Switzer Super Report

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Don't throw caution to the wind

I'm going to do something unusual this week. I'm going to join the bears for a bit. I'm still fairly confident we'll finish the year ahead, but although markets have rallied both here and in the US, I'm not sure we've seen the end of this 'tech wreck' just yet.

Charlie Aitken is also talking caution in his article today. He says investors should be shifting out of momentum stocks and moving into the Top 20. He likes stocks with big short positions, like JB Hi-Fi.

Also in the *Switzer Super Report* today, we've got investor extraordinaire Geoff Wilson on why you should try and avoid companies with PEs above 25 and Paul Rickard suggests a good yield portfolio in this environment in our *Questions of the Week.*

Sincerely,

Peter Switzer

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Sell hares and buy the ASX20

by Charlie Aitken

Globally and domestically I think "momentum/GAAP (growth at any price)" stocks have passed the "peak on euphoria" stage (Facebook + WhatsApp were the peak) and the broader equity markets are in the "mature on optimism" stage.

I think it's absolutely clear we have reached an inflection point in the GAAP/momentum vs. GARP (growth at the right price)/value relationship and I am now aggressively tilting our equity strategy to reflect that. In this world of hashtags #Iliketocallourstrategy #sellharesbuytortoises

As I have been warning for weeks, I think we are seeing a clear peak in 'momentum' being the main driver of share price performance. Momentum as an investment variable has peaked and you will continue to see money rotated from expensive momentum stocks to better value/yield/GARP laggards over the months ahead.

Every global and domestic macro scenario I can conceive, leads me to forecast this rotation back to large cap "tortoises" to continue. In fact I think it will accelerate as it becomes more obvious to all market participants that support from central banks will ease over the months and years ahead. The QE and ZIRP (zero interest rate policy) trade is nearing the end, but you don't want to be there at the end in the biggest beneficiaries of those policies. Remember, the NASDAQ is up 244% from the 2009 low.

Less free money

The next move in interest rates, both domestic and global, is **up**. Central banks are also in the process of putting away their unconventional tool kit. We are heading towards a more normalised monetary policy environment and that is why, strategically, I need to make adjustments to broader equity strategy.

They key reason we were on the right side of global and domestic equity markets in the last few years was simple. We believed you did not fight the Federal Reserve, European Central Bank, Bank of England, Bank of China, Bank of Japan and RBA working in unison (forcing people out of cash into risk assets). On the other side of that, I must adjust the equity strategy to reflect less largesse from central banks moving forward.

To put it simply: less free money = less risk tolerance. Similarly: less free money = more volatility.

In a previous life when I was young and reckless I would have driven over the equity strategy cliff *Thelma & Louise* style. Not this time around: if anything, I am going to slow the car down well ahead of the cliff. That is the process I have been starting in these notes over the last few weeks by identifying Australian GAAP/momentum stocks I thought were at risk of a top-down driven valuation correction. That caution has proved warranted in that set of stocks.

Just to remind you of that broader list of momentum stocks I think are vulnerable to a further top down driven valuation correction, here they are again.

REA Group (REA), Seek ltd (SEK), Domino Pizza Enterprises (DMP), CarSales.Com (CRZ), Xero Ltd (XRO), Vocus Comms ltd (VOC), TPG Telecom Ltd (TPM), iiNet ltd (IIN), CSL ltd (CSL), ResMed Inc (RMD), Ramsay Healthcare (RHC), Sirtex Medical (SRX) ,21ST Century Fox (FOX),Navitas (NVT),G8 Education (GEM),OzFoxex (OFX),Vocation (VET),Donaco (DNA),James Hardie (JHX),Magellan Financial Group (MFG),BT Investment Management (BTT),Platinum Asset Management (PTM),Henderson Group (HGG),Credit Corp Group (CCP),Veda Group (VED),ASX Ltd (ASX),Macquarie Group (MQG), Brambles (BXB), Amcor, Fletcher Building, IOOF (IFL), Sydney Airport (SYD) and Transurban (TCL).

