Switzer Super Report

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It's starting to look a lot like Christmas

Australia, apparently we don't know how good we've got it, according to Nobel prize-winning economist, and professor of economics at Columbia University, Joseph Stigliz.

Charlie Aitken is also expecting things to look a little bit better come next week if the outcome of the election is, as everyone suggests it will be, a decisive victory for one side. That should boost confidence, which in turn will boost retail sales and away we go. Read how it all fits in below.

Also in the *Switzer Super Report* today, we have George Boubouras from Equity Trustees, explaining why Transurban is definitely worth consideration and Ron Bewley examines Magellan and FlexiGroup in the financials sector.

Sincerely,

Peter Switzer

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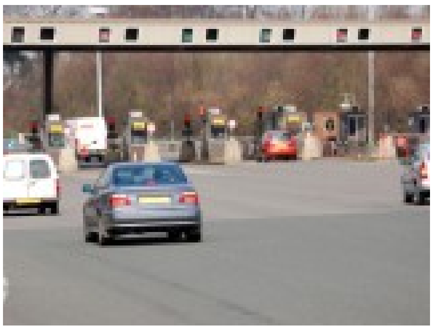

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Time to go shopping – JB Hi-Fi and Woolworths

by Charlie Aitken

I think it's going to be the best Christmas in many years for the right Australian retailers. I think the macro settings are very accommodative, and households will loosen the purse strings into, and over, the crucial Christmas period for retailers.

Recently, there has been commentary that low Australian household and business confidence readings were "*structural*" change. Similarly, high household savings rates and low corporate gearing levels, are also seen by some as "*structural*" change. I believe that will be proven completely wrong.

Elections and confidence

Confidence is *cyclical*, savings rates are *cyclical* and corporate gearing levels are *cyclical*. They are all set relative to confidence and clarity about the future, which in turn is a derivative of leadership. That is why I have always believed a decisive federal election result this weekend removes the final hurdle towards a broader confidence improvement.

Whatever your personal politics, I believe we will all look back with the benefit of hindsight and realize minority government was bad for Australian confidence – both household and business confidence.

If the betting odds are to be believed, and I take the view they most likely are, then we are in for a decisive federal election result on the weekend. My view at a *behavioural economics* level, is that it will be good for household and business confidence, and through time, those who believe Australian households and Australian businesses have become "structurally" low in confidence, will have to reassess their view.

What could easily happen here, is we, including bulls like me, are all surprised by how quickly and sharply consumer and business confidence turns up. In a world of instant information, confidence is like a virus. It's contagious.

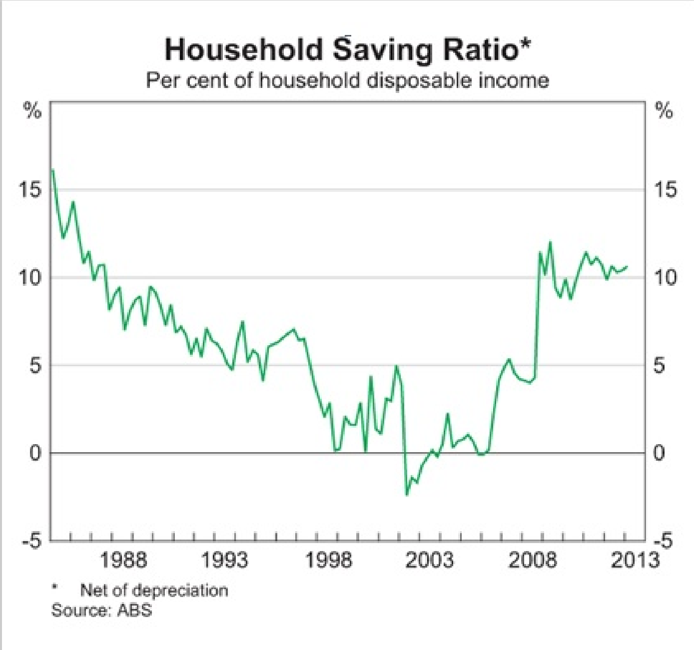
Australian business and Australian households have the balance sheet and free cash flow capacity to spend and all they need now is the will. Australians are not natural pessimists and not natural cash hoarders. They do not enjoy "*austerity*". In fact, history suggests the complete opposite!

