Switzer Super Report

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Countdown to taper

Minutes of the Fed's October meeting released overnight reveal that the central bank could start tapering its quantitative easing program very soon, as early as one of its next few meetings in fact.

If you're a regular reader of this report, you'll know that while I think tapering may have a small negative impact initially, the long-term story will be good. After all, when the Fed does start to taper, it will be because they're confident the US economy is able to take it.

In the *Switzer Super Report* today, everyone's favourite analyst, Charlie Aitken, explains how one of his favourite high-conviction stocks - QBE - will benefit from the QE tapering.

Sincerely,

Peter Switzer

Inside this Issue

Why you need international shares
by Barrie Dunstan
07

02 **QBE a buy on QE tapering**
by Charlie Aitken

04 **Buy, Sell, Hold – what the brokers say**
by Penny Pryor

05 **Graincorp – the odds are in your favour**
by Geoff Wilson

07 **Why you need international shares**
by Barrie Dunstan

08 **Try this global blue chip – Chicago Mercantile Exchange Group**
by Fundie's Favourite

09 **How much is enough?**
by Tony Negline

12 **Where to go for low-volatility yield**
by Questions of the Week

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QBE a buy on QE tapering

by Charlie Aitken

One of my favourite large-cap high conviction buy ideas is QBE Insurance Group (QBE). In my view, QBE is a classic top-down meets bottom-up story that is currently priced for the past, not the future.

Top down

Obviously, at the top-down global macro level, I believe in rising US long bond yields due to QE tapering and accelerating GDP growth. I also believe in a rising US dollar. QBE's correlation to both those macro themes is extremely high, as evidenced lately by price action around QE tapering timing speculation. The fact QBE confirmed that correlation to long US bond yields, while causing some short-term QBE share price pain, actually reinforces my bullishness.

US 10yr bond yields (blue) vs. QBE (green) last 12 months

But more interestingly…

US 10yr bond yields (blue) vs. QBE (green) last five years

And finally…

US Dollar Index (DXY) vs. QBE (green) last five years.

There is no stock in the ASX20 that has been more punished top down by the actions of the Fed than QBE. On that basis, as the Fed slowly winds down QE over the year ahead, there should be no ASX20 stock that benefits more than QBE.

Bottom-up

That is what attracts me to QBE top down, but I am also finding a high conviction bottom-up story that currently seems underappreciated by investors.

US dollar (USD) earnings bottomed for QBE in CY12 (Calendar Year 2012). The consensus view is that USD EPS (Earnings Per Share) rises from here, a view our analysis agrees with. The target is for plus 50% USD EPS growth in CY14/15 combined, and obviously that's before it's translated back to Australian dollars (AUD), in what should be a falling AUD/USD overlay.

QBE is a cheap growth stock with a rising dividend yield, albeit the dividend yield is only 30% franked.

Focus on CY14 and CY15 estimates, where P/E's drop to low double-digits and price to book just over 1x. That's cheap for double-digit EPS and DPS growth.

Margins and ROE are also rising strongly.

QBE is currently as unpopular and lowly rated as both SUN and IAG were two years ago.

QBE remains a core member of my high conviction buy list and is the number 1 ASX20 play on QE tapering.

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Buy, Sell, Hold – what the brokers say

by Penny Pryor

There wasn't much going on in analyst world this week, in the wake of AGM season. In the lead up to Christmas, brokers are going quiet and looking to earnings forecasts for direction.

In the good books

UBS and Citi both upgraded Mermaid Marine to Buy from Neutral, following a trading update. Mermaid Marine now expects FY14 profit to be in line with FY13 – at around $60.3 million. This is below UBS' estimates and reflects timing issues. Incorporating the revised guidance results in a 7.4% reduction to FY14 estimates. As earnings are underpinned by construction and production in the Australian offshore oil and gas sector, the recent share price weakness is considered to be a buying opportunity.

Citi noted that Mermaid Marine expects a weak first half. Falling vessel utilisation and lower activity at the supply base has meant Citi has cut FY14 profit estimates by 11% and a major second half bounce is needed to hit forecasts. However, on a medium-term view, positive earnings momentum is returning.

In the not-so-good books

Macquarie downgraded Qantas (QAN) to Neutral from Outperform, following the company's AGM last week. Macquarie says yield declines are worse than forecast and the weak domestic economy is taking a toll on the company, albeit weakness appears more widespread across the group. Intentions by Virgin (VAH) to add more capacity is just one reason there appears to be little respite ahead. The broker is not surprised QAN is moving its heavy maintenance offshore. Cost improvements, efficiency gains and the deal with Emirates are just not enough. Macquarie has slashed forecast earnings.

