Switzer Super Report

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Everything's gonna be bright lights and lollipops

You know what? I'm starting to think that everything IS coming up roses. What with Fed chairman Janet Yellen's testimony the other night that put the wind back into the US market, emerging markets stabilising and, here at home, we've got those brilliant banks that keep announcing record profits.

I spoke to Charlie Aitken this week about it all, and in our Q&A below (eat your heart out Tony Jones) he explains that the pessimists were wrong and why this earnings season we should see a lot of results that will support current market valuations.

Also in the *Switzer Super Report* today, Ron Bewley looks at the sectors he likes and Geoff Wilson reviews Warren Buffett's favourite book. Tony Negline walks us through asset segregation within your SMSF, in *Buy, Sell, Hold - what the brokers say*, ANZ and Cochlear get upgrades and in *Questions of the Week* we answer subscribers queries about ETFs and listed fixed-income investments.

Sincerely,

Peter Switzer

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Charlie Aitken on earnings season and the right kind of surprises

by Peter Switzer

This week I spoke with Charlie Aitken to discuss some of the earnings results and what is going on with the market.

Charlie, like me, is not a doomsayer and is feeling pretty confident about the outlook, particularly given the banks' strong lead. Commonwealth Bank's record half-year profit announcement of $4.27 billion was up 14% on the same time last year, and should calm any concerns about the banks.

Charlie, last week you called the volatility a "text book" trading correction. So what's been going on?

Thankfully it has played out that it was just a basic trading correction. I think I said last week the bank results would see the market do better and that's pretty much what's happened. The reporting season has got better as it has gone on, highlighted by the CBA record profit yesterday – CBA lifted the interim dividend 12% to 183c fully franked. And the day before that, there was the record ANZ result.

There have been other good results from companies like Boral. Its underlying profit for the half-year rose 73% to $90.4 million.

Early on there were plenty of analysts saying that earnings wouldn't support current valuations. So is this going to be a better reporting season than most pundits expected?

The earnings season always starts with the worst results. It's getting into the more high quality companies now. I think the reporting season is going to be a way of making money in this market.

What are some of the companies you like?

Well BHP – I'm hoping there is some sort of capital management surprise there. I like resource stocks that have potential to be shareholder friendly, like BHP and Rio. Costs have come down for the miners and their margins are now good. Remember BHP is sitting on a bucket load of franking credits.

I think the facts show they have passed the test and now the bigger companies are leading the market.

And what do you think about Telstra?

Yesterday I had my fingers and toes crossed that they would increase their interim dividend.

I thought they could be able to lift the interim dividend 1c to 15c and they lifted it half a cent to 14.5c. But the fact that Telstra has lifted the interim dividend is a big moment. It's Telstra's first dividend lift since 2005 – another positive sentiment event for a big cap stock.

The result is good – net profit after tax up 9.7%. I still think Telstra is headed to $6.00.

So the pundits got it wrong?

I think that negative view is proving broadly wrong – I think the results are more than justifying the valuations.

Companies like Boral rallied 9% after they announced and even Dominos, another company that people said was too expensive, that went up 13%.

So why do you think there were so many pessimists around reporting season?

I think people have still got post GFC-itis. They think everything will mean revert. When the world economy and the Australia economy are growing, earnings go up and markets, of course with some trading setbacks, go up too.

So it's all good news from here on in?

Don't get me wrong, of course there have been some that have lowered their guidance, like Bradken and Treasury Wine Estates. But I think we're going to see more and more instances of results justifying values. I think the market was too bearish coming into this season, particularly for the big cap stocks.

So what's your general market view for the year ahead?

Well, we got through Janet Yellen's recent testimony in the US and the debt ceiling in the US now seems to be a non-event. Emerging markets seem to have stabilised, to me it looks like we're in for a slightly brighter period. I still think the market can get to 6000, but it won't be without short-term trading volatility. As I have written and said numerous times, we can't get there without BHP being re-rated. Hopefully that process starts with capital management surprise at the interim result.

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Warren Buffett's favourite book

by Geoff Wilson

I enjoy reading books on investing and human behaviour. I recently read "David and Goliath: Underdogs, Misfits and the Art of Battling Giants" by Malcolm Gladwell. In his book Gladwell is trying to explain the asymmetry of opposing forces, why the nimble win and why the large institutions can't break small, dedicated groups of people.

A good friend of mine was talking to me about one of his and Warren Buffett's favourite books, "The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success," by William N. Thorndike (and a team of researchers). He loved it (as did Warren Buffett) so I asked him for a brief summary for my readers.