This also has ramifications for individual investor confidence, remembering 33% of the entire superannuation pool is run by SMSF owners, who set their investment strategy around the dinner table watching the 6.00pm news.

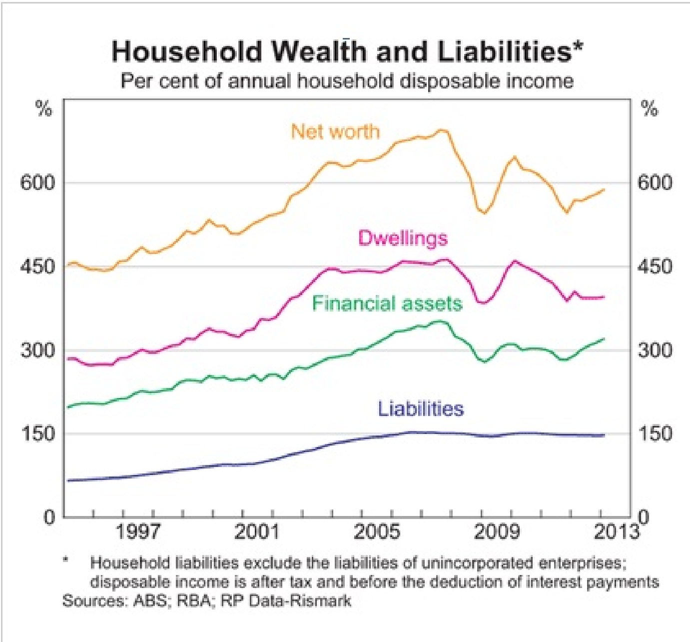
Investing habits

When Australians are confident, they save via residential property and equity market investment. The nuances of the Australian taxation system encourage home ownership (CGT free), ownership of investment property (negative gearing) and buy and hold equity investing (fully franked dividends, CGT concessions for holding over one year). Cash is the least tax-effective asset class in Australia, and it is highly unusual for Australians to embrace cash as an investment as much as they have over the last five years. Again, I think this is *cyclical*.

In the chart below from the RBA, you can see when Australians are confident the "savings rate" is 0% or even negative, as "saving" via rising residential property or equity prices offsets the need for holding cash. Equities are liquid (T+3 settlement).



Australians are also starting to feel **a positive wealth effect**, which is an essential ingredient of a broader confidence improvement. In the chart below, liabilities have been stable for six years and now we are seeing a rise in financial and dwelling asset prices leading to a rise in net worth.



Of course, house prices play the key role in both the liability and net worth lines above, and it is abundantly clear median Australian house prices are rising. This is one hell of a funny looking *housing crash*, reminding us all that offshore doomsayers on Australian housing/Australian mortgage banks truly have no clue about the underlying domestic dynamics of the sector. Is the sky falling or the land rising?

And in a textbook economic response, low interest rates are driving a rise in home loan approvals. Not so great for first homebuyers who are priced out of the market. They might be with mum and dad for a while longer.

Another point worth noting is that while household debt, as a percentage of household disposable income, is high at 148%, low interest rates have driven a fall in interest paid as a percentage of household disposable income, meaning households have free disposable cash flow. Recently, they have been saving that free cash flow, but that will change and it will be consumed.

And consumer sentiment is all that is missing now…When Australians are confident and spending, this reading is 120. It was 105.7 in August.

But this is where we must avoid over-complicating things. As much as this sounds blatantly obvious, overall discretionary retail spending is highly correlated to consumer confidence readings. In fact, it's really all about getting the direction of consumer confidence right, then picking the right categories where consumers are going to discretionary spend.

