Switzer Super Report

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It's time

The massive drop off in the US overnight, which lead to similar falls here, means that it won't be too long before the tapering starts. We all know it will eventually happen, which is why I'm sometimes surprised by the market reaction, but the sooner we get it out of the way, the sooner we can move ahead into 2014.

Speaking of which, today we have part 1 in a two part series from Charlie Aitken for the year ahead. Charlie doesn't like annual forecast notes, he explains why below, but he's done one especially for us and in part 2 next week he will focus on stock calls.

Also in the *Switzer Super Report* today, we have Lance Lai back with his charting forecasts, Ron Bewley talks about his mining picks - BHP, Rio and Fortescue - and how well they have done over the past six months and in *Buy, Sell, Hold - what the brokers say,* the analysts can't seem to make up their minds on Energy Resources Australia and QBE.

Sincerely,

Peter Switzer

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Picks for 2014 part 1 – rotate into cylicals

by Charlie Aitken

I have to admit I don't like doing annual forecast notes, not because I am scared of making forecasts, but because I see investing as like a game of football where there is no full-time siren. The change of calendar year shouldn't be a reason to change investment strategy: only a change in macroeconomic or stock specific fundamentals should trigger a change in investment strategy.

Let's start at the very top. The most certain aspect of 2014 is I will make mistakes in forecasts and stock-picking. In my job the game is to get more right than wrong and hope that the calls you get wrong aren't devastating to portfolios.

Time for a cleanout

If I can start with one piece of timeless advice – Cut your losers and let your winners run. All of us have a limited amount of investment capital. In my philosophy that investment capital should be working as hard as possible for me all of the time. I will tolerate some underperformance if I see clear and present value and a pathway to value release, but the lesson of the 20 plus years I have done this, is to swallow your pride and be a ruthless cutter of losing ideas.

Cutting losers is a good thing on multiple fronts. Firstly, it frees up capital to hopefully generate positive performance. Secondly, it frees up mind space to concentrate on making money. Thirdly, you may even generate a tax loss to offset some capital gains.

We all spend way too much time focused on the dud ideas. They take up a disproportionate amount of your investment process thinking and I can assure you that any time I have cut a loser it has been a positive experience in terms of moving forward and focusing my time on constructive ideas.

So that's my first piece of advice for 2014. Look through your portfolios and if there is a stock or two burning a performance hole in your portfolio and demanding a disproportionate amount of time in your investment thinking – cut it. There probably are a couple I recommended in that list too – cut them and rotate the capital to stocks that you feel comfortable with and have delivered day in, day out total returns for the last few years.

If nothing else, this time of year is good for cleaning up portfolios. The last thing you want coming back from the summer holiday is investment baggage. Start with a fresh sheet and a fresh mind. Trust me, I will be doing this myself in the next few days in my own portfolios and when I do press the sell button on a couple of losers I may even add an expletive or two to send them off.

Once we've all done that we can focus on where to be positioned for the year ahead.

The year ahead

In terms of overall equity strategy, the only real change I would predict for 2014 is global and local equity market leadership switching from defensives to cyclicals.

The world is getting better in terms of economic growth. Yield curves have steepened to reflect the prospect of stronger economic growth from the USA, China, UK, Japan and Eurozone, alongside the clear prospect of the Federal Reserve winding down its QE bond buying program.

QE tapering and eventual QE exit are not events equity market investors should be scared of, as long as they are accompanied by unequivocally strong US economic data. The US economy is close to escape velocity and I forecast a QE-less world in the second

half of 2014.

That means we need to continue to be cautious in asset classes that have been purely supported by QE. You have already seen long bonds, gold and the Australian Dollar correct sharply on the prospect of the Federal Reserve tapering QE purchases, but I think it's prudent to position for a QE-less world.

That would mean further price falls from long bonds, gold and the Australian Dollar in 2014, but I also believe the bid will start to lesson in "bond-like" equities. What I would consider "bond-like" equities are unfranked REITS and infrastructure holding companies, whose equity prices have traded inverse to long bond yields.

I do not consider Australian Banks or Telstra to be "bond-like" equities because firstly they offer the massive advantage of franking credits, and second, their physical dividends are rising in line with their growing earnings. I remain bullish on Australian Banks and Telstra for 2014, feeling the total returns will be solid, albeit less than we experienced in 2013.

Rotate into cyclicals

Once we have lowered exposure to pure, unfranked "bond-like" equities we need to increase exposure to both global and domestic cyclicals. The simple point is if the Fed reduces QE, it's because the economic growth data is strong. That should be good for cyclical companies.

