as "Capital Notes".

A "crackdown"? Hardly.

Table 2: ASX 200 sector statistics

	Sector	P/E ratio		Cons. rec.	Market cap.	Exuber-ance	12 month forecasts		
		historical	forward				yield	cap. gain	adj. gain
Resource-related	Energy	18.6	14.9	2.5	5.6%	0.0%	3.7%	25.6%	25.6%
	Materials	14.6	11.8	2.2	17.5%	-1.5%	3.2%	22.1%	23.6%
	Industrials	17.5	15.3	2.6	5.7%	-1.2%	4.2%	13.5%	14.6%
High yield	Financials	13.8	13.0	2.7	38.5%	3.7%	5.6%	6.0%	2.3%
	Property	14.8	14.1	2.6	5.9%	-2.5%	5.7%	4.7%	7.2%
	Telco	16.3	15.4	2.9	5.4%	6.6%	5.6%	5.5%	-1.0%
	Utilities	15.8	14.5	2.7	1.6%	-4.3%	5.9%	8.5%	12.8%
Other	Discretionar	19.8	17.7	2.3	6.6%	3.7%	2.3%	11.5%	7.8%
	Staples	17.8	16.6	3.3	8.0%	-0.4%	4.7%	6.7%	7.1%
	Health	22.4	19.7	2.6	4.6%	-0.2%	2.4%	12.9%	13.1%
	IT	19.7	17.4	2.6	0.7%	1.8%	3.2%	12.2%	10.5%
	ASX 200	15.5	13.9	2.6	100.0%	1.5%	4.5%	11.1%	9.6%

Note: the estimates in the Figure are current to the close of business 16th August 2013. They are based on Thomson Reuters Datastream and Woodhall Investment Research's analysis of that data.

Stick to the strategy

by Barrie Dunstan

After recent years, many investors still seem uncomfortable about the recovery in share prices and need constant, short-term reassurance. Perhaps it is a fear that it's too good to last, or political uncertainty, or ever-present worries that central banks will close the taps on the flood of liquidity.

But whatever the case, it seems many SMSF investors need to keep finding long-term reasons to maintain confidence in share investments. They need mental strength to overlook much of the short-term market chatter (while watching for possible significant changes) and confidence in their investment beliefs to support their long-term approach.

The important strategy

Stockbrokers used to say the best time to buy shares was whenever you had the money. Today, investors need more than blind confidence; they need a framework or theory, which provides some guidance. For instance, growth investors want companies with growing profits; value investors want shares selling below their intrinsic value.

Now, however, there are many more theories about when and what to buy in the share market. This means investors have to filter out much of the "white noise" around the market, generated by traders talking their short-term trading book.

For every theory on the stock market, there can be a counter theory – and some widespread beliefs often are wrong. For instance, despite the instinctive appeal of the idea, share markets do not always track economic conditions and the correlation between growth in GDP and share prices isn't clear cut.

Nor can consumer surveys provide an indicator of the market's direction and extreme highs and lows in consumer (or investor) sentiment are probably one of the best contrary indicators for the share market.

In recent years, some traders have turned counter-cyclical, buying shares which are out of fashion. Anyone who wants to take this approach has the problem of separating sensible from faddish fashion. Then there is the temptation to join the daily or weekly share traders. Members who dabble in this, need to isolate their trading operations from the main portfolio and remember that constant tinkering with a portfolio can lead to additional costs.

Rather than chasing individual hot stocks, it may be more sensible to use the overall market sentiment as an early warning sign to top up shareholdings, when people are too bearish, and to reduce holdings when people become too bullish.

The Buffett mantra

There's nothing new in this: Warren Buffett outlined it years ago, telling investors to buy when others are fearful and sell when others are greedy. Buffett also had his two golden rules: One, don't lose money; two, don't forget the first rule.

On stock selection, there's a general tendency for amateur investors to select well-known names on the assumption that the big companies are big enough and ugly enough to look after themselves (and their investors). While size and reputation can work, Buffett also advises investors to seek companies with what he calls a "moat" to protect themselves from competition.

Finally, investors do need to consider the general economic and business climate – but by looking at available statistics rather than listening to chatter. For instance, despite some political talk, current consumer sentiment is more than 9% higher than a year ago.

The real worry, of course, is the big economic factors beyond the control of any politician or business leader. What happens with China's economy and what the US decides to do with interest rates, are the two factors really driving the Australian and world markets.

Either or both these factors could turn nasty. So far, however, the optimists have profited and, despite periodical scares, China still seems a fair bet to continue its recent growth and the US Federal Reserve is unlikely to make any abrupt moves.

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Buy, Sell, Hold – what the brokers say

by Penny Pryor

As the markets waited on news out of the US and earnings results from the blue chips, broker activity was mainly driven by expectations – that is, the failure of companies to meet them.

In the good books

Although brokers were mostly underwhelmed with Fleetwood's result, it got two upgrades – from Underweight to Neutral by JP Morgan and to Neutral from Sell by UBS. The company's results exceeded UBS's expectations by about 30%, and although it doesn't have big expectations for the year ahead, it does believe a lot of that has been priced in. JP Morgan also believes the weaker outlook has been factored in.

It was a big week for healthcare companies (see Ron Bewley's review of the sector here). Both Ansell and Sonic Healthcare received upgrades from Credit Suisse and CIMB respectively. Credit Suisse's upgrade of Ansell to Outperform from Neutral was based on results meeting the low end of its forecasts. The broker was also impressed by its ability to grow, albeit slowly in a low-growth environment. CIMB upgraded Sonic Healthcare to Outperform from Neutral as it was impressed by cost-cutting initiatives, which are expected to support stable earnings growth.