Credit Suisse downgraded Prime Media (PMT) to Neutral from Outperform.

Prime Media has guided to FY14 profits of $31-33 million, 10% below consensus estimates. The advertising market has slowed, despite a strong start to FY14. The company also indicated the new affiliation agreement with Seven came at a higher cost but provides greater certainty over the longer term. Credit Suisse sees upside to the earnings from a cyclical recovery, and TV as a medium is likely to benefit disproportionately more than other sectors. The broker suggests a buy-back could also be on the cards, given the company's strong cash flow.

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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Graincorp – the odds are in your favour

by Geoff Wilson

There have been few takeovers over the years that the Foreign Investment Review Board (FIRB) has prohibited. The two high profile ones that come to mind are: Shell's bid for Australian energy giant, Woodside Petroleum; and the Singaporean based bid for the ASX. Woodside was seen as being of significant national interest due to its substantial energy assets. The ASX of course, is a critical utility in Australia's finance infrastructure and was seen as too valuable to fall into foreign hands, despite the industry de-regulating and the support of the ASX Board for the bid.

Government split

Today, we find ourselves in the midst of another bitter dispute over the current controversial takeover bid for Graincorp Limited (ASX: GNC), which has split the recent, election-winning Coalition down the middle. The country-based Liberals and the National Party have been forced to go public with their concerns after (it appears) being unsuccessful in their behind-the-scenes lobbying of the Treasurer to disallow the bid. This conflict has spilt into the mainstream media in spectacular fashion, with the Deputy Prime Minister Warren Truss (and others) speaking out against the acquisition of Graincorp by US-based, global agribusiness, Archer Daniels Midland. In response, the Treasurer, Joe Hockey, has made forceful comments that he will not be bullied. Graincorp controls the majority of grain handling and exporting facilities on the Australian east coast, which are seen as critical and strategic by many in the grain farming industry.

The farmers and the Nationals are adamant that it is not in Australia's best interest for the bid to proceed, while the Liberals want to be seen as being 'open for business'.

The farmers appear united in their opposition to a foreign company taking control of such an intrinsic part of their farming industry and question how a global player will prioritise the interests of Australian farmers, as Graincorp is perceived to do now.

Graincorp Limited (GNC)

Source: Yahoo

Unfortunately, the Australian agricultural industry does not have any major listed companies, whereas the mining industry has what was called the 'Big Australian', BHP. Also, it is disappointing from an Australian investor's perspective that slowly all the listed agricultural plays, such as the Australian Wheat Board and the Australian Barley Board, have been taken over mostly by international players.

I believe it will be no different this time with Graincorp.

An attractive buy

As investors, our role is to allocate capital where we believe the odds favour us making money for our investors, and buying Graincorp appears attractive on that basis. Even though it is a risky play.

Our analysis of the facts led us to believe the Treasurer will approve the deal, with conditions designed to protect the farmers.

It is interesting that the internal political tensions have flowed into the public domain, suggesting that opponents have taken this course out of frustration. For investors, this could have created a very

attractive buying opportunity.

The stock is currently trading at about $11.15. The bid is made up of $12.20 cash, plus a 75c franked dividend, with an additional 3.5c franked dividend for each full month of delay after 31 September 2013. The Treasurer has said he will announce his decision on the FIRB's recommendations by the 17 December 2013. In the event that it is approved, we expect to get paid by February 2014, giving us a cash return of 190.5c per share (17%) or 59% annualised. This return does not include the value of the franking credits. The risk is the takeover bid gets blocked, which would result in Graincorp's share price falling about 25% to its pre-bid price. We believe the odds are in favour of the bid succeeding and therefore see the risk/reward ratio as attractive.

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Why you need international shares

by Barrie Dunstan

SMSF trustees need to tread a careful path between avoiding the trap of constantly switching shares to follow current fads and of remaining stuck in a portfolio, set perhaps years ago. This particularly is a problem when share valuations are at an extreme and when there might be some significant changes in the market.

Managing potential risks

We don't know when the markets will change – though we can keep an eye out for warning signs – but investors can look at their portfolios' upside and downsides on a "what if?" basis. Banks and institutions do this regularly; it's called risk management.

