Switzer Super Report

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Back to the future

So here it is, the promised return to confidence, which is already translating into better equity market performance and is offering opportunities in new sectors as businesses start spending again. Charlie Aitken has the lowdown on which companies are set to benefit - Qantas, Crown and STW Communications are just a few names that spring to mind.

Also in the *Switzer Super Report* today, we have SMSF technical specialist Peter Hogan telling us what he does with his own fund. Peter is currently national manager, SMSF advice at MLC.

And the king is back! Chartist Lance Lai shares his view on the ASX/S&P 200 as Switzer expert Paul Rickard offers some very useful SMSF investment assistance for a subscriber.

Sincerely,

Peter Switzer

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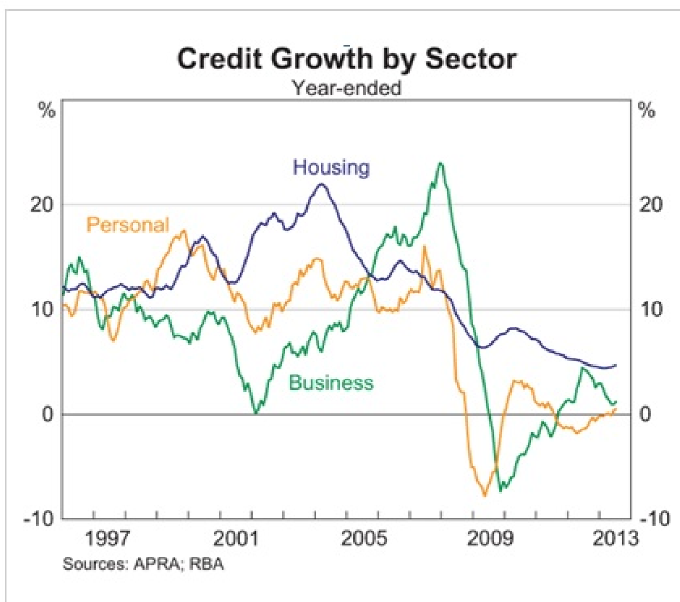
Back in Business

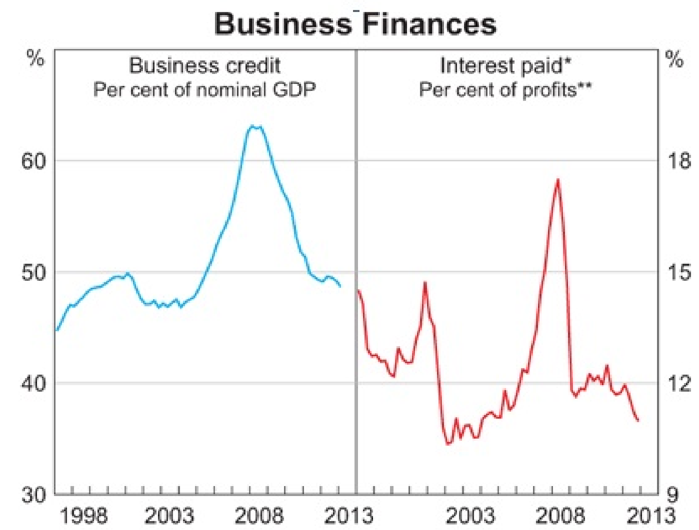
by Charlie Aitken

I get very little disagreement from the business sector to my view that Australian business confidence will pick up from this point, but that leads to further questions about how best to get equity market leverage to a sustained rise in business confidence.

Business confidence is crucial to GDP growth because of the GDP multiplier of a corporate dollar spent. When business confidence turns up, you get a concurrent lift in investment spending and corporate discretionary spending. You also get a lift in employment. It is productive cashflow and capital deployment.

The charts below from the Reserve Bank of Australia reminds you that business credit growth has been hovering around 0% for many years despite historically low interest rates and recovering global growth. The chart beside it reminds you interest paid as percentage of profits is well below the average of the last decade.





I think business credit growth is the first place you will see evidence of the improvement in business confidence. There will be an increase in the demand for credit to finance investment in property, plant and equipment and to finance growth by acquisition.

