Switzer Super Report

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Back in the USSR

The Ukraine drama has put pressure back on stocks today, and the market did not get off to a good start. But if you can ignore the day-to-day ups and downs for just a second, you should take heart from RBA Governor Glenn Stevens' comments in Hong Kong overnight, when he suggested that the handover from mining to private demand was beginning.

Charlie Aitken is another advocate of the private-demand led recovery and is big on the banks, based on the East Coast housing led recovery. Also, in the *Switzer Super Report* today, we have property guru Margaret Lomas telling us all about her SMSF.

Sincerely,

Peter Switzer

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My SMSF – property guru Margaret Lomas

by Margaret Lomas

Name: Margaret Lomas
Age: 53
Other members of the SMSF: Reuben Lomas

How long have you had your SMSF?

Around 15 years

Why did you start it up?

Initially we wanted better control over where our funds were invested, although at the time we probably weren't as good at managing it as we are these days.

How big is it?

Around $1.3m, some of it geared.

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

Initially it was more – designing an appropriate investment strategy and being prudent with the funds is a much more responsible job than most people think. If you take the spirit of the legislation seriously, as trustee of the fund you should be investing in a broad range of asset classes, which consider the fund members' individual investing strategy. In truth, these days most people seem to set them up just so that they can use super funds to get into the property market.

Now that I have more experience as an investor, it is much easier for me to make those decisions, which result in a diversified fund.

Do you enjoy managing it?

Sometimes I do – it can be exciting, considering what is the best for my short and long-term goals. My husband and I are at different phases of our career, and I will be able to access my super (if required) in two years' time (at 55) whereas my husband is only 44, and so he has a much longer investment time horizon. Therefore this has to be considered when making any decision about where to invest fund contributions.

Are you pleased with its performance?

I was mortified when the funds' managed fund investments performed so badly during and after the GFC, but now that there is a return to normality, I enjoy watching my future nest egg grow, as it is doing.

What is your asset allocation?

I have around 10% in cash, around 30% in managed funds across property securities and global equities and the rest divided between business real property and residential property (direct).

What are your favourite investments/stocks and why?

Property, because it's what I do

What investments do you have outside of superannuation?

I own more than 35 properties and a small amount of direct shares and managed funds.

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

No, I use myself although my accountant helps me with the technicalities.

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Australian banks still solid

by Charlie Aitken

I get plenty of questions about what I think about the big four Australian banks from here and my simple answer is I am still bullish.

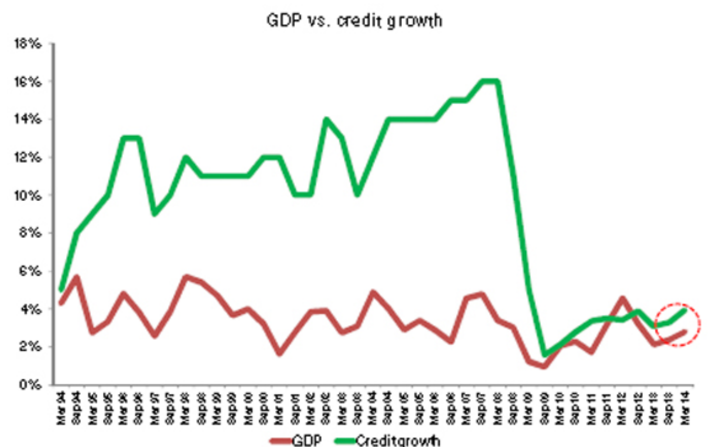
Total absolute returns from the sector will not be as spectacular as last year, but in real after-tax terms to an Australian taxpayer, they will destroy what is available in a 12-month bank term deposit, even if we only collected fully-franked dividends and didn't get any capital appreciation.

However, I think we will collect record fully-franked dividends and get capital appreciation. I am targeting a 15% total return (including franking credits) from the Australian banking sector this year.

Long live the yield trade

Where I differ from other commentators who say "*the yield trade is dead*" is that I believe, in Australia, we are witnessing a structural change in demand for relatively assured/growing fully-franked dividend streams, due to our ageing population, compulsory superannuation contributions rising to 12% by 2020, and the taxation advantages of franking, particularly in the latter stages of the superannuation cycle. I can see structurally increasing demand for tax effective yield streams, which are exacerbated in periods of ultra-low cash rates.