I want to make clear that this is my top down view of Australian stocks with characteristics that I believe make them vulnerable in the shorter-term to what is clearly a global correction in momentum stocks.

The problem when I write a list like this, even as it proves accurate, is the list of analysts/investors/companies who get their noses out of joint is long. It is like people have forgotten that shares can fall and it's unusual for any stock to simply rise in a straight line no matter how good the company is. This is particularly relevant in a global trend change event. So let's be clear, the list above, is a list of Australian stocks with vulnerable characteristics, the largest one being 12-month positive price momentum. It's nothing more than that and it's based on 22 years of sitting in front of screens reading price action signals.

What will happen next?

Once we have reduced exposure to high flying momentum names what do we do next?

My answer is that institutional investors should rotate to large cap laggards and individual investors should rotate to cash ahead of the seasonally weak May period.

Broadly I think it's time to position more defensively and for individual investors, that does mean raising some cash from multi-year big winners in the momentum space. This advice is twofold because if all we are seeing is a rotation from momentum stocks to laggards, those momentum stocks will still underperform, but if this does morph into a more serious broader equity market correction, those momentum names will lead the correction, exactly as has happened on the NASDAQ and Wall St.

The likelihood of a broader Australian equity market correction taking hold is clearly rising. I am monitoring developments closely but remain strongly of the view the ASX200 will outperform Wall St on all likely scenarios. Australian equities (and Australian dollar) have done very well relatively on a switch from Japanese to US equities recently, but it must be said that any further significant weakness on Wall St or Tokyo will be very hard for us to ignore absolutely. The ASX200 is now up 6.8% in US dollar terms this year and that does make us increasingly vulnerable to a correction.

Could the ASX200 lose 5%? Absolutely, in fact it's probably more likely than rising 5% in the next few months (banks ex div, May effect, tough Federal Budget). On that basis I am again focusing on where institutional investors who will remain fully invested will rotate to.

What to buy next?

The institutional rotational focus will be the ASX Twenty Leaders Index (XTL) with an emphasis on laggards (tortoises). Interestingly this week, one outperforming XTL member was Telstra (TLS), reinforcing our view it's time to be invested in the *"tracks"*, not the *"trains"*.

Other XTL members that delivered outperformance of the ASX200 are: Origin Energy (ORG), Woodside Petroleum (WPL), Suncorp (SUN), Wesfarmers (WES), IAG (IAG), Westfield (WDC), Westpac (WBC), National Australia Bank (NAB), Commonwealth Bank (CBA), Woolworths (WOW), BHP Billiton (BHP) and AMP (AMP).

To me this shows you the rotational playbook and I think the rotation is correct in terms of relative performance positioning. Get right up the quality asset and quality management team curve.

The other place I am focusing attention positively is in large open shorts, particularly East Coast ones.

The untold story (yet) of the last few weeks in currency and equity markets globally is somebody or some group of investors has been blown to pieces. The scale and speed of moves in momentum equities and currencies, almost certainly ensures some big losses have been racked up, most likely by leveraged investors.

On that basis I am of the view that stocks with large open short positions will outperform on forced covering by leveraged investors against other losing trades. Interestingly big open shorts broadly outperformed in Australia this week and I expect that to continue. My number one play on this theme remains the 13% shorted JB Hi-Fi (JBH). Below is the

price action in JBH over the last 10 trading days: note the underlying bid tone of short-covering.

JBH: shorts covering

It is time to be disciplined, sensible, selective, contrarian and very focused.

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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You're paying too much

by Geoff Wilson

"Buy low, sell high" is the classic investor's tactic and one used by Wilson Asset Management's investment team when hunting for undervalued and under-researched growth companies.

Recently however, we have witnessed a very different tactic. Investors are instead purchasing fashionable shares, which are trading at premiums. Why is this happening?