While the banks are leveraged cyclical activity stocks (GDP +), the next question becomes 'Where else do we find leverage to a sustained pick up in business confidence?'.

Back to the future

To answer that I am simply going to give you my personal experience of business confidence cycles and what happens.

You start by booking a big boat and filling it up with French champagne… Sorry, was having 2007 flashbacks!!

The big discretionary spending variables in all businesses are travel and entertaining, marketing/advertising and telecommunications/IT.

I think you can look forward to a big uptick in travel and entertaining spending, marketing and advertising spending and an IT upgrade cycle.

All businesses simply loosen the purse strings to some degree when they are more confident.

The theory is, and it is correct, you spend money on your clients when you think you can generate a return on that spending. It's the classic "return on lunch employed", or ROLE as we like to call it in this industry.

Similarly, you spend money on promoting your business when you think you can generate a return on that spending via finding new leads/clients.

And businesses have delayed IT upgrades in recent years that would improve productivity and profitability. But again, you only spend on IT upgrades when you think you can generate a return on that investment.

In summary when you are confident you get in front of your clients more, spend more on promoting your business and spend more on IT/telecommunications to facilitate better and more efficient client interaction. You might even buy a new suit and add a few new staff.

I think a genuine business confidence cycle, which in fact is just a normal business confidence cycle in Australia, is long-overdue. It's even more overdue because we had to experience the longest federal election campaign in history this year and the uncertainty that brings to the business sector.

But now we have certainty. I think we are all going to be surprised how quickly business confidence readings pick up and evidence of increased business spending becomes apparent. That will lead to GDP growth and earnings upgrades.

What to buy

In terms of stocks with direct leverage to the themes above, outside of the banks I would be focused on:

- Qantas (QAN) and Crown Resorts (CWN) for leverage to increases in business travel/entertainment spending;
- STW Communications (SGN) for leverage to increases in business advertising/marketing spending;
- Telstra (TLS) and Technology One (TNE) for leverage to mobile business data spending and IT upgrades;
- JB Hi Fi (JBH) for SME/smaller business hardware and software upgrades;
- Boral (BLD) for leverage to non-residential building/infrastructure upgrades;
- QUBE (QUB) for leverage to goods movement and Moorebank Intermodal project approval; and
- Caltex (CTX) for leverage to broader transport sector energy demand.

But at the end of the day EVERYTHING cyclical benefits in some way from a pickup in business confidence. The multiplier of cash moving through the economy is large.

What to sell

On that basis if you are looking for something to sell the answer is 10-year Australian government bonds.

In my view Australian GDP growth will recover to 3.5% and inflation will be 2.5%. In old school economic theory that equates to a 6.00% long bond yield. Just about the ONLY place to lose your investment capital over the years ahead in Australia in the economic and activity cycle I believe in for the next few years is in long-term government bonds. Sell long bonds and buy Australian banks, there's a switch that will continue to reap total return rewards.

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My SMSF – Peter Hogan

by Super Report Subscriber

Name of fund: Manyana Superannuation Fund
Trustees: Peter and Linda Hogan

How long have you had the fund?

Have had the fund around 12 years.

Why did you start it up?

We felt we had enough to commit to an SMSF that we could control – leaving substantial amounts in managed super accounts where investment decisions were not being made by us but by the fund managers. The amount in our SMSF is primarily for direct equity exposure and cash where we make the decisions.

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

Day-to-day management is OK as keeping it fairly simple – no direct property exposure and so on.

We also use an external administrator to prepare accounts, returns annually – this requires a good deal of work to present the information about the activities of the fund for the year in a way that is needed – transactions undertaken through the year are stored electronically as they are undertaken.

Do you enjoy managing it?

Managing the fund is just part of the process of having a fund – the enjoyable part is making investment decisions with a long-term view in mind and hopefully seeing steady results – we are not active traders in the SMSF.

What is your asset allocation?

The decision we have made as trustees is to be invested as much as possible – predominantly in direct Australian equities with a smaller percentage of international equities through managed funds. Exposure to property is also through property trusts, rather than direct property, but also a smaller percentage of the SMSF. Cash holdings are built up to ensure we can meet expenses as they fall due, but also to provide a cash reserve for opportunities that may come up from time to time – but usually kept to a minimum.