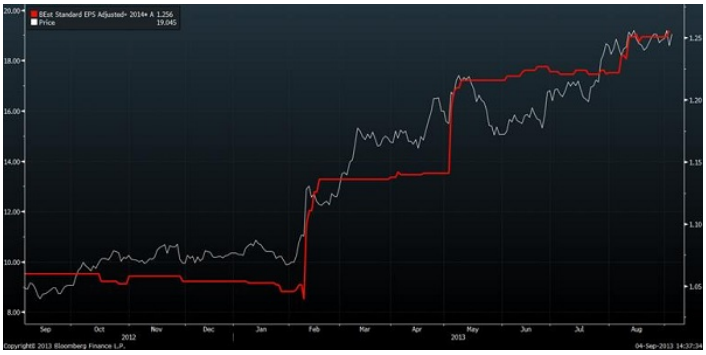
Stocks to watch – JB Hi-Fi and Woolworths

The two categories I think look best into Christmas are *food and liquor* and *electrical/electronic goods.*

Food and liquor has grown by 3.8% over the last 12 months, led by supermarkets, while electrical/ electronic goods is up 2.3% versus the previous corresponding period, and up 2.7% month on month.

I feel Australians are going to discretionary spend more on food and liquor this Christmas and it seems that all kids and Gen Ys want, is the latest electronic gadgets. On that basis, my two high conviction plays on the strong Christmas theme are Woolworths (WOW) and JB H-Fi (JBH). Both stocks are very well leveraged to a broader confidence and spending pick up.

Some people have said the recent rally in JBH was all short covering. No doubt, some part of the rally was short covering driven, but in all reality, this is a fundamental rally because the analysts have been way too low on their earnings forecasts. That continues to this day, with JBH in a clear EPS upgrade cycle. Below is a chart of JBH share price and FY14 consensus forecasts. Note how the analysts all upgrade after a result or guidance from the company, but then keep their sells on the stock. Without being too rude, they have been completely wrong, yet persist with their negativity.



A genuine Australian confidence cycle is well overdue. I am absolutely convinced the conditions are in place for that positive cycle to evolve over the remainder of this year and beyond. It has started in residential property and parts of the equity market and it will spread to discretionary spending. You can feel there is pent up demand to spend some money.

On that basis, I am going to declare the end of "Australian austerity" and do what I should have done last week by officially adding Woolworths (WOW) and JB Hi-Fi (WOW) to my high conviction buy list. These are high quality companies about to experience a genuine tailwind.

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Reasons to love toll operator Transurban

by Fundie's Favourite

How long have you held the stock?

We've held Transurban since the global financial crisis, when the company committed to controlling costs and paying future dividends through operating cash flows.

What do you like about it?

Toll road operators are a simple infrastructure business that can grow earnings in line with broader economic activity. While not quite as cyclical as an airport infrastructure asset, they do exhibit a very predictable earnings outlook and are ideal for having in a portfolio context.

Transurban needs to keep on top of its gearing levels and costs going forward. It has a good management that can stand out versus its global peers.

How is it better than its competitors?

The quality of its assets, the control it has on future price movements, and its ability to keep costs low due to its gearing levels. Management has had a good track record over the past five years.

What do you like about its management?

The previous management was one of the first companies to communicate to the market in the GFC that it would address its gearing levels, keep costs down, deliver predictable earnings and pay a dividend via operating cash flows. Management has since changed; however, the philosophy remains the same.

What is your target price on TCL?

Our 12-month forward target price $7.15, with circa 4.8% yield (i.e. yield around 50-75 basis points greater than the broader market).

At what point would you sell it?

If it became de-listed. The long-term cash flow of this type of asset is the ideal asset for a large pension fund, either globally or domestically (industry super fund or Future Fund).

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

TCL is up nearly 17% (including dividends) over the past 12 months. This is well above expectations. Expected returns for this exposure is around 9% p.a. total return.

Where do you see the value?

The value is in the assets. Also, it has simple predictable earnings growth in line with broader economic activity. Costs need to be maintained going forward. We believe it is the ideal stock to construct a diversified equity portfolio that ideally needs defensives and cyclicals.

Financials outside the Big Four – Magellan and FlexiGroup

by Ron Bewley

When last I conducted a review of the finance sector (excluding property trusts) on the 19th February 2013, only one of the big four, NAB, had an acceptable consensus rating by my definition for inclusion in a High Conviction portfolio. That is, they were in the top 100 and met my '2.5' broker recommendation status (please see my paper on the Market Updates tab of our website www.woodhall.com.au) for details. Not meeting these criteria does not mean they would not have been good investments – particularly for a yield play – but for those wanting growth, the other three did not look like good investments.