While Switzer readers have varying share portfolios and allocations, the ATO's figures tell us that, on average, SMSFs have below average or virtually no overseas shares compared with the large institutional funds.

But the recent strong performance of the most likely share holdings – the banks, Telstra and BHP – in many portfolios is likely to have increased many share exposures. And, because these six stocks represent about 40% of the index, many funds could have a quite concentrated exposure to the share market. While such portfolios also have produced better returns than cash or short-term fixed investments, there is a greater risk of capital loss, if the share market gets the hiccups.

Realistically, there is a good chance that conditions will change sometime in 2014, when the US Federal Reserve is expected to ease its Quantitative Easing (QE) policy of injecting cash and holding interest rates low. In theory, markets should have built in some allowance for this, but whether markets are prepared or not, the US Fed's action is likely to still affect interest rates, stock prices and the exchange rate.

In addition, the flush liquidity from QE has encouraged investors, with worrying signs emerging of over exuberance at the speculative end of the markets, as evidenced by the rush for Twitter shares. And it's not just in the US; the India share market has been bubbling away and there has been a rush of hot new IPOs from China. All this suggests caution if the Wall Street stock market runs into major adjustments – whether from a rise in interest rates or just a change of investors' mood.

Time for a change

Potentially, however, the biggest impact may come from the foreign exchange markets, if any Fed boost to bond yields lifts the $US in relation to the $A. This would improve local investors' returns from holding US shares. While the gains would depend on the extent of the adjustment, it would reverse the recent pattern, where a stronger $A eroded gains from overseas shares. So the timing might be right for a tactical shift of some equity money from Australia to the US (or even Europe).

This might not entirely solve the problems of some over-priced shares (like local banks) but it would produce some geographical diversification into share portfolios and increase the quality of shares held.

Low-cost Exchange Traded Funds now enable a move into overseas markets via a listed index fund. ETFs are liquid, so investors can act quickly if conditions change. For those seeking exposure to top US stocks, iShares S&P 500 ETF (IVV) is one active fund. For a broader exposure, a SPDR fund based on the S&P world index, ex-Australia, (WXOZ) gives exposure to 25 overseas stock markets and I gave my broker an order last week to buy some WXOZ.

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Try this global blue chip – Chicago Mercantile Exchange Group

by Fundie's Favourite

How long have you held Chicago Mercantile Exchange (CME) Group?

We invested in Chicago Mercantile Exchange Group in April 2012 when the stock was trading on 13 times forward PE, in line with cash equity exchanges (historically Chicago Mercantile Exchange Group has traded close to 30 times forward earnings and at a significant premium to cash equity exchanges). The market had become overly bearish on the stock and was viewing a cyclical downturn in volumes (post GFC) as a structural issue. Thus, we took advantage of the relative mispricing.

What do you like about it?

Chicago Mercantile Exchange Group is the largest interest rates, equity, commodity, energy and currency futures exchange in the US. Exchanges are attractive, scale businesses, which have low capex needs and provide a high ROE. We favour futures exchanges over other exchanges, as they do not face the competition risk equities exchanges face, and their trading exclusivity results in minimal market share risk and pricing power. Chicago Mercantile Exchange Group has a near monopoly position and faces no viable competition in the medium to long term, which, combined with an intrinsically high return business model, makes it an attractive long-term investment.

How is it better than its competitors?

Chicago Mercantile Exchange Group has a near monopoly position and has shown the ability to exercise pricing power. Chicago Mercantile Exchange Group's monopoly position has been derived from its vertically integrated business, providing both a trading platform and clearing house. The clearing house locks in the customer base, as contracts are not fungible. Thus, competitive threats for Chicago Mercantile Exchange Group are minimal and it has maintained 90% plus market share, even while exercising pricing power and repeated attempts by large competitor exchanges, such as NYSE Liffe to take market share.

Chicago Mercantile Exchange Group (CME)

Source: Yahoo

Equities can be traded on any exchange, irrespective of where they were originally listed, but futures contracts can only trade on the exchange that is associated with the clearing house, so traders are essentially locked in. The cost associated with closing and opening positions is significantly higher than any benefit gained from lower transaction fees.

What do you like about its management?

In our view, we believe management to be very good operators and not interested in acquisitions for the sake of growth. They are tight on costs, know how to retain clients and prefer dividends to buybacks.

What is your target price?

At normalised volumes, it would equate to = $4+ Earnings per Share = 23x-25x = $US92-$100

At what point would you sell it?