A possibility is that the market has found itself short of investment options. Many Australian businesses are facing a combination of operational restructuring, soft demand, high capital expenditure requirements, and flat revenues. This has perhaps resulted in slim pickings amongst a handful of companies that have performed favourably over the last year and have displayed resilient business models. The problem with this is that the market is already aware of most of these opportunities.

Too expensive

Recent evidence from the February reporting season just passed found that premium rated stocks were the best performers. Some fund managers are happy paying high multiples for perceived earnings certainty given the current fragile and patchy nature of the Australian economy. For the month of February, Seek Limited (SEK) rallied 38% while another market darling, REA Group (REA), rallied 22%. These companies trade on price to earnings (PE) ratios of 30 times and 39 times respectively.

The average 12-month forward PE multiple of a basket of 10 premium-rated industrial stocks, now sits at approximately 28 times. Historically, the market trades on an average PE of around 15 times. These premium-rated stocks are: REA Group Limited (REA), Domino's Pizza Enterprises (DMP), Navitas Limited (NVT), Seek Limited (SEK), Cochlear Limited (COH), Ramsay Health Care Limited (RHC), James Hardie Industries (JHX), Carsales.com Limited (CRZ), Breville Group Limited (BRG) and CSL Limited (CSL).

In recent years, some of these stocks have experienced significant earnings growth however, their share prices have run well ahead of this growth in most cases. For example, Domino's Pizza has delivered strong growth of 15-20%, in recent years however its PE has moved from 18 times two years ago, to 37 times currently. That's an increase of more than a 100%. Some of these premium rated stocks are now the most expensive they've ever been in their listed lives.

Overvalued stocks under-deliver

A recent research report from Goldman Sachs, highlighted that buying stocks that trade on a PE of 25 times or above, generated an average return of -5% for the year after. Goldman Sach's research went further and pointed out that as the multiple moves higher, these stocks are more susceptible to large underperformance.

My observations are that when an adverse event occurs with a high multiple stock, the pain on the downside can be large. Generally for profit upgrades or downgrades, all else being equal, the share price of a company should move by that same amount. A recent example of this was the downgrade by Coca Cola Amatil (CCL), which trades at a digestible PE of 13 times.

The company announced a 15% earnings downgrade and CCL stock fell by 15% on the day. If you see a high multiple stock deliver some negative news, it's highly likely that the share price will fall by more than the earnings downgrade, as the PE premium re-rates lower on the lower growth expectations from investors.

A valuable lesson lies in the cautionary quote by Benjamin Graham: “In the short run, the market is a voting machine but in the long run it is a weighing machine.”

Investors should be aware that they may be paying too much for Australia’s most coveted businesses.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Coca Cola was the centre of broker's attentions this week after it announced a downgrade in earnings and a strategic review. It received both upgrades and downgrades, as did Bank of Queensland after it released its interim financial results.

In the good books

CIMB Securities upgraded Telstra (TLS) to Add from Hold. CIMB now thinks NBN payments may accelerate more sharply than previously estimated. The broker values the asset sales component of the NBN deal at $11.4 billion, with payments peaking in FY19 at over $2.0 billion. Separating asset sales from ongoing operating income and using a lower discount rate for related government guaranteed payments means the broker's valuation has increased.

CIMB Securities upgraded Coca Cola Amatil (CCL) to Add from Hold and Credit Suisse upgraded to Outperform from Underperform after the company downgraded first half earnings. The company has guided to a 15% reduction in first half Australian beverages earnings. The rating is upgraded to Add from Hold, as risk is now seen moving to the upside. Credit Suisse thinks the challenges in the Australian beverages business can be overcome, via reduced overheads, narrowing the business to core non-alcoholic beverages and improving the relationship with The Coca-Cola Co. See downgrades below.