From Table 1, all four big banks produced returns well in excess of the ASX 200 index (at +1.4%) and naturally gained around the same as the financials index (at 6.5%) being so large. But Challenger (+41.3%) and Henderson (+20.7%) in the top 100 and Magellan (+43.1%) in the next 100 kicked the lights out over the last six months.

Is it worth venturing outside the big four?

There are currently five financials stocks with a recommendation better than a '2' in the top 200: Magellan Financial Group (1.50), Lend Lease Group (1.93), FlexiGroup (2.10), Suncorp (2.10) and ANZ (2.40). While I would not abandon my overall strategy of choosing larger companies with good ratings, I am not against substituting some of my exposure to big banks with smaller investments in smaller cap stocks.

Since Lend Lease (LLC) and Suncorp (SUN) are in the top 100, it is a no-brainer to at least consider them. ANZ is a genuine high conviction stock – but what about Magellan (MFG) and FlexiGroup (FXL)?

Table 1: Data on companies in the ASX 200's Financials-x-REITs sector

Index	Code	Company name	Capital gains from 18/2/2013 -	Consensus recs. 18/02/2013	Consensus recs. 30/08/2013
ASX 100	CGF	CHALLENGER	41.3%	2.24	2.50
	HGG	HENDERSON	20.7%	2.25	2.60
	MQG	MACQUARIE	12.9%	3.20	2.70
	QBE	QBE INSURANCE	11.4%	3.00	2.90
	CBA	COMMONWEALTH BANK	10.7%	3.40	3.20
	IAG	INSURANCE AUS. GROUP	10.6%	2.50	2.90
	SUN	SUNCORP	7.7%	2.13	2.10
	NAB	NATIONAL AUS. BANK	7.6%	2.31	2.60
	BOQ	BANK OF QLD.	5.3%	2.75	3.00
	ANZ	AUS.AND NZ.BANKIN	4.2%	2.59	2.40
	WBC	WESTPAC	3.9%	2.69	2.80
	ASX	ASX	-0.4%	3.25	3.20
	BEN	BENDIGO & ADELAIDE BANK	-0.6%	3.33	3.10
	LLC	LEND LEASE	-8.1%	2.00	1.93
	AMP	AMP	-13.7%	2.73	3.00
Small Caps	MFG	MAGELLAN FINANCIAL	43.1%	1.50	1.50
	FXL	FLEXIGROUP	3.8%	2.40	2.10
	IFL	IOOF HOLDINGS	2.2%	2.58	2.70
	PTM	PLATINUM ASSET MAN.	0.8%	3.50	3.40
	PPT	PERPETUAL	-2.2%	3.15	2.90
	FKP	FKP PROPERTY GROUP	-21.4%	3.33	3.20

Note: the estimates in the Table are current to the close of business 30th August 2013. They are based on Thomson Reuters Datastream.

Magellan has had a spectacular run in the market and a massive run in funds-under management as a fund manager. I should declare a potential conflict of interest, in that I'm on an investment committee that has an MFG fund as one in which clients' funds are invested. I'd have no problem in investing my own funds in that company if I felt the need to invest in a managed fund.

However, my concern is that, if by chance or management, their flagship fund has a bad quarter or two in terms of performance, could the gloss come off and the price run retrace a little? This is not a big chance in my opinion but that is why I would keep my Magellan exposure small, compared to that in the big banks.

FlexiGroup does retail point of sale finance for IT and electrical goods. I defer to brokers' knowledge of the company and the improvement in the rating from 2.40 to 2.10 over six months, while the share price has only gone up by 3.8%. On this basis, if I were tired of just collecting dividend cheques from my preferred big banks, CBA and WBC, I could imagine reducing that banking exposure by say 10% to 20%, and replacing it with investments in Magellan and FlexiGroup – with a leaning towards FlexiGroup because of Magellan's recent strong capital gains.

Sector outlook

From Table 2, it can be noted from my recent contributions to this column, our ASX 200 capital gains forecasts have slipped to as low as 10.4% for the next 12 months. When I take exuberance, or mispricing, into account (in the final column), the adjusted forecast for the market becomes 9.1%. The adjusted capital gains forecast for financials is only 2.1%, but the expected yield without franking is 5.6%. This seems like a reasonable motive to take a good look at Magellan and FlexiGroup.