While cash rates in Australia have almost certainly bottomed, we are potentially many years away from cash rates being raised to levels that can make grossed-up bank dividend yields look relatively unattractive (let alone paying CGT on the sale of the stock). In fact, if you consider why the cash rate cycle has bottomed, it's because monetary policy is stimulating cyclical economic activity and asset price rises, which are good for banks, particularly mortgage banks in terms of bad and doubtful debts (BDD)/ average LVRs and credit growth.



Banks are GDP proxies. The East Coast recovery is good for bank earnings. They are, in effect, leveraged financial cyclicals. Their own activity in lowering term deposit rates and fixed mortgage rates (while maintaining NIM) is driving both investors out of cash and cyclical growth activity. Competition for deposits has clearly peaked, with all banks holding excess regulatory capital.

Last year I created "***the self-fulfilling virtuous circle of bank equity demand in an ultra-low interest rate environment***". The conclusion was that the ultimate winners of ultra-low interest rates in Australia are the oligopoly mortgage banks. I am going to attempt to illustrate my concept of a self-fulfilling virtuous circle that I believe Australian mortgage banks are in an ultra-low interest rate, rising domestic risk asset price environment.

Ultra-low cash rates ? refinancing ? credit growth? rising asset prices? low BDD? net interest margin? ROE? NPAT? dividend? super system? demand for dividends? demand for bank equity? bank share prices?..

The focus

The way I attempt to approach the Australian

mortgage banks top-down is simply a view on interest rates, employment, economic growth and residential property prices. I see them as basic proxies, leveraged proxies, for East Coast GDP growth. I then try to work out what the SMSF retail army will pay for the fully-franked dividend growth (income streams) the banks spit out. I pay absolutely zero attention to Australian bank pricing relative to global peers. In my view, that remains irrelevant and misleading, particularly given the registers of Australian banks are dominated by domestic investors with domestic specific drivers of the investment decision.

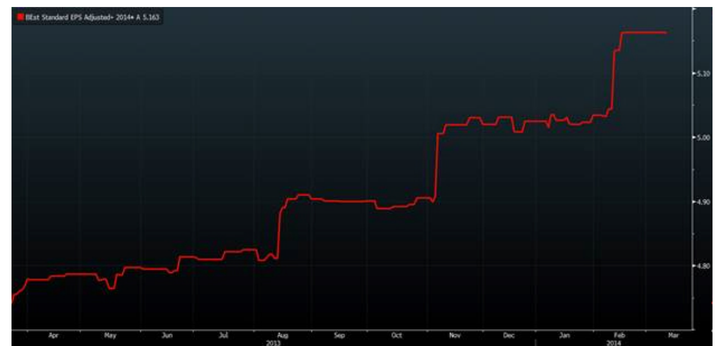
I will write at a bank specific level over the next few weeks as we approach the FY14 interim reporting season for ANZ, NAB and Westpac (WBC), but at the macro sector level it's blatantly obvious that the trends CBA (No.1 pick) reported in Feb (positive JAWS, falling cost to income ratio, low BDD, high ROE, high TIER 1), which led to consensus upgrades, will be evident in the broader sector.

On the way up

Similarly, since Feb, pretty much ALL Australian economic data has surprised on the upside and I personally think bank EPS and DPS consensus estimates are too low for FY14 and FY15 and need positive revision. Bank analysts have been too bearish on EPS and DPS for years now and it continues to this day.

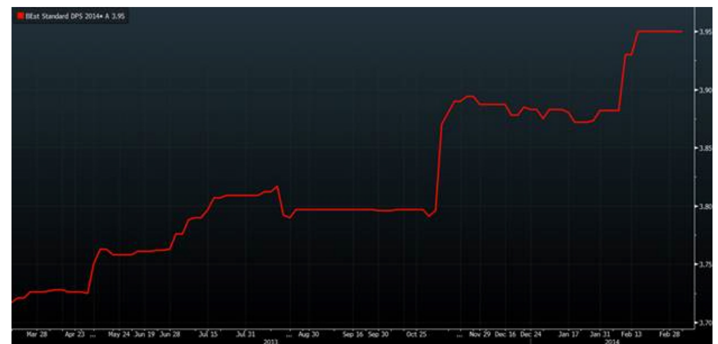
This positive EPS and DPS revision cycle has been underpinning the bank sector move for three years now and it will continue. For example, below is the consensus FY14 EPS forecast for CBA over the last 12 months and the consensus FY14 DPS forecast for CBA over the last 12 months. Note how consensus responds to results confirmation. Four buys, seven holds, seven sells currently on CBA…hmmmm, but that's been the case since $60.00.