I work in a cyclical price taking business: stock broking. I understand cyclicality and how it works. Most cyclical businesses, both global and local, are coming out of a five-year downturn. That is the longest downturn of the last 40 years.

What happens in extended downturns is business managers take out every fixed and variable cost they can just to scrape through. Industries reduce productive capacity. But as you come out the other side, and demand for your product picks up, you experience both product price and volume gains, while running recessionary costs.

That translates to free cash flow picking up sharply, which translates to dividends. That is why I believe global and domestic cyclicals will deliver earnings, free cash flow and dividend surprise in 2014.

The local cyclicals I like are wealth managers (which also have structural support from the compulsory superannuation system), property developers, building materials, steel, transport, infrastructure construction, and selected discretionary retailers.

The global cyclicals I like for 2014 are the big miners. The big miners underperformed in 2013 but in 2014 I can see top-down and company specific developments that drive total shareholder return outperformance. BHP and FMG remain my two key picks, as Chinese growth accelerates, and both companies deliver stronger volumes of production into firm Australian dollar commodity prices.

BHP vs FMG

Source: Bloomberg

But the real reason I like big miners for 2014 and beyond is the clear change in strategy to manage the business for free cash generation. We are all going to be pleasantly surprised by the fully-franked dividends the big end of mining pays us in 2014, and that is going to be the driver of a re-rating of the stocks that reward investors the most generously.

6,000 forecast relies on BHP

In all reality, my forecast of the ASX200 hitting 6,000 in the second half of 2014 can't be right unless BHP starts leading the index. Without a BHP re-rating it's pretty much mathematically impossible for that index forecast to be correct, because BHP represents almost 10% of the index itself.

That's probably the biggest change in my thinking about what lies ahead. To get to 6,000, BHP is going to have to do some genuinely heavy index lifting, with

assistance from the banks and Telstra. It's the old "barbell strategy" as we used to call it.

Buy US

Outside of that I continue to encourage you to gain more exposure to US dollar earners, which can be done by big miners etc, or physically deploy more capital to offshore markets.

I have been bearish on the AUD/USD cross all of 2013 and I remain bearish for 2014. If I am right and the AUD/USD cross heads to 80 US cents in 2014 then we all need more exposure to US dollar earnings or direct US dollar assets.

What I have been telling my clients all year is to get some capital into US equities, but use a proven fund manager or hedge fund manager to oversee the investment. None of us are US experts and I am prepared to pay fees for experts to do that for me.

That strategy has worked well in 2013 with the US S&P500 up 43% in Australian Dollars. I expect that strategy to work well again in 2014, albeit with less spectacular gains.

What I write above is part 1 of a piece on what lies ahead for 2014. I will dive down to some more specific stock calls next week.

I hope 2013 has treated your portfolios well. It hasn't ended quite as strongly as I would have hoped, but the good news is that makes it easier to make money in 2014 in Australian equities.

Now that you have read this, go and print off your portfolios and decide what to cut. We all have one or two that need to go.

Thanks for putting up with me.

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Big miners BHP, Fortescue pay off for investors

by Ron Bewley

In March of this year I doubled my exposure to BHP in my margin loan but I had no room to move in my super fund. As it turned out, I could have got a better price by waiting a little longer. However, I have still made about 10% on those purchases in nine months plus a dividend payment.

In my June review of the Mining Sector I continued to be optimistic about where this sector was going:

"Although there is little doubt that the mining boom is not what it was, it seems many investors are treating China as though its infrastructure spend is over. I think this part of the market has been very oversold."

The sector since that June review has outperformed the broader index at 9.6% to 8.6%. But from Table 1, we can see that the three heavyweights – BHP, Rio Tinto and Fortescue Mining (BHP, RIO, FMG) – outperformed the Materials index. I did enjoy the 25.1% and 11.1% gains on RIO and BHP.

I owned (and own) Atlas Iron, Mount Gibson Iron, and Lynas (AGO, MGX and LYC). Two out of three ain't bad! I was sorely tempted to add to my AGO and MGX exposure around June, but I concluded that would blow my risk position out – so I held tight.

The outlook

With 22 of the 28 stocks in Table 1 being in the red, will their fortunes change? I am still bullish on China, but few of the mining stocks have consensus recommendations better than 2.5. Only one stock, Sundance, has a better rating than either BHP or RIO so I am not tempted to go fishing down the list.