Leadership qualities

The book is the product of a forensic analysis of the best eight performing CEOs in America (at least in the listed world) all of whom delivered exceptional performance to shareholders during their leadership. The shortest period was 19 years and the longest (Warren Buffett) is 46 years, and still counting, so their performance was not a function of luck, these CEOs really delivered.

The companies these CEOs managed, delivered an average annual return of 21.6% versus the S&P 500, which delivered 10.2%. That's double the return of the stock market; the long term compounding effects are an investor's dream. For every 10 years on a pre-tax basis, the additional performance is a factor of 2.7 times.

The CEOs, while running different businesses in different industries, had a number of things in common. Probably the most notable similarity, and the one thing that really sets them apart from most managers, was their disciplined approach to capital management and their unemotional detachment to assets. They weren't necessarily great managers in areas of product, marketing, process or people, although I expect they were at least competent. But these CEOs were outstanding capital allocators with the ability to buy when value was compelling and sell when prices were high, with little emotional or corporate bias.

Most of these managers operated independently of the day-to-day operations of their businesses, instead choosing to give high levels of authority and responsibility to managers close to the coal face, while focussing on the deployment of the organisation's capital as effectively as possible. A ruthless focus on deployment of capital to where it would provide the most attractive, absolute (risk-adjusted) return was consistent amongst the group of exceptional CEOs.

Outside the square

As a group, they exhibited great patience and resistance to market fads and fashions. Very often, they were stringently opposed to the contemporary trend, by selling when others were buying and buying (including their own stock) when others were selling. At times, they showed supreme patience by sitting on capital for prolonged periods of time, waiting for appropriate opportunities, or giving it back to shareholders. As we know, Warren Buffett (CEO of Berkshire Hathaway) sits on tens of billions of dollars of cash, while waiting for opportunities and Henry Singleton (CEO of Teledyne) ultimately bought back approximately 90% of Teledyne stock, when the price traded at cheap levels. This approach is particularly effective in America, as Wall Street tends to under-rate companies executing buybacks, considering it a negative and reflective of an organisation with no growth options. Wall Street therefore tends to sell a stock that is undergoing a buyback. This seems counter-intuitive to us. If

management believe the stock is cheap enough to buy back, then it is most probably good buying. I prefer not to sell stock into a buyback. The insiders, after all, know more about the company than anybody.

In this day and age, our investment industry appears to be moving more and more towards quantitative analysis, but if the examples in this book tell us anything, it’s that really good management makes a big difference to investment returns over time. Therefore, it’s worth analysing the quality of management and its capital management qualifications as closely as the valuation process.

The Australian equivalent to “The Outsiders” is my good friends Matthew Kidman and Alex Feher’s book “Master CEOs”. A great read.

Australian masters

At Wilson Asset Management, we place significant importance on the quality of management, particularly when we are looking for undervalued small to mid cap growth companies. The ones we favour currently are Andrew Grech from Slater and Gordon (SGH), Greg Shaw from Ardent Leisure Group (AAD), Adrian Di Marco from Technology One (TNE) and Shaun Di Gregorio from iProperty Group (IPP).

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High-yield sectors look attractive again

by Ron Bewley

With so many exciting things going on in the market, I have decided to wrap up this third round of my sectoral review today and then move on to some more topical and fascinating subjects likely to evolve in future weeks and months. Reporting season is underway and world growth seems to be building!

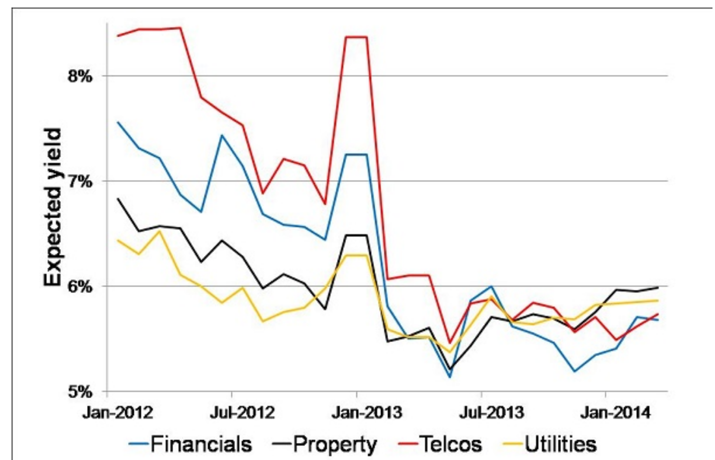
There are eight sectors left to review: four are the so-called high-yield sectors (financials, property, telcos and utilities) and four are 'the others' (consumer discretionary, consumer staples, health and IT). I had the high-yield sectors largely 'on hold' in my super fund – but 'on a sell watch' in my margin loan account outside super – since about April 2013 because of dividend compression. I actually executed my sells of all of my banks in my margin loan account near the end of October 2013.