What are your favourite stocks and why?

The focus of our stock selection is moving slowly towards yield stocks with dividends that are also fully franked the closer I get to retirement. While not concerned with the equity exposure, we want to maximise the cashflow generated by that investment where appropriate. We are mindful that there is a need to carry a little more cash in pension phase to meet those additional income stream payment obligations whenever that happens.

What investments do you have outside of superannuation?

Investments outside superannuation are predominantly for shorter-term financial goals – cash for anything within 12 months.

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

Linda is a financial planner and so discussions around what should be done with the fund are regular, especially if there is a build up of cash.

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Game theory – Ainsworth set for big things

by Roger Montgomery

While I cannot understand why people play poker machines, the likes of Jamie Packer, Steve Wynn, and founder of Ainsworth Game Technology Limited (AGI) Len Ainsworth, know it is better to own the casino or make the machines and don't begrudge others who enjoy "gaming" as their entertainment.

Len Ainsworth founded Ainsworth in 1995, at the age of 72. The gaming machine industry veteran had previously founded Aristocrat Leisure Limited (ASX:ALL). Both companies design, develop, manufacture and service gaming machines.

AGI has recorded an extraordinary recent three years to June 2013. Revenue has risen from $69 million to $198 million, while pre-tax earnings have jumped from a $2 million loss to a $69 million profit. AGI's share price has accordingly risen from under $0.20 per share to the current $4.07. With 322 million shares on issue, AGI now has a market capitalisation of $1.3 billion.

Top marks

AGI's FY13 results were impressive. Revenue of $198.1 million was up 32% while the pre-tax profit of $69.3m was up 50% on FY12. Net profit after tax was down 19% to $52.2 million, but that is because in FY12 the company didn't pay any tax and this year its tax rate was 25%. On that basis you are better off looking at the pre-tax numbers for signs of change. Return on average equity of $183 million was 28.5%, and the company finished the year with net cash of $39 million.

Source: Bloomberg

Domestic revenue grew 21% to $124 million, but the real excitement was the international revenue, which grew to $74 million – a 55% increase on the preceding year. Assuming these trends continue, AGI will soon be announcing larger international than domestic revenue. When presenting the FY13 results, management noted: "Further revenue growth is expected within all international markets." Growth in South America was 77% but total revenue was just $19 million – less than 10% of AGI's total revenue – although AGI has only relatively recently started selling its products there.

In the US, the biggest market in the world, total revenue was $49 million or 25% of AGI's total revenue. The company now has 602 gaming operating units installed at casinos across the US, after the installed base grew by 186 units from 416 at 31 December 2012. And keep in mind that the personnel at AGI has plenty of experience managing much bigger operations in the US.

Australia's revenue growth of 21% was the lowest annual growth since 2008, however it seems there

are still large market share gains available. AGI is understood to have around 15% of the clubs and hotels market, while the two largest operators, Aristocrat Leisure (ALL) and IGT, have a combined 65% market share. There is optimism surrounding the approval and installation of the A560, the Premium Mega Top, the Wide Boy Quad Shot and the Multi Pay Big Time 11.

AGI sold a total of 2,021 total units in FY13, up 57% compared with 1,288 in FY12. The second half saw 1,196 units sold, compared with 825 in the first half and 1,052 in the previous corresponding period. In other words, AGI is ramping up. A key indicator of future orders, 'units on trial', looks healthy with 354 units on trial as at the end of June 2013, representing a significant increase on the 229 trial units on trial at December 2012 and 142 on trial at 30 June 2012.

Pricing power

Importantly, not only is the company selling more units, each unit is generating stronger returns. For other businesses, this is tantamount to selling more products at a higher price. After releasing its new range of games into the gaming operations market, Ainsworth saw a 39% increase in its average revenue per day during the year. Over the course of the year, the company achieved a yield of about US$39 per day, compared with $10 less per day in FY12. In some venues in the US this is as high as US$60 per day.