Mount Gibson has been downgraded from 2.6 to 3.0 over the last six months – possibly on the basis of its stellar run. While I think there is a bit more growth to go, I believe it is too late to join that party without taking too much risk on board. Atlas Iron is more interesting. While it too has been downgraded (from 2.2 to 2.9) it just announced a promising new find. It will be worth watching the progress of broker recommendations on this one.

Table 1: Data on companies in the ASX 200?s Mining sector

Index	Code	Company name	Capital gains from 7/6/2013 - 9/12/2013	Consensus recs. 7/06/2013	Consensus recs. 9/12/2013
ASX 100	FMG	Fortescue Metals	70.2%	2.25	2.50
	RIO	Rio Tinto	25.1%	1.87	2.00
	BHP	BHP Billiton	11.1%	2.24	2.00
	ILU	Iluka resources	-15.7%	2.76	2.60
	OZL	Oz Minerals	-24.5%	2.38	2.70
	RRL	Regis Resources	-27.9%	2.40	2.80
	PNA	Panaust	-33.4%	2.47	2.10
	NCM	Newcrest Mining	-41.7%	2.25	3.10
Small Caps	MGX	Mount Gibson Iron	117.7%	2.60	3.00
	AGO	Atlas Iron	56.4%	2.20	2.90
	SDL	Sundance Resources	23.5%	3.00	1.50
	BDR	Beadell Resources	-0.7%	1.50	2.00
	SFR	Sandfire Resources	-5.3%	2.08	2.70
	AQG	Alacer Gold	-9.2%	2.75	2.80
	IGO	Independence Group	-9.3%	2.54	2.50
	OGC	Oceangold	-18.3%	2.11	2.00
	NST	Northern Star	-20.8%	1.50	2.10
	WSA	Western Areas	-26.4%	2.21	2.40
	MML	Medusa Mining	-30.3%	1.75	2.20
	SIR	Sirius Resources	-32.8%	1.67	2.00
	EVN	Evolution Mining	-39.0%	2.40	3.00
	LYC	Lynas	-43.7%	2.14	2.70
	CDU	Cudeco	-44.5%		
	RSG	Resolute Mining	-44.7%	3.11	2.20
	KCN	Kingsgate Consolidated	-49.3%	3.50	3.70
	SLR	Silver Lake Resources	-53.8%	2.50	3.40
	SBM	St Barbara	-59.5%	1.91	2.70
	PRU	Perseus Mining	-76.7%	1.94	2.70

Note: the estimates in the Table are current to the close of business December 9, 2013. They are based on Thomson Reuters Datastream.

Turning to the sector analysis in Table 2, a lot has changed over the last couple of weeks or so. No sector is currently overpriced, but that situation might not last long. The Materials sector is just in the lower half of expected unadjusted capital gains, but 15.3% (including mispricing adjustments) over the next 12 months would be nice if we can get it. Interestingly, banks did get a little oversold – after we called a correction in October – and so yield and gains are again attractive.

Table 2: ASX 200 sector statistics

	Sector	Index weights	Exuber-ance	12 month forecasts		
				yield	cap gain	adj gain
Resource-related	Energy	5.6%	-7.4%	3.8%	21.9%	31.0%
	Materials	17.8%	-3.1%	3.3%	11.8%	15.3%
	Industrials	5.8%	-5.8%	4.2%	16.1%	22.9%
High yield	Financials	39.9%	-2.4%	5.6%	6.3%	8.9%
	Property	6.0%	-5.6%	6.0%	3.8%	9.6%
	Telco	5.4%	0.0%	5.8%	3.7%	3.6%
	Utilities	1.6%	-5.9%	6.0%	10.5%	17.1%
Other	Discretionary	3.9%	-3.6%	3.6%	13.6%	17.6%
	Staples	8.5%	-4.3%	4.8%	8.5%	13.2%
	Health	4.7%	-1.8%	2.4%	11.9%	13.9%
	IT	0.7%	-1.2%	3.1%	13.3%	14.6%
	ASX 200	100.0%	-3.7%	4.7%	9.3%	13.3%

Source: Thomson Reuters and Woodhall Investment Research
Note: Exuberance is a measure of mispricing (negative is underpriced) and cap(ital) gain is adjusted for exuberance
Cons. Rec. is the consenus recommendation from Thomson Reuters . 1 is a buy, 3 a hold and 5 a sell

Note: the estimates in the Figure are current to the close of business December 9, 2013.