CBA EPS FY14



Source: Bloomberg

CBA DPS FY14



Source: Bloomberg

For a large version of these charts, click here.

We are going to see all-time record interim dividends from the sector in May and the domestic SMSF army will cheer. It's that simple in my view and it is interesting that the ASX Bank Accumulation Index (XFJAI) (in blue) continues to lead the ASX Bank Index (XFJ) (in green). To me, this confirms we are seeing structural demand for these tax-effective and growing-in-absolute-terms dividend streams, which in turn are driving capital appreciation in bank equities. I expect absolute dividend growth to continue to drive bank share prices higher.

I continue to recommend being overweight the big four Australian banks (+SUN/BOQ/MQG) at the Australian equity strategy level, with the two highest conviction ideas remaining the two big East Coast banks in CBA and Westpac. Yes, those two are more expensive that NAB/ANZ, but there are many valid reasons for that premium rating.

The strategy

In terms of individual investor bank strategy, I wouldn't be committing new money to the sector, simply reinvesting dividends and effectively playing the compounding/accumulation game, which has worked so well in recent times and will continue to do so in my opinion.

Record profits and record dividends are coming in May, followed by consensus EPS/DPS upgrades. That is the simple summary of my still bullish view on the sector – bullish view that has been unchanged for three years.

Ignoring doomsayers on Australian banks has worked well for three years now. I expect that trend to continue, albeit as I say, at a lower total return rate than the last few years.

100% of Charlie Aitken's fees for writing for the Switzer Super Report are donated to The Sydney Children's Hospital Foundation

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Retailers were the focus of brokers this week as both JB Hi-Fi and Kathmandu got upgrades. On the flip side, Metcash's strategy briefing disappointed at least one broker, prompting a downgrade.

In the good books

JP Morgan has updated Nufarm (NUF) to Overweight from Neutral.

Nufarm's interim result beat the broker on a strong sales and margin performance from South America, offsetting weakness elsewhere. Working capital has greatly increased to fund the South American ramp-up, which is pushing up debt. The broker believes this will be a focus for the market but does not believe a capital raising is on the cards. The broker is backing improving seasonal conditions in North-America and Australia, as well as South-American earnings growth.

BA Merrill Lynch upgraded JB Hi-Fi (JBH) to Buy from Neutral. The broker has raised FY15 and FY16 forecasts by 6% and 12% respectively. Merrills thinks JB Hi-Fi is a well-managed business with world's best cost discipline. There are three avenues for earnings growth in the broker's opinion – new store openings, further roll out of JB Home and from the commercial business. Merrills considers current multiples undervalue the earnings potential over the next three years and this provides for an attractive buying opportunity.

Credit Suisse upgraded Kathmandu (KMD) to Neutral from Underperform. The first half results were welcomed by Credit Suisse, as Kathmandu's momentum was better than relatively poor performances from competitors in the same outdoor retail segment. Gross profit margin expansion at 130 basis points also impressed the broker and this was combined with product traction over the key second quarter. Credit Suisse has revised FY14 earnings forecasts up by 7.5% and FY15 by 11.3%.

In the not-so-good books

Deutsche Bank has pulled back its rating for Myer (MYR) to Hold from Buy, while reducing its price target by 14% to $2.80. Target price is $2.80 Current Price is $2.27.

Macquarie downgraded Metcash (MTS) to Underperform from Neutral after the company's strategy briefing. Macquarie believes, while the "fix it" part of the strategy is going to take at least 12 months to implement before the "invest for growth" comes to the fore, there is going to be little good news in the short term as the company continues to navigate a challenged landscape. While acknowledging it may be belated, Macquarie downgrades to Underperform from Neutral.

