Switzer Super Report

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A trend or a tease

A big day on the markets yesterday and we're halfway to our target of 6000 by the end of the year already. We even had a bit of downward pressure on the Aussie dollar and that's good news for some of the stocks in our *Switzer Super Report* portfolios that report in US dollars.

The next few days and weeks will reveal whether this is a trend or a tease but don't be surprised if volatility continues. This market is also looking hot for M&A activity and this week Tony Featherstone reveals six potential takeover targets in Part 1 of our *SSR* investigation. The next six will be revealed in two weeks' time.

Also in the *Switzer Super Report* today, Ron Bewley explains why you should be targeting 8% to 11% in your investment portfolio and Dr Robert Schiavuzzi, talks about how much he has enjoyed running his SMSF for the past 20 years.

Sincerely,

Peter

Peter Switzer

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SSR takeover targets – Reckon, iiNet and NIB Holdings

by Tony Featherstone

Investment bankers are notorious for predicting a boom in corporate activity. For once, they might be right. Talk of a record year for Initial Public Offerings is well grounded, with several multi-billion-dollar offers on their way. And mergers and acquisitions (M&A) activity is finally heating up.

Investors who seek quality companies with takeover appeal must also identify a catalyst for M&A. Stocks are often touted as perennial takeover targets on the basis that they are undervalued. That is too simplistic. More important is understanding a trigger for a predator to pounce, and to pay way above the odds because the target company has significant strategic value that is hard to replicate.

Below are six takeover targets:

1. Perseus Mining
Australian gold explorers and producers working in Ghana, Burkina Faso and other parts of West Africa boomed in 2010 as the market leapt on giant minerals discoveries and the rallying gold price. They just as quickly crashed when the gold price tumbled, fears of sovereign risk intensified, and resource stocks generally were dumped.

More consolidation of West African gold companies looks inevitable. Centamin West Africa Holdings' takeover of Ampella Mining, a one-time star gold explorer, and other takeovers of West African gold companies in the past year, is a sign of things to come.

Perseus has had operational problems, most recently a fire at its flagship Edikan Gold Mine in Ghana, but remains the best-quality Australian-owned producer in West Africa. It has slumped from $3.50 in May 2011 to 34 cents.

Perseus still has 7.1 million ounces of measured and indicated mineral resources that comply with the JORC Code, has been in commercial operation in Ghana since January 2012, and has forecast gold production of 230,000 ounces annually for 10 years.

With the top 20 shareholders owning 40% of Perseus, the register is open for a global gold producer that could add the company to its portfolio. Good judges, such as Paradice Investment Management, have bought more shares this year. A bigger predator might find Perseus' resource base attractive, as it rides out the lower gold price.

2. Reckon Group
The well-run accounting software group has formidable local competitors: the fast-growing Xero that is targeting cloud-based computing, MYOB, and US accounting software giant, Intuit.

If accounting software evolves like other technology industries, it could eventually boil down to two big players: a market leader that has a significant gap over the number-two player, and is light years in front of the third. I cannot see four players slugging it out in Australian accounting software industry as technology reshapes it – over a long period.

More likely is the smallest of the four, Reckon, joining forces with a larger rival. Reckon has an excellent brand, good products, and a sticky client base that would have significant strategic appeal to a larger rival. It also has an open share register, and is a stock you would be happy to own, preferably at a slightly lower price, regardless of takeover. Reckon is one of the market's higher-quality small-cap companies.

3. Automotive Holdings Group
The fast-growing car dealership would fit neatly with fellow dealership AP Eagers, and would be unlikely to go without a decent fight. AP Eagers owned almost

18% of Automotive Holdings at April 2014, according to Morningstar data.

Automotive Holdings, Australia's largest car dealership, has been busy raising funds through an oversubscribed $115 million placement in March 2014, and expanding the business with its own acquisitions – an oft-used tactic to make it harder for predators.

Takeover speculation about Automotive Holdings has been rife since 2012. AP Eagers argued its stake in Automotive Holdings was simply a strategic investment that provided exposure to the West Australia market. The car dealership market in Australia is highly fragmented, meaning both companies have plenty of scope for growth by acquisition.

But a merger of the two key players, and greater scale in the car dealership market, makes plenty of sense. It looks more a question of when, rather than if.

4. iiNet

It is hard to think of a more impressive sector than telecommunications in the last few years. TPG Telecom, iiNet, and M2 Group have spearheaded booming share-price gains for second-tier telcos.

Most M&A activity in the sector has been mid-sized players acquiring smaller fry: M2 buying iPrimus and Dodo, for example. Consolidation among larger players seems inevitable as mid-size companies join forces to improve scale and better compete with industry giants such as Telstra.