The yield chase

What I had noted from earlier versions of Chart 1 is that widely disparate expected yields came together at between 5% and 6% from April 2013. I surmised that there was a floor for yields of about 5% to reward investors for equity risk over holding cash. So a potential floor for yield meant no capital gains were likely to be forthcoming – and my exuberance measure was above the 'magic 6%' threshold that I use to pick such moments – a clean out of those sectors became appropriate.

These yields have largely kept closer together than they historically have for nearly a year. As the Fed's tapering of the US stimulus program took hold over the last few months, yields in these sectors rose to nearly 6% and the capital gains forecasts in Graph 1 are starting to make these sectors attractive again.

Graph 1: Expected dividends for the ASX 200



Source: Woodhall Investment Research & Thomson Reuters Datastream.

The poor jobs data in the US on 7 February 2014 seems to have had an impact on investors' demand for yield. More recent sharp price rises in the banks and others are rapidly eroding expected yields in these sectors. It is not too late to buy in for a super fund but not, in my opinion, for a margin loan portfolio.

Some healthy signs

Turning to the 'other' sectors in Table 1, their expected gains are starting to look healthy using my exuberance measure, but largely because they had been oversold. Recent data on consumers borrowing behaviour and confidence levels are seemingly guiding investors into the discretionary and staples spaces.

Although broker forecasts for the health sector are still very strong, many stocks – include CSL and Ramsey – have run so hard over the last year or so, I find it hard to be too positive about most stocks in this sector, especially as the expected yield is typically so low.

Table 1: ASX 200 sector statistics

	Sector	Exuberance	12 month forecasts	
			yield	cap gain
Resource-related	Energy	-4.8%	3.7%	26%
	Materials	-1.1%	3.3%	8%
	Industrials	-3.8%	4.3%	25%
High yield	Financials	-1.8%	5.7%	8%
	Property	-3.6%	6.0%	8%
	Telco	-0.9%	5.7%	4%
	Utilities	-2.0%	5.9%	12%
Other	Discretionary	-2.3%	3.6%	16%
	Staples	-2.7%	4.7%	11%
	Health	-0.7%	2.4%	13%
	IT	-2.7%	3.1%	14%
	ASX 200	**-2.7%**	**4.7%**	**11%**

Source: Woodhall Investment Research & Thomson Reuters Datastream.

So, with reporting season starting in earnest this week, sharp investors will be looking for signs in outlook statements of more promising futures. At this point in time, energy and industrials stocks look the best for capital gains, while the high-yield four can produce steady incomes for those who need or want it.

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My SMSF – hard work pays off

by Louise Biti

Name: Louise Biti
Other members of the SMSF: None
How long have you had your SMSF? Two years

Why did you start it up?

Like most SMSF investors, I wanted more control over my savings and retirement plans, with visibility on which investments were performing well and which were not. The ability to minimise fees due to my knowledge and skills was also a major consideration.

From an investment point of view, I wanted to transfer some existing shares into super and am also considering investment into direct property. So an SMSF made sense.

I have left some superannuation in a retail fund as it was cheaper to leave my life and TPD insurance in place in that fund, than to take out new policies.

How big is it?

Earlier in my career I focussed more on paying off my home loan than building my superannuation, as this gave me the flexibility and security to make my own life choices. I am now well on track to building my superannuation savings to meet my retirement goals.

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

It is easy to underestimate how much work is actually involved and I probably fell into that trap.

It takes time and effort to manage the fund, as I am doing all of the work myself (except for audit). This is not a difficult exercise, but it does require commitment to set aside regular time to keep track of the fund, complete the administration tasks, research investments and monitor performance.

Do you enjoy managing it?

Mostly, yes. But sometimes when I am busy (and particularly around tax time) I question why I set one up. However, it has been a good decision and I am learning a lot about the day-to-day practicalities of running an SMSF.

Are you pleased with its performance?

Yes. The fund has achieved good and consistent growth, albeit with some ups and downs. I have been a little less aggressive over the last two years than I would normally be with super, given the long timeframe I am still facing, but I wanted to keep flexibility while I evaluated what structures and investments to use, both inside and outside super.