The above was compiled from reports on the FNArena database, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.

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What not to buy

by Ron Bewley

I find the question posed by, "What not to buy" one of the more important to ask when building a portfolio – especially for those investors with less experience. It is so easy to get distracted when trying to cover too much ground. Big mistakes can be made by missing some detail in one, or more, of one's investment selections. It is not important if you miss a few stocks that happen to do well. But it is very important to try and exclude potential duds.

Once enough stocks are excluded from view, a viable watch-list can be formed. The investor can then read and analyse in-depth only on those stocks in the list. The list can be updated in say six months or a year when then the whole portfolio should be reviewed. But blinkers are needed to keep focus. Remember, after the event, it is clear which stocks did well. Before the event we would have needed to assess the risk in investing in those stocks and the risks may have been too great for the *expected* return!

Making a list

The three simplest filters are size, sector and recommendation. The price volatility of large capitalisation stocks tends to be lower than those for smaller cap stocks. Therefore, I find it very easy to exclude any stock outside the top 100. I used this rule when building portfolios for people with several million dollars invested. Wealthier people are often more focused on wealth preservation and so they are quite happy to steer clear of smaller stocks and the associated risks.

The optimal number of stocks in a portfolio reflects, in part, the amount to be invested. I find 25 stocks enough for even a multi-million dollar portfolio. A hundred thousand dollar portfolio might only justify 10 to12 stocks to reduce the impact of brokerage costs (it is not just the cost of buying the portfolio but the rebalancing that should go on from time to time).

As there are 11 important sectors in the ASX 100, allocating one stock to each of the smallest two sectors of IT (0.8% weight) and Utilities (1.7% weight) would attract only $800 and $1,700, if the investor followed the index leaving $97,500 to be allocated across only eight to10 stocks. To get some diversification within a few big sectors, some sectors have to be avoided in small portfolios. Excluding the two smallest sectors is one obvious rule for an index-hugging style – but more of that in a few weeks time when I again write about yield and other 'styles'.

I rely heavily on Thomson-Reuters consensus recommendations ('recs') in my own portfolio construction. On a scale of '1' for a buy to '5' for a sell, the consensus average for a stock is seldom close to 1, as some brokers are usually a little less enthusiastic and there is a strong bias against even a '4' (for an underperform) let alone a sell at '5'. As a result, I would never build a new portfolio unless the consensus could at least manage a 3 (or hold). In my next column I will discuss recs in more detail. This '3' rule excluded 23 stocks from the ASX 100 on Monday's close.

Additional rules

I find three other construction exclusion rules to be useful. First, some stocks in the top 100 would not currently be ranked in the biggest 100 stocks in the ASX 200 because the S&P/ASX index team takes a longer-term view of price movements and it only rebalances the index (i.e. chooses the 100 or 200 component stocks) every three months – as it did last Friday. Seven stocks are excluded by this rule by – almost belonging to the lower half of the ASX 200. When a stock leaves an index, there is some pressure for certain fund managers to sell, as the stock may no longer satisfy its mandate.

Given that we have just gone through reporting season, I also excluded stocks with a significant downgrade over the period since the beginning of February. I used a slip of 0.25 in the rec to trigger an exclusion. That removed six stocks from the ASX 100.

And my third additional rule is to exclude stocks that, in my personal view, have too much volatility or downside risk. I include insurers (QBE and IAG) in this list because unpredictable natural disasters can have a big impact on share prices between possible very good periods of capital gains. I exclude airlines (only QAN, as Virgin has already left the index). Leighton (LEI) seems to go through too many periods of good and bad spells, often because they handle very big lumpy contracts. I also omit Arium (ARI) for reasons similar to LEI. That rule takes out six stocks.

Some stocks get excluded by more than one rule. After allowing for such overlap, I can still easily omit 34 stocks from the ASX 100. Since 66 stocks is far too big a number for my watch-list, I need another final rule. I rank each stock by market cap within each sector. With a 25 stock portfolio, I am unlikely to need more than five stocks in any sector. Therefore I chose the five stocks with the best recs. That leaves me 39 stocks in my watch-list. I can manage that number.