Management went on to note that profit after tax in the first half of FY14 is expected to be at least 15% ahead of the $22 million reported for the half year ended 31 December 2012. Consensus net profit forecasts for the year to June 2014 are for $61 million and growth of 17% (or 19 cents per share), with some analysts predicting figures as high as $65 million (24% year-on-year growth) or 20 cents per share. So the prospective PE at $4.40 is around 22 to 23 times.

In short, AGI is growing strongly and has enormous potential. However, the remaining part of the investment puzzle is value. The company's shares are not a bargain at the moment, and while we own plenty in The Montgomery Funds, we'd want to buy more if the price fell back somewhat. That might seem unlikely, but in the stock market it is amazing how often the odds can fall in your favour.

The Montgomery Fund and The Montgomery [Private] Fund own shares in Ainsworth Game Technology Limited.

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Buy, Sell, Hold – what the brokers say

by Penny Pryor

It's been a very thin week so far when it comes to broker activity. Perhaps analysts were too busy celebrating an expected return to confidence following the election, or perhaps companies were just laying low and providing no new information that brokers could do anything with.

In the good books

JP Morgan upgraded Transurban Group (TCL) to Overweight from Underweight. The broker expects the company to benefit from the new government's commitment to infrastructure and the range and extent of concessions Transurban may achieve as part of the F3 [now M1] link to the M2 project in Sydney. A recent share price fall also makes the stock more attractive to JP Morgan.

JP Morgan also upgraded Westfield Retail Trust (WRT) to Overweight from Neutral on the back of the 33.4% sale in Karrinyup, at a 19% premium to NTA by WRT and Westfield Group. Following recent underperformance, this transaction, along with the buyback expansion, provides support.

In the not-so-good books

Citi downgraded Beadell Resources (BDR) to Sell from Buy after the company announced expected average line-of-mine production of 150,000 ozs over eight years in its interim results. Citi says it struggles to identify attractive value using the three-year average gold price forecasts of US$1,220/oz.

Credit Suisse downgraded ALS Limited (ALQ) to Underperform from Neutral, based on its belief that around 50% of the group is facing headwinds as exploration activity amongst miners declines. Credit Suisse does not think ASL's current 18.6 times multiple sufficiently captures this risk.

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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ATO makes things simpler … for a change

by Tony Negline

As you no doubt know, or should know, all income and capital gains – except from non-arm's length investments – from assets used to support a pension are tax-free inside your super fund.

On SMSF tax returns until the 2013 financial year, this income exemption was actually claimed as a tax deduction. Yes that's right. Your pension income was included as income subject to tax (called 'assessable income') and then taken out as a tax deduction when working out how much tax had to be paid.

Why this bizarre system was adopted has passed out of collective memory, but it has created quite a lot of confusion even for experienced tax accountants.

About a third of SMSFs pay pensions and almost 83% of tax deductions claimed by SMSFs in the 2011 financial year involved income and capital gains from assets supporting pensions. This equated to over $10.2 billion in exempt pension income. (Interestingly in the same year, APRA regulated funds – the large retail and industry funds – had $11.8 billion of exempt pension income or 43% of total deductions claimed by these types of funds).

As you might expect, something that is generating such large concessions will attract a lot of interest within the Tax Office. In its 2012/13 compliance program document, the ATO said that exempt pension income was seen as a risk.

Thankfully, the ATO has changed the 2013 SMSF return. The first item involving money on this return asks for the pension income and realised capital gains to be entered. In other words, you no longer claim the pension income as a deduction on the return.

Pension and accumulation money in the same super fund

There are still a few tricks that you need to know in relation to pension income and capital gains:

1. Are your assets segregated or unsegregated? This is an important point. Segregated assets means that specific assets have been set aside in your super fund's accounts to pay pensions. Most small super funds won't find this approach useful, especially as it often costs more to administer these funds. In some cases it can be quite handy. You should seek advice before deciding to use this approach;
2. An actuarial certificate must be obtained before lodging the annual return if you use the unsegregated approach. If you don't get an actuarial certificate, the pension income may be subject to tax, however if your fund only pays one or more pensions – and has no pre-retiree money in the fund – then there is no need for the actuarial certificate;
3. SMSF assets must be revalued to their current market value before a pension commences; and
4. If the minimum pension standard hasn't been met in a year of income, the pension won't meet the definition of a super income stream and the pension income won't be exempt from tax (which may mean that a fund with two pensions, where one meets the pension minimum payments rules and other doesn't, may need to get an actuarial certificate).