Like Reckon, iiNet is an impressive company that investors would be happy to own, regardless of takeover. It is not cheap: few telcos are, after stellar gains in the past few years. But iiNet has excellent growth prospects, and a suitor would have to pay up for a business of its quality.

iiNet announced in April that it will use a $350 million war chest to acquire media and internet companies – a move that will make it harder to take over, although chairman Michael Smith emphasised it was about making iiNet's operations more diverse and valuable.

With founder and long-time CEO Michael Malone stepping down, the path looks clearer for a predator – my money is on TPG Telecom – to move in.

5. NIB Holdings

A possible $4 billion IPO of Medibank Private in FY15 will surely put the blowtorch on other listed health insurers. Scale will be increasingly important as an ageing population pressures the health insurance sector.

As in the telecommunications sector, fast-growing health insurers will need more size to take on industry incumbent Medibank. Smaller providers that can add significant customer numbers to larger insurers will be in demand.

The well-performing NIB Holdings looks an obvious target for a larger health insurer. It has a good brand, solid market position, and rising return on equity.

Although not cheap, NIB Holdings, like iiNet and Reckon, is a quality mid-cap stock for portfolios. Its takeover appeal, well known to the market, should ensure solid interest in the stock this year.

6. iCars Asia and iProperty Group

Middle-class consumers in Asia-Pacific (households with daily spending of US$10-US$100) are estimated to grow from about half a billion in 2009 to 3.2 billion in 2030, according to research cited in the former Federal Government's Australia in the Asian Century white paper, released last year.

If that forecast is even half-correct, Australian companies will need to quickly build a much bigger foothold in Asia, and buying entrepreneurial ventures to do so is an option.

A logical takeover candidate is iCars Asia, an early-stage venture that is trying to become the Carsales.com.au of South East Asia. Carsales is an obvious buyer, and already has a 20% stake in iCar.

I have followed iCar closely since it listed in September 2012, and kept an eye on other listed companies in the Catcha Group stable: the more established iProperty Group, and the recent listed iBuy Group. Catch Group's chairman, Patrick Grove, clearly has knack for developing early-stage ventures

in emerging markets, and attracting strategic investors. Like all good young entrepreneurs, he is setting the ventures up to be bought out by larger players.

iCars' sister company, iProperty Group, aiming to be the realestate.com.au of Asia, also has significant strategic value to a larger property advertising company. As an early-stage loss-making venture, iCars is speculative.

iProperty soared from 75 cents in mid-2013 to a 52-week high of $4.04. Now at $2.67, it is among the pricier internet-related stocks. Further share-price weakness is a good bet if the recent rout in global technology stocks continues. That could put iProperty on the radar of a bigger player, provided a few key shareholders on its register are willing to take on a strategic investor.

Watch and wait for better value, mindful that iProperty is a riskier stock, albeit with a valuable foothold in Asia and of significant strategic interest to a larger property player. If iCars and iProperty can do nearly as well as their Australian internet rivals – in a market the size of Asia – they will be worth a lot more than their current valuations to a suitor.

- Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply stock recommendations.

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My SMSF – a hobby not a chore

by Super Report Subscriber

Name: Robert Schiavuzzi
Age: 61
Other members of the SMSF: None – single member

How long have you had your SMSF?
Over 20 years.

Why did you start it up?
In the wake of the 87 crash I had money with one of the life houses – firstly with a stockbroker and then with the GIO. But I thought I'd have more control with an SMSF so I established my own fund.

How big is it?
Well in excess of $1 million.

Is it more or less difficult to manage than you thought it would be?
The administration is not onerous. Most of the work is done by the accountant. The investment management is done by me, but it's something I would do anyway, because I have an interest.

Do you enjoy managing it?
Yes I do, because I have an interest in economics and investing.

Are you pleased with its performance?
Yes.

I don't assess it in number terms from year to year.

My priorities are having a mixed bag of investment criteria, which involves more than just absolute return.

I don't actually chase the highest return. I'm more interested in long-term returns. I am not so much a trader as a long-term investment.

Firstly I read extensively and I do research extensively. I read the financial press daily. I read certain economic texts and I make my decisions according to how I'm feeling at the time. I'm certainly not a chartist. I'm not purely a growth investor; I'm not purely a value investor. I'm all those things at various times.

What is your asset allocation?
I have 25% in cash and the remainder in equities. Around 80% of the equities allocation is in domestic equities and the rest is in international. I currently don't have any bonds, but have in the past.

What are your favourite investments/stocks and why?
I don't have bank stocks – I had plenty before. I like Qube, which I've been invested in for a long time.

As far as a de facto index fund goes, I like Argo Investments. I prefer listed equities i.e. a listed investment company, rather than an exchange traded fund.

For foreign investments I also used a listed vehicle – Platinum Capital rather than Platinum Asset Management. Until recently I had Magellan. I thought [Magellan] had had a very strong run. I had it from the early start.