Sector specifics

The biggest change to my analysis over recent weeks is the building strength in the Industrials sector. My capital gains forecast has climbed about 4% over the last week – from 12% to 16% before the underpricing is factored in.

So with Christmas just around the corner, it turns out that my January 1, 2013 forecast for an end-of-year target of 5,150 shouldn't be too far off – especially since the collective reported (AFR) wisdom of a dozen forecasters was for a gain of only 29 points in 12 months! So the 13.3% figure for the next two months for the ASX 200 in Table 2, with dividends of 4.7%, suggests 2014 might be pretty good as well. And we are also forecasting low volatility.

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Buy, Sell, Hold – what the brokers say

by Penny Pryor

Broker actions so far this week were driven by corporate announcements. But analysts weren't in consensus, with Energy Resources of Australia and even QBE both receiving upgrades and downgrades based on their recent problems.

In the good books

Deutsche Bank upgraded Billabong (BBG) to Hold from Sell. The company has updated on the year to date, although it resisted giving FY14 guidance. The chairman has suggested the company's performance is steady or slightly improving in most markets, except for the Americas. Deutsche Bank notes the comparatives are less demanding in the second half but there will be a number of one-off expenses.

JP Morgan upgraded Energy Resources of Australia (ERA) to Neutral from Underweight. The broker says the leach tank failure is not a big deal valuation-wise. This failure could put underground mine plans at risk as it aggravates traditional landowners concerns about the dangers of uranium mining. Most of the broker's valuation of ERA comes from assuming Ranger Deeps goes ahead. See below for downgrade.

Credit Suisse upgraded Newcrest Mining (NCM) to Outperform from Neutral. The broker has assessed operating and capex scenarios in FY15 for Newcrest and assumes savings of $120-150 million plus another $100 million odd from production stripping. Newcrest intends to pursue other cost saving measures, but these are yet to be identified. Further liquidity should not be required if gold stays over US$1150/oz and at present the broker's forecast exceeds this level.

Following QBE's profit warning JP Morgan cut forecast earnings by 19% and dropped its target to $11.94 from $14.50. But with the share price having fallen 30% in two days, the broker believes the stock is now showing value and upgraded to Neutral from Underweight. QBE's new 10% margin guidance for 2014 is feasible, and JP Morgan notes the stock is now trading at an attractive PE compared to peers, and still offers upside as a play on lower interest rates and a weaker A$. The main risk is that a new CFO could make further reviews, leading to further write-downs. See below for downgrade.

In the not-so-good books

UBS downgraded Energy Resources of Australia to Neutral from Buy after the company confirmed there's been no impact on 2013 production with the failure of the leach tank at Ranger. The impact on 2014 production is being assessed. The broker's Buy case is based on the underground mine going ahead but traditional owner support is needed. The rating is downgraded to Neutral from Buy to reflect the need to restore credibility to support Ranger 3 going ahead.

Macquarie downgraded QBE to Underperform from Outperform. The company's North American portfolio problems saw QBE downgrade its margin guidance and Macquarie downgrade its earnings forecasts by 26-28% in 2013-15. The chance of "material" valuation from current forecasts is high, the broker warns, due to poor visibility. Despite macro conditions seemingly going QBE's way, and despite the early share price response, the broker downgraded to Underperform from Outperform.

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Why I'm considering an SMSF

by Penny Pryor

Name: Penny Pryor
Age: 43
Other members of the SMSF: None

How long have you had your SMSF?

I don't have one yet but I'm seriously considering establishing one in the next 12 months now my balance is approaching the level that many say is cost effective.

Why would you start it up?

Having written about them for so long, I hope I have an understanding of how the industry works and a working knowledge of investment markets and factors such as diversification. I also think the practical knowledge that having my own SMSF would give me would be invaluable in further understanding this sector.

How big is it?

I would set one up at $200,000.

Do you think it will be difficult to manage?

I believe it will be time consuming but quite possibly not as onerous as I anticipate.

Do you think you will enjoy managing it?

I think I would enjoy managing it, and that's part of the reason I would do it. If anything, it would force an even more constant diligence of investment markets (obviously something I do at the moment).

What about performance?

If I could keep costs down, I believe I could probably do slightly better than where it is now, in a well-performing industry fund.

What is your asset allocation?

I would have a reasonably conservative asset allocation, with the majority in 20 stocks that were allocated across the sectors in line with their respective asset allocations in the ASX 200. I still have a while to retirement, so I would also have an additional four or five small cap stocks. And I do think it's important to have international exposure – however I would probably do this through one of the international ETFs listed on the ASX, as it is still pretty expensive to buy international shares and I'm not sure I've got the time to manage currency risk.