The not-so-good books

After announcing an 11% increase in cash profit for the first nine months last Friday, seven brokers maintained their ratings on ANZ – six Buys or Outperforms and one Neutral – while JP Morgan was the lone broker to downgrade the group. Although the announcement was broadly in line with JP Morgan's expectations, it wasn't very impressed with a two basis point decline in group margins, which are expected to fall even further (by 20 basis points) in the second half to September.

Bendigo and Adelaide Bank announced on Monday. Figures were broadly in line with expectations, with again only one broker out of the eight in the data base choosing to downgrade. UBS shifted its rating from Buy to Neutral, because the bank fell short of its earnings expectations by about 2.5%. It also did not like the fact that the loan book grew a lot faster than deposits.

CIMB downgraded Monadelphous Group to Neutral from Outperform, after lowering its profit forecasts for FY14. This was based on expectations of lower growth in second half FY14, although the broker believes activity should pick up in FY15/16, due to a stronger tender pipeline.

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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When are my financial advice fees tax deductible?

by Tony Negline

The tax deductibility of financial advice has always been an important issue for investors. Most people want a clear set of rules about which advice expenses they can and cannot claim as a tax deduction.

Unfortunately, there are no specific rules about the deductibility of advice fees, which means these costs fall under the ordinary deductibility rules.

These rules say that you're allowed a deduction for any expense you incur in gaining or producing income subject to tax (officially called "assessable income") except where the expenditure is: of a capital, private or domestic purpose; relates to earning exempt income; and specifically isn't allowed as a tax deduction by the tax laws.

Here are some examples (which don't involve financial advice fees but you'll understand the point):

- Personal contributions to super wouldn't ordinarily be tax deductible – because they would be seen as private expenditure – but specific tax rules allow some of these contributions as a tax deduction, if you satisfy various rules.
- The costs incurred in earning pension income in a super fund aren't allowed as a tax deduction because that income is exempt from income tax.

So where does this leave financial advice fees? Well, let's look at some different types of fees.

1. Setting up an investment portfolio or financial plan

This is a capital expense and is not tax deductible. Way back in 1995, the ATO released a Tax Determination on this subject (TD 95/60). It said putting investments into place has an insufficient connection to earning income from those investments. The costs incurred to draw up a financial plan also falls into the same category.

2. Existing investment portfolio – management and retainer fees

Financial advice fees for servicing an existing investment portfolio are allowed as a tax deduction. However to be fully deductible, the fees must relate to earning income. This means that if the advice relates to items that don't earn income (for example, insurance premiums, management of pension assets or private loans), then only a proportion of the fees will be tax deductible.

Sometimes you might receive advice to alter the mix of investments held. If this is part and parcel of managing your investments, then these costs will be deductible. But if the costs relate to drawing up an investment plan, then it isn't allowed as a deduction.

3. Investment loan arranging fee

This is considered to be a borrowing expense and is tax deductible over the lesser of five years or the life of the loan.

However, the purpose of this loan has to be to earn income, which is subject to income tax.

4. Cashflow management and other issues

If any advice fees relate to cash flow management or other issues (such as insurance needs), then this doesn't relate to earning assessable income for tax purposes and is therefore not tax deductible.

5. Commissions

These are not incurred directly by you and hence aren't tax deductible.

Breakdown of costs

Ideally, your financial adviser will break their costs down so you have some documentary evidence on what can and cannot be claimed as a tax deduction.

If they can't do this, then the ATO will accept a reasonable estimate. For example, if your adviser spends 15% of their time reviewing your current income producing investments, then 15% of your adviser's fees is tax deductible.

For over 30 years, the financial advice industry has been pushing to make all advice fees – including commissions – tax deductible in all instances. The Government has successfully ignored all this pleading and I'd be surprised if the rules, as I've described them here, change to a significant extent in the near future.

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Pension payments and Liberal policy

by Questions of the week

Question 1: *A well known financial media person advised on the radio, (about 12 months ago) that when an SMSF is converted to 'pension mode' and starts paying an account-based pension, all pension payments MUST be made by cheque only. No electronic transfer of pension payments is allowed.*

Is this correct? If so, please advise where this regulation is written, for example, in the SIS Act 1994 or some other SMSF reference. I am reviewing the SIS Act 1994 and I can't find (yet) any paragraph as to how an account-based pension must be paid. The Trust deed for my SMSF does not state the exact method of account-based pension payments either.

Answer (by Tony Negline): There's nothing in the *SIS* Regulations saying that EFT can't be used. What can't be used is non-money i.e. in-specie payments. The *SIS* Regs (refer to Part 6) says pension income payments must be money – APRA and the ATO interpret this word narrowly.

Question 2: *In a February interview with Joe Hockey, you talked about his party's philosophy on taxing SMSFs. Is there any way of lobbying to make sure the original terms of these funds being 'tax exempt' is adhered to.*

Answer (by Peter Switzer): The stated Liberal Party Policy is not to make any changes that are adverse to the superannuation system. The words that appear are: "only the Coalition can be trusted not to make any unexpected detrimental changes to superannuation in the next term of Parliament."

I think that a tax on pension income qualifies in this category. Also, for reasons that Tony Negline made clear the other week in the *Switzer Super Report*, administering any such tax will be very problematic. I don't think this proposed change will ever see the light of day.

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