Macquarie upgraded Bank of Queensland to Neutral from Underperform following the company's result. The acquisition of Investec should provide some growth but the broker is concerned the group is becoming more complex rather than less, and a riskier proposition given reliance on trading profits and corporate lending. The Queensland recovery will nevertheless assist and growth may continue if BOQ pushes on with its acquisition spree.

In the not-so-good books

Coca Cola Amatil was downgraded to Sell from Hold by Deutsche Bank, Neutral from Overweight by JP Morgan and Sell from Neutral by UBS. Deutsche has made a deeper downgrade to 2015 forecasts, to allow for further margin impact stemming from the price investment that is likely to be needed. JP Morgan says the issue now for CCL is the stock will be perceived as less defensive as it once was and thus could well be de-rated further, with management strategy unclear at this point. UBS thinks CCL and its parent have failed to get on top of changes in consumer preferences and too much earnings growth has been coming from price.

BA Merrill Lynch downgraded Bank of Queensland to Neutral from Buy. The first half result was broadly in line with the broker's forecasts. The intention to acquire Investec's financial and asset finance and leasing businesses is a solid deal but not likely to drive significant upside in the broker's opinion.

Citi downgraded Sigma Pharmaceuticals to Sell from Neutral. Sigma shares have rallied 30% in recent sessions and Citi analysts cannot by the love of god comprehend why that has happened. Their remedy is rough and straightforward: downgrade to Sell.

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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Short 'n' Sweet – don't panic and David Jones

by Penny Pryor

It's been a pretty rough week on markets, although the local market was starting to look up a little yesterday – a bit like Sydney weather.

It's hard not to panic when everything is going pear shaped and the memories of the global financial crisis and euro debt crisis are still quite clear in our minds.

Here at the *Switzer Super Report* we're still pretty confident that the recent run on stocks was a reaction to some of the big tech stocks falling from their overinflated highs. After all it was the NASDAQ, not the Dow Jones, that suffered the biggest falls.

Last week Charlie was very prescient in his suggestions to rotate into mega caps the day before the biggest falls in the US. And he continues to preach on this theme today.

He suggested taking some profits on stocks like: REA Group (REA); Seek Ltd (SEK); Domino Pizza Enterprises (DMP); CarSales.Com (CRZ); Xero Ltd (XRO); and a bunch of others including the big health companies CSL, Resmed (RMD), Ramsay Healthcare (RHC) and Sirtex Medical (SRX).

The mega-cap companies he suggested rolling those into included the big four banks, Suncorp, Macquarie, AMP, IAG, Telstra and BHP.

And a few weeks ago, James Dunn was already looking at what might be the next REA Group, Carsales.com.au and SEEK, given those companies were so overvalued. He came up with iCar Asia, iProperty Group, Onthehouse Holdings, Disruptive Investment Group and iBuy.

A lot of those companies are not yet making profits. But as James pointed out:

"At one point, the prospects for SEEK, REA Group, Carsales.com, Wotif.com and Webjet would have looked similar. Fortune certainly favoured the brave speculator back then – for that's what this kind of investing is – and those taking a similar leap of faith in this group could potentially be well-rewarded, too."

And can we remind you again that the *Switzer Super Report* speculated that David Jones would probably be more likely to receive a foreign bid before Myers had another go?

James Dunn said a month ago that any "offshore bid that needed clearance from the Foreign Investment Review Board (FIRB) would arguably stand a greater chance of clearance than a domestic department-store merger would of getting past the Australian Competition and Consumer Commission (ACCC)."

David Jones' share price has been hovering pretty close to the Woolworths South Africa bid price of $4 a share ever since the acquisition was announced.

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Be careful of low interest rate loans to your SMSF

by Tony Negline

Charging a low (or zero) interest rate on a super fund loan might lead to some high penalty rates in your super fund following a recent Private Binding Ruling released by the Australian Taxation Office.

The loans allowed in SMSFs are Limited Recourse Borrowing Arrangements or LRBAs. There are all sorts of rules governing these transactions and they're quite easy to muck up. Good advice is essential when you set these structures up, when you're running one and when you want to unwind them.