What investments do you have outside of superannuation?
I have my own home and I have a mortgaged investment property.

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

Is there anything else you would like to tell us about your SMSF?
I've enjoyed running my fund.

There is nothing particularly mysterious about an SMSF. It's really like any other investment. The essential difference is favourable taxation treatment.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In just two days of trading, there have been broker actions on only five stocks, including the Woolworths upgrade by UBS, which we covered on Tuesday. Analysts are certainly taking advantage of the shorter week for a break.

In the good books

Credit Suisse upgraded Alacer Gold (AQG) to Outperform from Underperform. Ahead of the March quarter production numbers, the broker has adjusted sulphide operating expectations, forecasting a higher start-up grade. There are no changes to near-term earnings but a 2017/2018 uplift drives a valuation change.

Alacer Gold (AQG)

Following its March quarterly activities report, Mount Gibson Iron (MGX) was upgraded to Outperform from Neutral by both Credit Suisse and Macquarie and to Add from Hold by CIMB Securities. Third-quarter production was behind CIMB's estimates but the company remains confident it can deliver 9.5mt for FY14. A positive update on infill drilling and outcomes from optimisation studies offers potential catalysts for the stock. Credit Suisse believes Mount Gibson has been steadily overcoming short mine life through exploration and minor acquisitions. Mt Gibson's production, sales, product mix, realised prices and cash flow all disappointed Macquarie. But the broker has upgraded to Outperform based on strong expectations for June quarter production. FY14 guidance has been maintained.

Mount Gibson Iron (MGX)

In the not-so-good books

UBS downgraded Charter Hall Group (CHC) to Neutral from Buy on the back of strong price growth, which means it is approaching full valuation. Charter Hall has outperformed both the A-REIT and broader equities market by around 8% over the past quarter.

Charter Hall Group (CHC)

The above was compiled from reports on FNArena, 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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Segregation anxiety – how to split assets

by Tony Negline

Segregation of pension and non-pension assets is an important issue for all SMSFs that pay pensions.

Asset segregation can have some useful benefits but only in certain circumstances. In the majority of cases, segregation serves no practical purpose. Over the coming years, this may change as different and much longer work patterns become more widespread.

The Tax Office has just released a Tax Determination on when a bank account will be considered to be a separate asset and hence satisfy the requirement for asset segregation purposes, so that your pension assets will remain tax-free.

It notes that some banks – and similar institutions – offer accounts that contain "sub-accounts". You can use a single bank account and place all pension transactions into one sub-account, even if other sub-accounts aren't used to pay pensions.

In other words, these sub-accounts are seen as bank accounts in their own right (however they might not have a separate bank account number).

The end result here is that you can have segregated pension assets but do not need to have separate bank accounts, as long as your bank has the right sort of service. This will help to keep your costs lower.

You can achieve a similar result using your fund's accounting software.

Splittable income

When using a single bank account that contains sub-accounts, your super fund will sometimes receive income that needs to be shared between the various sub-accounts. (A good example is the interest earned on the bank account's deposits.)

The correct amount of this income needs to be allocated to each sub-account. The ATO says this re-allocation needs to occur within a "reasonable time".

All the examples in the Tax Determination point to action being taken promptly to allocate expenses or split income appropriately or fix errors quite quickly.

Although not explicitly defined, it would seem that the ATO doesn't want you to muck around and forget. The larger the amount, the sooner it would need to be corrected.

Incorrect allocations to sub-accounts

In a similar way to income being allocated to various sub-accounts, incorrect allocations need to be adjusted. Again, this must occur within a "reasonable time."

A good example of this is super contributions being accidentally allocated to a "pension sub-account".

When this occurs, the contribution might earn interest whilst in the pension sub-account. Both the contribution and the relevant interest earned (and potentially associated costs) need to be moved from that sub-account to the non-pension sub-account.

Splittable expenses

The use of a single bank account with sub-accounts will see various expenses having to be paid that are shared by the various sub-accounts. For example, financial accounting fees, ATO regulatory fees and audit fees.

Again, the appropriate portion of an expense must be allocated to each sub-account within a reasonable time.

Sub-accounts in your fund's accounting software

As noted, you can use your fund's accounting software to create appropriate sub-accounts. This can be more complicated because your fund's administrators and bookkeepers would need to work out which income and expenses need to be allocated.

Most large funds would use this approach because they have highly detailed accounting and administration software. They also have a large team of people allocating money and transactions correctly to each particular member and investment option.
I'm not convinced this would be an efficient approach for SMSFs, especially given the small number of transactions that typically occur.

I would expect using a bank's sub-accounts infrastructure would provide a more accurate and cost effective solution for SMSFs.