The fact that my total operating expenses for last year were around $700 has certainly boosted the effective returns.

What is your asset allocation?

The asset allocation as at 30 June was:

- Cash and fixed interest – 40%
- Listed shares – 31%
- Equity index funds and ETFs – 22%
- Listed property trusts – 7%

Over the last six months, I have started moving more of the fixed interest into equities. My main holdings in direct shares are in banking stocks.

What investments do you have outside of superannuation?

I am currently holding property outside superannuation and have been transferring share holdings into superannuation. Fixed interest is held

across both. I am not sure if you can call my artwork collection a good investment but it is definitely held outside superannuation, as I like to be able to hang them on the walls.

My income protection and trauma cover are both held outside superannuation.

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

No. I only use a registered auditor because legally I can't do this myself. It is also good to have an external auditor to act as a check on what I am doing. I use a discount broker to buy equities.

Is there anything else you would like to tell us about your SMSF?

There is nothing really remarkable about my SMSF. I try not to push the legislative boundaries too far and have not used reserve accounts.

I have a corporate trustee, which does add to the expense and administration but allows me, as a sole member, to have sole control of the fund. When I had my will redrafted last year I also included instructions for the transfer of shares in the trustee company. I also put in place a binding death benefit nomination. My Enduring Power of Attorney will allow the attorney to take over the role of Director, and therefore trustee responsibilities.

Louise Biti is an SMSF Specialist Advisor™ (SSA) and a co-founder of Strategy Steps and Aged Care Steps. Both companies support the financial planning industry with technical support and strategies that are client-focussed and practical. She is also a Director on the SPAA Board.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Analysts were busy digesting results this week, as earnings season kicked off. ANZ's good result on Monday only prompted one upgrade, as the other seven major brokers all chose to keep their ratings unchanged.

Although its results disappointed, Cochlear was also upgraded as some analysts had already factored in the poor numbers.

In the good books

UBS upgraded ANZ to Buy from Neutral. The quarterly trading update revealed cash profit of $1.73 billion. UBS notes operating trends were solid and the bank now expects bad debt charges to be down around 10% in FY14. Concerns over emerging markets have led to ANZ underperforming over the past year but given the fall in the share price, the broker considers it's time to upgrade to Buy from Neutral. The seven other brokers on the database kept their ratings on hold following the quarterly update, with three Outperforms, two Neutrals and two Underperforms.

BA-Merrill Lynch upgraded Cochlear (COH) to Neutral from Underperform and JP Morgan upgraded to Neutral from Underweight, following a lacklustre first-half result. For BA-Merrill Lynch, the announcement delivered on its Underperform rating so this is now upgraded to Neutral. The price target is reduced to $54.75 from $55.05. Merrills thinks, despite concerns regarding the outlook and the FY14 guidance downgrade, the run rate in the second half is improving and this means an uplift in FY15. The stock is not quite a Buy yet for the broker, because there are still unanswered questions regarding the industry growth rate. JP Morgan says it was another disappointing result from Cochlear, with guidance cut by 15.6%. As the broker had assumed, technological advances from peers has meant a loss of market share for Cochlear. The compromised N6 release, and the absence of any new product, suggests bottom of the cycle earnings. That said, the last quarter featured strong underlying growth, the broker notes, market share aside. The broker feels FY15 could thus be a year of general earnings growth, if not of regained market share, and, as such, has upgraded to Neutral.

Credit Suisse upgraded iiNet to Outperform from Neutral. Credit Suisse has had a close look at the stock and decided to upgrade profit forecasts by 6.5% and 9.2% for FY15 and FY16 respectively. The broker thinks the company has reached a major turning point in broadband subscriber growth and, moreover, can sustain a higher rate of growth. Revised NBN assumptions result in expected broadband market growth of 5-6% for the next five years and iiNet is expected to benefit.

In the not-so-good books

UBS double downgraded Aurora Oil and Gas Limited (AUT) to Sell from Buy, following the announcement of a bid by Canadian company, Baytex Energy, for Aurora at $4.10 a share, via a scheme of arrangement. The bid has been recommended by Aurora directors, and UBS thinks the premium is justified. Whilst a higher bid cannot be ruled out, UBS is doubtful one will emerge. Shareholders will get to vote on the transaction in late April/early May. The rating has been downgraded to Sell from Buy and the price target is set at the bid price, $4.10 against $3.70 previously.