I've got an investment property so I would consider an unlisted property trust if I could find one that had a small enough minimum investment (probably unlikely), so I might invest in a listed real estate trust for property exposure.

What are your favourite investments/stocks and why?

I like companies that are exposed to demographic trends such as ageing like Ingenia and first movers like companies making 3D printers. I was fascinated to read about Stratasys earlier this year.

NEXTDC is also a company that is making inroads into new technology.

What are your least favourite investment stocks and why?

It's not completely rational but there are a lot of the big bluechips I don't like, like Qantas and Telstra. As Paul Rickard said on Monday, just because something is a national icon doesn't make it a good investment, although I would be silly to exclude

Telstra due to its superior yield. As a company I also believe the telco has made massive improvements over the past five years.

What investments do you have outside of superannuation?

An investment property.

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

I would use an administration platform and possibly a low-touch financial advice service if it didn't eat too much into the costs of running the fund.

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What deeming changes will mean for your pension

by Tony Negline

In a previous article I mentioned that from January 2015 Centrelink will deem super pensions.

This will replace the existing generous treatment, which sees pensions receive a concession based on the actual income paid, less an amount deemed to be part of the original capital you used to start the pension.

For most people this approach means they have very little income counted for Centrelink's income test unless you elect to take a reasonably higher income than the minimum.

This existing treatment will continue to apply to any pensions that commence before 2015.

Deeming

On the other hand, deeming assumes your investments earn a specific rate of return.

Currently if you're single, the first $46,600 of income is deemed to earn 2% each year. For pensioner couples the first $77,400 is deemed to earn 2% per annum. Any assets above these limits are deemed to earn 3.5% per annum.

The Government adjusts these deemed rates of return based on prevailing market conditions. The assumed rates of return were most recently updated in early November. The thresholds are indexed each 1 July.

Typically the deeming approach will see more income counted towards Centrelink's income test. So what impact does this have on pensioners?

The impact

Well overall the income test is less severe than the assets test.

Based on my modelling, a single person who owns their own home and owns $100,000 of non-income earning assets, such as personal effects, motor vehicle etc, and no other assets except a super pension, will be impacted by this measure when the pension has an account balance of between $140,000 and $190,000. (In my modelling I've ignored all fees and charges as well as the pension supplement and clean energy supplement).

For homeowning couples who are in a similar position – and both eligible for the aged pension, they are impacted when their super pension has an account balance between $240,000 and $290,000.

In my modelling I have assumed the prospective Centrelink recipients took 5% of their account balance as income.

So fortunately only a very few people will be impacted by this measure. If deeming rates increased then this will have a much bigger impact of retirees.

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Property options and what to do with Telstra

by Questions of the Week

Question: *I'm looking for some advice on a listed property trust and wondering if you could shortlist a couple for me. Listed versus unlisted – which do you prefer and why?*

Answer (By Paul Rickard): I am not a huge fan of listed property trusts at the moment – think in the main they got quite expensive and many are now trading at premium to Net Tangible Assets. James Dunn has written extensively in Monday's *Switzer Super Report* about the unlisted and listed markets. In the listed market, he likes some of the niche operators, including:

Cromwell Property Group (CNW)
Bunnings Warehouse Property Trust (BWP)
Generation Healthcare (GHC)
APDC Group (AJD)

Question 2: *I have 20,000 Telstra in my SMSF for which I paid $3.18. I need dividends. Do I sell part, sell all or keep all? As I watch the price coming down I question what I should do?*

Answer 2 (By Paul Rickard): I am not sure what you mean by the "price coming down". Sure, it has come down from its high of $5.23 – however at around $5.00, it is still up 25% on its price at the start of the year.

Telstra will pay a 28c fully-franked dividend next year (could be as high as 29c or 30c). Assuming this is only 28c, this is a yield of 5.6%, which grosses up to 8.0% if you are in pension – or 6.8% if you are in accumulation.

If you need the income, keep all.

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Chart of the week

Two months ago chartist Lance Lai predicted that the market would rally up and then come down to the resistance level and the 200-day moving average, and guess what - it's done exactly that! And according to Lance, now is one of the rare occasions where Australia is leading the world.

For the weeks and months ahead though, there is still negative momentum driving the local market, as was evidenced by the big falls today. Watch and wait for buying opportunities over the next few weeks.

Whether or not our market falls to the third S on the chart at 4863 will depend on how the US travels.