The largest potential risk to Chicago Mercantile Exchange Group's business model is if US

regulators seek to break up its business and make its clearing house accessible to other exchanges in order to increase competition. This risk is minimal, as regulators in both the US and Europe have conducted a number of studies and concluded that it is legally unmanageable to allow open access to Chicago Mercantile Exchange Group's clearing house. However, if this were to eventuate, we would look at reducing/selling our position.

If the stock reached our price target, we would also look to sell our position.

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

The average price we have paid for the stock is $48.19, the stock is currently $81.14. Until June 2013, the stock has added 1.4% to the overall fund performance, with the fund currently holding a 1.9% position.

Where do you see the value?

Our analysis indicates that as US interest rates and yield curve returns to normal levels (i.e. higher than current), trading activity on the Chicago Mercantile Exchange Group will increase significantly. As the Federal Reserve and other central banks indicate that they are looking to reduce QE measures, there will be greater volatility in financial markets and hedgers and speculators will increase their activity in this changing environment. This increased activity will underpin revenue growth and, subsequently, result in a 10% plus normalised EPS growth for Chicago Mercantile Exchange Group over the medium term. At current consensus, an FY14 multiple of 20 times still does not reflect the full potential for long-term volumes rebound. We believe as Chicago Mercantile Exchange Group's volumes and earnings begin to show 10% plus growth, the returns for the business will increase and be reflected in Chicago Mercantile Exchange Group's share price.

Uday Cheruvu joined PM CAPITAL in 2008 and holds a Bachelor of Engineering and a Bachelor of Commerce, both with Honours, from the University of Melbourne, as well as a Master of Applied Finance from Macquarie University. Uday has a background in both private equity and investment banking, in equity and credit analysis.

Uday has experience in financial modeling and creating financial (credit based) models for hybrid instruments in the Australian market. At PM CAPITAL Uday analyses the global financials sector as well as credit related opportunities for the Enhanced Yield Fund.

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How much is enough?

by Tony Negline

The Association of Super Funds of Australia's (ASFA) Retirement Index is an important indicator of what most people might need in retirement.

Love of a lifestyle

ASFA produces data that calculates what single and couple retirees would need in retirement income, if they wanted a "simple" or "comfortable" retirement.

For example, for the September 2013 quarter, ASFA reckons retirees looking for a comfortable retirement would need at least $41,830 in income each year, if single, and at least $57,195 for a couple. These numbers assume you own your own home.

These numbers tally up pretty well with what many retirees I have met over the years say they need. That is, couples seem to be satisfied with an income of about $1,100 per week and single people with an income of about 70% of this amount.

Mind you, throughout my working life, I've met many different retirees. For example, I once met a couple, who were very happy with spending $16,000 a year. At the other extreme I have met retirees, who were convinced they needed income of at least $300,000 a year.

How to get there

The super industry group then take the next step and estimate how much money you would need in super to generate these numbers.

For a single person, they think you would need at least $430,000 and a couple would need $510,000 to generate this level of income.

I have a definite view on how retirees need to structure their financial affairs. The key is simplicity and the name of the game has to be earning income from investments. Not just any income, but income that increases at least as fast as the inflation rate, even when it's low (you can read my article on inflation from last week here).

This means capital growth in assets and market movements in asset prices are very much less important than the income these assets generate.

Before retirement you live off income either from your employment or from your business investments. Now that you're retired, you need your assets to generate income so you can continue to live.

A retiree couple both aged 65 with $510,000 in super will still receive some Centrelink aged pension.

With this level of assets, it should be possible to earn 6% income each year (including franking credits, if you've decided that Australian shares are best to pay you inflation-linked income). This means that $30,600 in income should be possible from your $510,000.

It's possible for income from an investment to fall, so this needs to be factored into your planning. For example, during the GFC, the capital value of ASX listed shares fell by about 54% but the income paid by these companies fell by only 20%. A similar result didn't occur in the previous big crash of 1987 because of tax changes introduced by the Hawke Government (the income paid by ASX companies during this period actually increased).

So for safety's sake, it might be a good idea to assume that your assets can only generate $25,000 – that is, 20% less than what you can currently earn.

An alternative approach

The super laws demand that 65 year olds take a

minimum pension of 5% of the market value of the assets. In this case, that would be $25,500. So this is the income you should assume your super fund can pay you.