Of course, investors need to use rules that suit their own needs but perhaps this column might help some form a view on how their own watch-list might take shape. I present this list in the table along with their recs. I should stress though that this is not my buy list – or indeed anybody else's. It is a list from which to try and find a good portfolio – and that is the topic for my next column.

It is worth noting that the consumer staples sector did not have any stocks that passed my stated filters. Even financials did not have five suitable stocks!

A possible watch-list

Sector	Code	Rec	Sector	Code	Rec
Energy	OSH	2.06	Health	RMD	1.8
	ORG	2.31		CSL	2.31
	STO	2.36		RHC	2.69
	WOR	2.86		SHL	2.79
	WPL	3	Financials	MQG	2.47
Materials	BHP	2		NAB	2.53
	RIO	2.19		ANZ	2.59
	FMG	2.25		WBC	2.65
	ORI	2.43	Property	WRT	2.18
	AMC	2.64		WDC	2.33
Industrials	BXB	2.15		GMG	2.46
	SEK	2.24		SGP	2.53
	TCL	2.33		GPT	2.77
	AZJ	2.44	IT	CRZ	1.94
	SYD	2.54		CPU	2.81
Discretionary	CWN	2.07	Telco	TLS	2.79
	FLT	2.29	Utilities	SKI	2.4
	TTS	2.92		AGK	2.67
	ALL	2.92		APA	2.83
				SPN	3

Source: Woodhall Investment Research; Thomson-Reuters Datastream; data as at market close, 24 March 2014

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Changes to superannuation pension assessment and you

by Tony Negline

When deeming was introduced about 18 years ago, something unusual happened.

The government of the day expected that this change would generate a large amount of contact from people trying to understand how they would be impacted. But the exact opposite occurred.

Very few people asked for additional information or assistance. Retirees and others who were to have their assets deemed (such as disability pensioners) seemed to understand what deeming is and the impact it would have on them.

Therefore, a good place to start is to accept that deeming isn't hard to understand.

Deeming applies to bank accounts, managed funds, term deposits, shares and some other investments. It assumes your investments earn a certain amount of income under Centrelink's income test. If you earn more than the assumed earning rates, then the additional income isn't counted under the income test.

Currently if you're single, the first $46,600 of assets are 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.

The big change is that deeming will now also apply to all superannuation pensions that commence after December 2014.

How are pensions assessed before 2015?

Under current rules, Centrelink (or Veteran's Affairs if you're a veteran) takes your pension's purchase price (I'll use $300,000 as an example) and divides it by your current actuarial life expectancy. Males aged 65 currently have a life expectancy of 18.54 years. Females of the same age have a 21.62-year life expectancy.

The result of this calculation is called your pension's deductible amount or DA. In our example, the deductible amount is $16,181 if you're male and $13,876 if female.

The amount of income counted by Centrelink is the income paid from your pension less the deductible amount. If your pension paid you 5% of the account balance as income, or $15,000, and you're male you would have no income counted for Centrelink's income test ($15,000 less $16,181). Females would have just over $1,100 counted.

For most people, as their age increases and their minimum pension increases, the amount of income counted under this test also increases.

Deeming rules after 2014 – males to loose a small advantage

Under current rules, males (because they live shorter lives on average) get a small advantage because less income is counted under the Income Test.

This is lost under deeming because it applies to both sexes in the same way.

Taking the $300,000 pension as an example and no money in the bank, then applying deeming will see a single person have $9,801 (or $377 per fortnight) counted as income under the income's test (2% on

the first $46,600, 3.5% on the balance of $253,400).

A couple would have $9,339 ($359 per fortnight) counted towards their income test.

Note that the amount counted won't change because of your age, as occurs under the current rules. This means you can take whatever income you like from your pension and it will have no impact on the pension's income test assessment.

No change if impacted by assets test

If your pension is reduced because of Centrelink's assets test, then this change won't alter how your aged pension is determined. If you are ineligible for a pension under the assets test, then this change won't have any further impact on you.

New Australian life tables before 2015?

It's possible that before the end of 2014, the Australian Government Actuary might issue 2010/12 Life Tables. At this stage, we don't know when the tables will be published but it's expected to be in the next 12 months or so. If they're published before 2015, they would apply to Centrelink pensions that commence between their date of issue and January 2015.