Table 2: ASX 200 sector statistics

	Sector	P/E ratio		Cons.	Market cap.	Exub-erance	12 month forecasts		
		historical	forward				yield	cap. gain	adj. gain
Resource-related	Energy	18.7	15.4	2.5	5.7%	1.5%	3.7%	21.2%	19.8%
	Materials	14.2	11.7	2.3	17.0%	-3.8%	3.3%	20.4%	24.2%
	Industrials	18.1	16.1	2.5	5.8%	-0.2%	4.2%	11.8%	12.1%
High yield	Financials	13.8	13.1	2.8	38.4%	3.3%	5.6%	5.4%	2.1%
	Property	14.8	14.1	2.6	6.0%	-2.3%	5.7%	4.5%	6.8%
	Telco	15.6	14.6	3.0	5.2%	2.1%	5.8%	6.3%	4.1%
	Utilities	16.5	15.4	2.6	1.6%	-0.8%	5.6%	6.9%	7.7%
Other	Discretionar	20.6	18.0	2.3	6.7%	4.9%	2.3%	13.4%	8.5%
	Staples	18.5	17.1	3.3	8.2%	2.2%	4.5%	7.8%	5.5%
	Health	23.2	20.5	2.5	4.8%	4.8%	2.3%	11.5%	6.7%
	IT	19.7	17.6	2.6	0.7%	-0.1%	3.2%	11.5%	11.6%
	ASX 200	15.5	14.0	2.7	100.0%	1.3%	4.5%	10.4%	9.1%

Note: the estimates in the Figure are current to the close of business 30th August 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

As earnings season drew to a close, analysts and the market seem to be taking a breather, with very little activity causing very little movements on ratings.

In the good books

National Australia Bank (NAB) was upgraded to Outperform from Neutral by CIMB but that was because the broker decided to lower the risk-free rate used in discounted cash flow calculations to 4.25% from 5.25%. That had a positive impact on the bank's target price, which rose to $35.02 from $31.72.

Harvey Norman was also upgraded to Buy from Neutral by UBS, which was the only broker to move after the company announced its results late last week. The other seven kept ratings at one Outperform, two Neutrals or Holds and three Underperforms or Sells. Harvey Norman reported in line with consensus but below UBS's forecast. However, the broker remains upbeat on the back of improving housing trends, better pricing and a reduction in franchisee support.

An upgrade in Bank of Queensland's credit rating by Standard & Poor's – to A-minus from BBB-plus – prompted JP Morgan to upgrade its rating on the stock to Neutral from Underweight. The ratings improvement, which relieves some concerns the broker had around the ability of the bank to fund its growth efficiently, had not been factored into JP Morgan's earlier forecasts.

In the not-so-good books

Macquarie downgraded pharmaceutical company Acrux to Underperform from Neutral. An extensive survey by the broker of 381 endocrinologists globally about testosterone therapy, showed a lack of affinity for Acrux's product, Axiron. The broker is now concerned about further market share gains and price.

Also in the pharmaceutical sector, CIMB downgraded Sirtex to Underperform from Neutral, due to inroads made by a competing drug Stirvarga in the EU, where it was approved for the treatment of metastatic colorectal cancer. This makes Europe an even more difficult market for Sirtex.

Credit Suisse downgraded Evolution Mining on the back of its earnings results, which missed consensus. The second half was near break-even, which confirmed the broker's expectations for weakness, and it was downgraded to Underperform from Neutral.

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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Hands off our super ATO

by Tony Negline

Two recent Federal Court cases should ring alarm bells for everyone with a superannuation account.

The two cases involve Kevin and Helena Denlay against the Tax Office. The matter involves the ability of the ATO to satisfy a tax debt that was owed by the Denlays using their super fund money.

The back story

Five to six years ago, the ATO began auditing the Denlay's financial affairs, because of information it had received from a former employee of a bank based in Lichtenstein.