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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Is asset segregation in your SMSF right for you?

by Tony Negline

Asset segregation is an administration process used in the running of super funds, which can provide benefits in some circumstances.

Asset segregation has several different layers to it. A key issue when working out if asset segregation is useful to you, is to decide how many layers you wish to use.

Before implementing asset segregation in your super fund, you need to decide if you're going to segregate assets at the fund level or at the member level:

(1) Do you want to segregate assets between non-pension (pre-retiree) and pension assets? This often has two primary aims. Firstly, you might want a different investment strategy between non-pension and pension member interests. Secondly, you might want to engage in some tax planning because your fund pays no tax on the gains made if the assets are supporting pensions.

An example of the first purpose might be helpful – the Fitzpatrick Super Fund has four members: Jim Fitzpatrick and his wife Lyn, as well as their two children, Maryann and Frank. Jim and Lyn currently receive transition to retirement pensions. The children are both under 30.

The trustees believe that they need two different investment strategies because of the wide difference in ages of the fund's members.

A practical problem with this decision is that the Federal Government's super legislation demands that fund trustees put in place an investment strategy for the fund. That is one investment strategy, not several.

The key to documenting these different strategies in one document is to note the different member ages and their different requirements. For example, "to provide the fund's younger members with sufficient retirement income, the trustees will focus on capital growth and reinvesting investment income; for our pensioner members, the trustees will focus on earning investment income, which will then be distributed to the members and pension income payments".

(2) Do you want to segregate assets between specific members? For example, one of your fund's members is particularly attracted to a specific asset that the fund owns. Within SMSFs, splitting assets might occur if a fund has two non-relative members or has a spousal couple going through a separation, and one of them would like to keep specific assets in their super fund after the spousal finances have been officially split.

What does asset segregation involve?

It involves the keeping of appropriate fund records – especially financial accounts – by noting specific assets belong to a certain type of member (eg all non-pension members) or to a particular member.

Effectively, your accountant will use different General Ledger accounts for your different asset segregation policies. There is no need for identification on property titles or the ASX Chess system or bank accounts or any other assets.

Once that General Ledger identification has taken place, then all income and gains from these assets has to be allocated accordingly.

This isn't a complex process, but depending on how many assets you own in your different strategies (especially the same assets) it can be a pain in the neck making sure income has been allocated to the right General Ledger account. (The job of your annual

external audit is to make sure this work has been completed correctly.)

Can be costly

Administering asset segregation in SMSFs is more expensive because there is more work to be done. In some cases, auditors will charge more to check the accounts of an SMSF with segregated accounts, because they need to confirm that all money has flowed to where it needs to be.

These higher costs partly explain why most SMSFs don't use it. But also many SMSFs don't use asset segregation because it doesn't have any practical benefit for their fund.

What does your trust deed say?

What rules in your trust deed govern how you can segregate your super fund assets? You must answer this question before embarking on this process.

If you plan to change your trust deed and you use asset segregation, then you should make sure that the new deed you purchase won't interfere with how you run and manage your asset segregation.

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ETFs and listed bonds, floating-rate notes and hybrids

by Questions of the Week

Question: *I have just established an SMSF and I'm looking to invest $900,000 over the next couple of months. I have reviewed your model portfolios and cannot find any recommendations/investments for either Australian or International ETFs. I have also reviewed your articles, which give great education value on ETFs.*

Why are either Australian or International ETFs not in the model portfolio? I would have thought that a model portfolio would have mix of shares and ETFs? And is the advice in the articles on ETFs current, or will they be updated soon?

Answer (By Paul Rickard): In regards to your first question about our portfolios, the purpose of the portfolios is to demonstrate an approach to the construction of a portfolio of Australian direct shares.

The key take-outs around a top-down approach, sector biases, number of stocks for diversification etc wouldn't be readily demonstrated if we included ETFs.

Further, Australian ETFs tend to be "market-based" rather than "sector-based". While I can acquire an ETF that gives exposure to the broader market (e.g. STW and the S&P/ASX 200), or Small Ordinaries (through ISO, for example), there are not yet ETFs that cover each of the 11 GICS sectors.

In terms of more up-to-date commentary on international ETFs, perhaps you might find this article useful. I wrote it about two weeks ago and it provides tips on how to invest in ETFs, and which ETFs to take a look at.

I also recently provided some more general feedback on ETFs in a subscriber Q&A posted last week, please find that article here.