The new life tables will undoubtedly show that we're all living longer. The bottom line impact is that your deductible amount will be lower than if the current rules are applied, meaning that more income might be counted under the income test.

For example, suppose that there is a 10% increase in life expectancies. In this case, a 65-year-old male would be expected, on average, to live for another 20.39 years. Taking our example above, the deductible amount would be $14,713.

Current rules versus deeming

There are many issues to consider here.

Looking at our example above and assuming the 2005/07 Life Tables continue to be used, a single male would need to be taking a pension of almost $26,000 a year to have the same amount of income counted under the current income test, as will apply under deeming.

This is an income payment of about 8.6% of a $300,000 account balance. Retirees aged older than 85 need to take at least 9% income from their super pensions.

From this very simple case study, I conclude that if you intend to take the minimum pension payment and you aren't going to be impacted by the assets test, it might be a good idea to lock in your Centrelink income test assessment approach before 2015.

I suggest you should seek some advice. If you don't use a financial adviser (and don't wish to use one) then Centrelink provides a Financial Information Service. It's a free service and you can contact them here.

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Monadelphous and SMSF estate planning

by Questions of the Week

Question: Monadelphous was a stellar stock for so long but now is in the doldrums. What do you think of its potential, long term, in a, SMSF?

Answer (By Paul Rickard): I am not sure that Monadelphous would be a integral stock in my SMSF portfolio. The performance was stellar and management has a pretty strong reputation, although it was largely earned in a booming resources market. It is now under pressure, as construction activity wanes and margins fall.

It is clearly out of favour with the brokers, who have a consensus target price of $15.95, and sentiment of -0.5 (-1.0 most negative, +1.0 most positive).

I think you are going to need to be patient holding this stock. Market expectation is that there is more bad news to come (and of course, it is priced for this).

Question 2: Good article on estate planning Tony. Thank you. For me the issue is that I am the only member in a fund that has my son and myself as individual trustees. I have a Death Benefit Agreement in place. What does my son need to do should I 'move on'?

Answer 2 (By Tony Negline): This will depend on who the death benefit is payable to, and if the binding nomination is valid according to your trust deed.

If your son is happy to pay the death benefit to the nominated beneficiaries, then the process should happen pretty smoothly. However, if he wants to ignore your wishes and pay it out some other way, then litigation might follow.

I suggest a frank and open discussion with your son and to check your fund's trust deed.

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ASIC promises equal scrutiny

by Penny Pryor

The mainstream superannuation funds have, for some time, been understandably concerned by the loss of members to SMSFs, as our sector of the superannuation industry has grown. Many large funds, like AustralianSuper, have launched 'member-directed' options, which allow fund members to choose investment options that enable some limited choice of shares and other investments.

These options are relatively new (although AustralianSuper launched its first incarnation over a decade ago) and have not attracted too many members to date. The AustralianSuper option has $1.7 billion of the fund's total member assets of $75 billion.

Last week at the Conference of Major Superannuation Funds – the annual meeting of the not-for-profit superannuation sector, which oversees $600 billion in superannuation savings – delegates expressed their concerns on oversight of the DIY sector during a regulator update session.

Australian Securities and Investments Commission (ASIC) senior manager, investment managers and superannuation, Alex Purvis, said in response to a question from the floor about equal scrutiny for all sectors of the superannuation industry, that the regulator would continue to keep its eye on SMSFs.

"The fact that we have a taskforce obviously suggest that were taking the growth in SMSFs fairly seriously," she said.

"The concern is you will end up with people in these arrangements that shouldn't be there."

ASIC's focus is also on advertising and misleading advertising regarding SMSFs, such as the recent infringement notice penalty paid by one SMSF administration provider.

SuperHelp Australia paid a $10,200 fine following misleading statements made about the cost of setting up a self-managed superannuation fund. ASIC was concerned that representations that the fund set up was "free" subject to some conditions that were not made clear in the advertisement was a misrepresentation.

"[Our] work in advertising…has mostly been driven by the SMSF taskforce," Purvis told the conference.

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Did you know?

Earlier this week Paul Rickard and I sat down to talk about why the Australian market has been lagging the US market and why we haven't yet got back to our pre-GFC highs. Watch the video here.