Don't do this

The Institute of Chartered Accountants told their members about several common mistakes SMSFs make in relation to their pension income including the following:

- Capital losses earned by pension assets that are segregated can't be used to offset capital

gains on other super fund assets (effectively this means the benefits of the losses are lost);
- Super contributions which are taxed at 15% in the super fund can't be part of pension income (even when they've been used to pay a pension in the same year);
- Non-arm's length income – for example, investments in related companies or trusts that you control – is taxed at 46.5%;
- If your fund has an income tax loss, then that loss is reduced by your exempt pension income; and
- Expenses used to generate pension income can't be claimed as a tax deduction. This means expenses will need to be apportioned.

If your fund pays you a pension, then my suggestion is that you make doubly sure you get the numbers right on your SMSF annual return.

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SMSF strategic advice

by Questions of the week

Question: *I am 45 and have an SMSF of about $350,000. I usually transfer $50,000 every year. My investments are via a buy and hold strategy with $20,000 every year going to big bank shares and $15,000 each in vanguard shares index and $15,000 in term deposits.*

Do you thing it is a good strategy looking long term?

Answer (by Paul Rickard): While it's a pretty simple strategy, it is a good starting point. At 45, you need to think about your super being in place and lasting another 45 to 50 years – so this implies exposure to long-term growth assets. Also, to build your super so that you can enjoy a comfortable retirement, it requires regular and ongoing contributions – which you are doing.

Of the $50,000 going in each year, 70% is going into growth assets (Australian equities), and 30% into income based assets (30%). Presumably, you are re-investing the dividend income – so your SMSF has a reasonably strong growth bias.

The selection of major bank shares and the Vanguard Shares Index is giving you are a bias towards almost 'annuity' style shares in the major banks, paying fully franked dividends, plus some exposure to the overall market through the Vanguard Index fund. The latter is pretty cost effective.

What are the main risks in what you are doing?

1. You are not covering all the major asset classes. You don't have any real exposure to international shares, and you are underrepresented in property.
2. You are "overweight" bank shares. While the major bank shares (excepting the NAB) have done fabulously well over the last two decades, I am not convinced that this is going to be the case over the next two decades. Post the GFC, we are in an era of "re-regulation" which means that banks will need to hold more capital for prudential and regulatory reasons. Longer term, bank ROEs are likely to fall.
3. You potentially have a reduced exposure to other sectors/stocks that may grow over the next decades – for example, healthcare.

I like the simplicity of your strategy, your regular contributions and "buy and hold approach". I would give it a 6 or 7 out of 10.

Could it be a little more sophisticated?

Probably. Here are some suggestions:

1. Start to get some exposure to international shares. Perhaps through an ETF;
2. With your direct shares – either start to diversify into some other sectors/stocks (reduce the ongoing contribution into the major banks), or increase your ongoing contribution to the "market" through Vanguard or other equivalent fund/ETF;
3. On the fixed interest /term deposit side – in addition to term deposits, also consider some other securities/investments to boost the running yield; and
4. At some stage, look at property as an asset. An allocation here (or not) will also be impacted by what other assets you hold outside superannuation.

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Chart of the week - ASX200

Our resident chartist [Lance Lai](#) appeared on my TV show on Monday, when the S&P/ASX 200 was 5,181.

The last time he was talking to me in July, the ASX/S&P 200 was 5048. Since then it has moved up 2.6%.

The local market is a follower of other markets, rather than a leader at the moment, but it is still showing an upside bias with further momentum.

"That 200-day moving average - it was threatened back a few months ago before July and now it has reasserted itself and if the global markets continue to stabilise like they have been, I think we're looking good to go take out those highs," Lai said.

The chart king says there should be opportunity to buy in the short/medium term.