In August 2012 I wrote about your ability to personally loan money to your super fund as part of an LRBA at a very low interest rate. You can read that article here .

The information from that article came from questions super industry representatives had submitted to the ATO via a liaison committee that has since been disbanded.

One of the points I made in the 2012 article, was that if you want to use a low interest rate LRBA, with you as the lender, then you should consider applying for a Private Binding Ruling (PBR) from the Tax Office.

Some people seem to have followed my suggestion because over the last 20 months or so the Tax Office has published some PBRs about this topic.

Low interest loans and non-arm's length income (NALI)

When a super fund receives NALI, it pays 46.5% tax on that income or realised capital gains. All income or capital gains distributed from a discretionary trust (that is, any trust that gives the trustee any discretion on how to distribute income or capital) will always be deemed to be NALI.

The situation for distributions from companies and all other trusts isn't so clear. For these entities, NALI will typically occur when a super fund investment isn't continually based on normal arm's length principles. For example, a super fund might have paid a discount for its investment in an entity or received a distribution that didn't equate to its investment. In other words, the super fund and the entity weren't dealing at arm's length.

Until recently, the PBRs that have been issued about low interest rate LRBAs have stated that in the Tax Office's view, NALI doesn't apply.

The ATO took the view that NALI didn't arise because the income received by the super fund from the LRBA asset when a low interest rate was being charged wasn't greater than the amount of income it would have been paid on an arm's length basis, and the super fund wouldn't face 46.5% tax on the income it receives from the LRBA asset.

New ruling

In the last month the ATO has changed its tune in relation to a zero interest LRBA involving real estate. The ATO stated in one PBR that NALI will apply because:

- If the interest rate on the loan was greater than zero then the super fund wouldn't have borrowed the money and hence wouldn't be receiving any income on the potential investment. That is, the rent isn't an arm's length amount.
- The net rent received by the super fund would have been lower if an interest rate greater than zero had been charged.

I know many SMSF practitioners who don't agree with this new interpretation.

There have been media reports that a PBR like this has been appealed to the Courts. It'll be interesting to see if this action leads to a hearing and published judgement (most tax cases are settled out of the public eye).

In any event it will take some time before this issue is fully clarified.

So if you have a nil interest LRBA in place and no PBR on foot, then I suggest you consider getting one now. (Be aware however that the PBR might not be favourable.) If you are interested in putting in place a low interest LRBA then I still suggest you consider getting a PBR before proceeding. One of the key issues for you will be the wording of your loan agreement and the super fund's rights as the sole beneficiary of the Holding Trust. As always it pays to get good advice.

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The best five yield stocks

by Questions of the Week

Question: Can you name five good yield stocks to buy in this downturn?

Answer (By Paul Rickard): If you are looking for reliable yield stocks (assuming also that franking is important – so I will exclude property trusts and other unfranked stocks), I think you should largely stick with S&P/ASX 20 type stocks, spread across a few sectors for diversification, in this market.

The five I would go for are:

- Commonwealth Bank
- Westpac
- Telstra
- Woolworths
- Woodside

Question 2: Can you please advise which companies will be able to take advantage of the new Sydney Airport at Badgerys Creek?

Answer 2 (By Paul Rickard): I think this is such a long-term project that it is almost impossible to predict with any confidence the benefits/costs to any company. That said, some of the winners/losers on paper would appear to be:

- Sydney Airport (SYD) – a loser due to potential competition.
- Qantas (QAN) and Virgin Airlines (VAH) – maybe winners because competition might lead to lower airport charges.
- Leightons (LEI) – it and other construction companies are possibly winners.
- Transurban Group (TCL) –possibly a winner if there are tollways to be built/operated.

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Did you know?

What's going on with Coca Cola Amatil? Paul Rickard and I got together on *Super TV* to discuss the share price drop.