Assuming a couple has $100,000 of other assets that are counted for Centrelink asset test purposes, our pensioner couple would receive a part aged pension.

At present, they would receive about $16,500, excluding any additions to this amount, such as the pensioner supplement and clean energy supplement.

So, in my view, with about $500,000 in super and $100,000 of other assets, you could only safely earn about $42,000 each year in income.

That is, $15,195 short of the ASFA 'comfortable' income level.

So what assets do you need to generate ASFA's retirement standard?

I estimate that a couple would need just under $1.2 million in super assets to safely generate about $58,000 retirement income. A single person would need $871,500 to generate $41,800 in retirement.

At these asset levels, neither the single nor couple would be eligible for any aged pension. This is an unfortunate by-product of the calculation.

Why such a difference in our numbers? ASFA's objective is that you run out of money after a period of time. With my approach, the objective is to generate income linked to inflation. I'm interested in reducing your main risks – running out of money and losing your lifestyle because of inflation.

In a future article, I'll discuss how much money assets can generate when combined with Centrelink's aged pension.

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Where to go for low-volatility yield

by Questions of the Week

Question 1: *I like watching and learning about your investment strategies and also get a lot out of the webinars you run. Do you have a view on the income ETFs, as an alternative to holding stocks independently as per your income portfolio? I see iShares has a high-dividend ETF and there are others.*

Answer (By Paul Rickard): The income ETFs are an alternative way to do it – although not the same. You can be pretty certain that you will get an 'index' return.

Vanguard's 'Australian Share High Yield' ETF (ASX Code VHY) tracks the FTSE ASFA High Dividend Yield Index. Although it is a market capitalisation weighted index, it uses forecast dividend yields to work out the underlying index constituents. Over the 12 months to 31 October, it has returned a pretty impressive 32.65% (after fees).

iShares S&P/ASX High Dividend ETF (ASX Code IHD) tracks an index called the S&P/ASX Dividend Opportunities Index. This index comprises 50 stocks out of the ASX 300, selected according to yield, profitability, dividend stability and some other factors. The ETF has returned a less impressive 28.70% over the same 12-month period.

Interestingly, the largest stocks in the S&P/ASX Dividend Opportunities Index are Mineral Resources and Adelaide Brighton. Financial stocks only comprise 21.15% of the index.

Russell has the Russell High Dividend Australian Shares ETF (ASX Code RDV). It tracks the Russell Australian High Dividend Index, which comprises up to 50 larger cap companies, selected from those that are expected to make higher dividend payments. CBA is the fund's largest holding – and 44.7% of the fund is in financials. Over the 12 months to 31 October, the fund has returned 31.12%.

As I said at the beginning, you will get an 'index return' – so it is worth understanding what the index is. I am not sure I am a huge fan of the iShares ETF (or more precisely, the S&P/ASX Dividend Opportunities Index), so if you are contemplating an ETF option, I would be inclined to look at Vanguard's VHY followed by Russell's RDV.

Question 2: *My SMSF is in pension mode. I am looking at buying around $20,000 in a Vanguard fund. Can you see much difference between the High Yield Australian Shares Fund and the Index Australian Shares Fund (other than one is more conservative than the other?*

Answer (by Paul Rickard): Assuming that you are talking about the Vanguard ETFs (the Vanguard Australian Shares Index ETF – ASX Code VAS; and the Vanguard Australian Shares High Yield ETF – ASX Code VHY), they differ as follows:

- The former tracks a pure market capitalisation based index (S&P/ASX 300), while the latter follows a derived index (also market capitalisation, but based on forecast dividend yields) – the FTSE ASFA High Dividend Yield index;
- Management fees – VAS is 0.15% pa, VHY is 0.25% pa;
- Performance in the recent short term has been very different – in the 12 months to 31 October, the pure market cap ETF (VAS) returned 24.65% after fees – the high yield ETF returned 32.65%. These returns include both growth and income.

The last 12 to 18 months in the market has been fairly unique, where all the action has been in the higher yield stocks, such as the banks and Telstra. So, it is

not surprising that the high yield ETF has done a lot better than the pure market cap ETF. Over the long term, however, you would probably expect the pure market cap ETF to produce a higher return (with more variability/volatility) than the high yield ETF.

In pension phase, if income is important or you require less volatility in the capital value, it could sway the argument marginally in favour of the high yield ETF. In accumulation or in pension phase, where these aspects aren't that important, I would elect for the pure market cap ETF (VAS).

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