Question 2: *Are there any listed bond, floating-rate notes or hybrids you see as good value at present? Or do you prefer 100% equities?*

Answer 2 (By Paul Rickard): Only in the most unusual circumstance would I ever recommend 100% equities. I think you need a balance across the asset classes (equities, bonds/fixed interest, cash, property and alternative assets).

That balance changes according to your risk profile, investment timeframe, need for income/capital/liquidity etc., and also as markets change and you use the opportunity to change your weightings.

In terms of hybrids and floating-rate notes, the market has got pretty pricey and spreads have narrowed. ANZ has announced a new jumbo issue (ANZ Capital Notes 2), which is expected to be priced at a margin of 3.25% to 3.40% over the 180-day bank bill rate. This offer is very much in line with secondary market spreads (pricing adjusts very rapidly), so this might be the best avenue to consider. The offer is due to open on 19 February.

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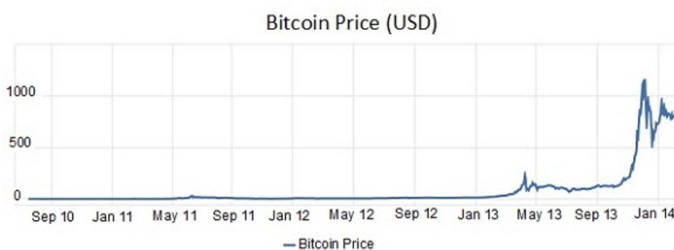
Do you know what a bitcoin is?

by Brittany Ruppert

Bitcoin is a digital currency that operates over the internet as an alternative to traditional money. The Bitcoin network allows users to transfer bitcoins directly from peer-to-peer, without going through a bank or financial institution. It is completely decentralised, meaning there is no central bank to float the currency. As such, its value is based entirely on the forces of supply and demand.

The strength of these forces have been made starkly apparent by the bitcoin's rapid rise in value over recent years and months. In September 2011, the bitcoin (BTC) was valued at $US7.61, by April 2013 it sat at $US135.19. Today it is worth $US605.48 – however this is down from figures of $US900-1000 seen earlier this year.



Source: Coinbase – 12 February, 2014

How does it work?

To understand the Bitcoin system, punters often draw a comparison between the digital currency and gold. It is gold's rarity that gives it value – if anyone could dig gold nuggets up out of their backyard, it wouldn't have a particularly high market value. Similarly, there is a finite supply of bitcoins – 21 million to be precise. There are already about 12 million in circulation, with around 25 bitcoins generated every 10 minutes. This rate will decrease over time, until the supply is estimated to be completely exhausted. Estimates of when that could happen vary from 40 to 100 years. It is important to note, that Bitcoin is not the only digital currency in circulation – it is just the most popular and valuable.

Like gold, these bitcoins are 'mined'. That is, uncovered by unlocking increasingly complicated algorithms online using sophisticated computers. The mining software can be downloaded for free on any computer, and once a bitcoin is 'mined', it can be traded on the market – which means you don't necessarily have to be a tech-genius to own bitcoins, you just have to accept the currency as payment for your goods and services. Because bitcoins are not a tangible currency, they can be divided into infinite smaller units – so you can still buy a cup of coffee for a tiny portion of a bitcoin.

Transactions take place when one user sends money to another user's Bitcoin Wallet address, which is usually a random sequence of 30-characters. This 'wallet' is not dissimilar from an internet banking account and is unlocked using a password. Again, this wallet can be downloaded for free online. Although there is no central regulator, all transactions are recorded on a public ledger called the Block Chain, which is shared by all Bitcoin users. These transactions can take place directly between users or via an exchange market, the largest of which is Mt. Gox.

There is speculation that the fast-growth of bitcoins – based entirely on market forces – is creating a bubble, which could lead to a total loss of valuation, if consumer sentiment shifts unfavourably. Whether or not this is the case is yet to be proven as the currency matures.

Our prediction

Society is becoming increasingly tech-savvy and technology increasingly accommodates for the digital currency. Plus, further swings in the traditional

market, such as those experienced during the global financial crisis, might be enough to make Bitcoin a viable alternative.

Former Federal Reserve Chair Ben Bernanke believes the currency has legs, writing in a letter tabled by the Senate Committee that virtual currencies, such as Bitcoin, "may hold long term promise, particularly if the innovations promote a faster, more secure and more efficient payment system."

The Australian Taxation Office has also acknowledged the growth of virtual currency, and is currently working on a draft tax determination on the following topic – *Income tax: Is Bitcoin a 'foreign currency' for the purposes of Division 775 of the Income Tax Assessment Act 1997?* – to clarify the ATO view.

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