As a result of the audit, in December 2008, the ATO issued the Denlays with invoices for outstanding taxes and penalties of almost $1.7 million for several financial years. By September 2011, this amount had been increased to over $7.4 million.

The Denlays didn't have sufficient money to satisfy these debts. They had successfully argued before the Queensland Supreme Court – both at an initial stage and on appeal – that the ATO's assessments would not have to be paid for a period of time.

In these Supreme Court cases, the Denlays argued that if they were made bankrupt, they wouldn't be able to conduct any further judicial appeals against ATO decisions on their tax affairs.

In December 2009, the ATO knew that the Denlays had an SMSF, but they had moved the money from this super fund to a large retail super fund run by BT Funds Management Ltd.

At one point the SMSF had a balance of just over $262,000. By August 2011, only $62,000 of this remained with BT.

The ATO made a decision to demand money be taken out of the BT super fund as part satisfaction for the Denlay's tax debts. BT paid this money in December 2011. At about this time, the Denlays became bankrupt.

Hands off their super

The Denlays took Federal Court action and argued that the ATO was being unreasonable in demanding payment of their super fund money for their personal debts. The Federal Court agreed and said the super fund money had to be returned.

The importance of this case involves the use of super fund money to satisfy personal tax debt. In most cases, the ATO's stated policy is that super fund money can be used for personal tax debts but any payment order will only have effect if the money can be paid out of the super fund – for example because of permanent retirement.

In many cases, a bankrupt's super money is protected unless it can be shown that super contributions have been made to frustrate a creditor's legitimate financial demands.

What to do about it

One potential course of action is to become bankrupt if the ATO issues a payment demand to a super fund for payment of personal tax debt. This would have the effect of cancelling out the payment order issued by the ATO to a super fund.

It needs to be remembered, however, that ATO payment demands can only be challenged before a judge, which means if bankruptcy isn't an option, then expensive legal costs will have to be incurred to fight the Tax Office.

As the Denlays had been made bankrupt, the Court had to decide who would receive the super money forcibly removed from the BT super fund. Should it be the super fund or the Denlay's bankruptcy trustee?

Ultimately, Justice Logan decided that the money should be paid back into the BT superannuation fund. The bankruptcy trustee had argued before the Court, that the super money wasn't personal property under the bankruptcy laws and hence they had no right to it.

While the facts surrounding this case are slightly unusual (for example, money held in overseas bank accounts), it does show a willingness of the ATO to seek money from super funds for personal tax debts.

The best broker for my SMSF

by Questions of the week

Question: *We have recently set up an SMSF and are in the process of rolling funds over from other super funds. We are small ($350,000) and are managing investment activity ourselves, until we are large enough to gain economies of scale from external management.*

What sorts of factors should we consider when deciding on a traded investment facility for stocks/ETFs/bonds – broker or online share trading? We are looking at Shaw and Macquarie for the former and the major banks for the latter. Do you have any recommendations in either category? What are the pros and cons of both?

Answer (by Paul Ricakrd): In terms of whether you use what is described as a “full service” or “online” broker – it really comes down to whether you want to pay a higher price to potentially access the expertise of an adviser or not. In other words, does the adviser add value to the transaction? The “services” (apart from the advice as to whether to initiate a transaction) are now pretty much the same.

Typically, advisers tend to work very independently. While the “house” (i.e. Macquarie or Shaw) adds some value through the provision of research, under continuous disclosure, research, information and ideas are freely shared in the market (there is very little “proprietary information”). So it largely comes down to the expertise, experience and judgement of the individual adviser. I don’t think it is possible to recommend Shaw over Macquarie or vice versa – it really depends on the individual adviser.

Typically, advisers display “more interest” in clients with bigger portfolios –they can charge a larger flat fee, or there is more brokerage. Most smaller clients tend to trade online (via CommSec, Westpac, Bell or Nabtrade etc), and it is even common for clients who have an adviser to also trade online.

Given that you plan at some stage to access external management expertise (who will have their own preferred broking arrangements), and at $350,000, you are a relatively small fund, my sense is that you will probably be better off using the services of an online broker. A critical consideration in choosing an online broker is the arrangements around settlement: Do you need a particular bank account? What rate of interest is paid? How easy is it to access etc?

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