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Why you need to target a return of 8% to 11%

by Ron Bewley

Perhaps the simplest way to get exposure to Australian equities is to buy an Exchange Traded Fund (ETF), such as STW from State Street that is a mimic of the S&P/ASX 200. Alternatively, there are index-tracking managed funds such as those provided by Vanguard Fees are very low on these products compared to an actively managed fund that seeks to outperform the benchmark index. So what return should an investor expect?

The long run

In any given year, it is very hard to predict the return on the index. However, over longer periods, the task gets a bit easier. Since data on the ASX 200 only goes back to 1992, I have analysed data on the All Ordinaries in Table 1 back to 1962. The All Ordinaries comprises the ASX 200 plus about 300 smaller capitalised stocks listed on the same exchange. In the left hand panel of Table 1, I have averaged the capital gains (that is excluding dividends) in periods all ending in December 2013 but with differing lengths of data.

Table 1: Average historical growth rates on the All Ordinaries

Time interval	Growth	Time interval	Growth
1963 - 2013	6.3%	1962 - 2012	6.8%
1968 - 2013	5.9%	1967 - 2012	6.6%
1973 - 2013	7.5%	1972 - 2012	6.5%
1978 - 2013	7.9%	1977 - 2012	8.4%
1983 - 2013	6.7%	1982 - 2012	8.3%
1988 - 2013	5.2%	1987 - 2012	5.8%
1993 - 2013	4.7%	1992 - 2012	6.4%
1998 - 2013	4.4%	1997 - 2012	4.9%
2003 - 2013	4.9%	2002 - 2012	5.7%
2008 - 2013	8.1%	2007 - 2012	-4.3%

Source: *Wren research*

Starting with the latest five-year period, the average capital gain was 8.1% per annum. That figure is higher than in many five-year periods because it so happens the market was near the bottom of the cycle in December 2013 and near a five-year high in December 2013. Adding previous blocks of five years of data, makes the average fall to around 5% per annum until the 1983-1988 period is included. Prior to that period, the average jumps back up. So which average should be used as a guide?

In devising my own investment strategies, I use 5% as a rough base for a long-run return and supplement my 12-month-ahead view with my broker-based forecasts that I have discussed on this site and I post my forecasts on a weekly basis.

Dividends supplement the capital gains on the index. The dividend stream (in dollars) is typically smoother than the price index so that the ratio – or dividend yield – is more variable than the income stream. A reasonable historical average yield is around 4.5% pa.

Franking credits do change over time but 70% – 80% is a rough guide many use for predicting what are known as grossed-up dividends (that is, grossed up for franking credits) on the ASX 200. So my conservative (70% franking) estimate for a grossed-up yield for the index is 4.5% x (1 + 0.7 x 3/7) = 4.5% x 1.3 = 5.85%. For my personal calculations, I use 5% capital gains and 6% (grossed-up) yield – or 11% total return – as my guide for long-run expectations.

Don't forget inflation

Investors should always adjust expectations for tax and inflation. For zero-tax payers, only inflation needs to be considered. Inflation was rampant in the 1970s and 1980s but has been contained by Reserve Bank (RBA) intervention since then. If the RBA continues to be as successful, a forecast of 2.5% or 3% per

annum is a reasonable annual rate of inflation going forward. The inflation rate only needs to be subtracted from the capital gain as the yield is itself a percentage of the stock price. So, for a zero-tax universe I use what is called a 'real' (or inflation-adjusted) capital-gains forecast of 2.5% per annum and a yield of 6% per annum making a total (grossed up) return of 8.5% per annum. While inflation at 2.5% might seem small enough to ignore, it does mount up over time and so it should be accounted for.

For investors no longer contributing to super but drawing down 6% or less in a pension, the capital might not need to be touched and it might grow at around the real rate of 2.5% per annum. More importantly, not needing to draw down capital during bear markets is really important as any part which is drawn down cannot 'bounce back' if the market subsequently bounces back.

My new portfolio

I am in the process of creating a new yield-type portfolio for myself that seeks to make capital gains as well as produce a high yield. My current forecast from that prototype model is 6% yield (or 8% grossed up) with the prospects of a capital gain for the next 12 months of 9%. Of course, my gains' forecast could well be off track – particularly if there is another big global macro event such as those experienced in the last few years – but I believe there is a good chance of getting a grossed-up yield near 8%. If I draw down only 5% and a bear market strikes, I can reinvest that excess 3% at possibly a market low or I can keep it in cash to supplement the next year's pension drawdown.

Since it is my opinion that I think the market will be soft in the April – June quarter, I am not in a rush to rebalance and possibly make a mistake. It is my savings that are at stake.

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Time for a cleanout and off-market transfers

by Questions of the Week

Question: *Charlie Aitken in the latest Switzer Super Report advises us before May to sell off high PE stocks such as Ramsay RHC, Orora ORA, CSL, which are in your investment portfolios, plus a few others that I had regarded as pretty safe such as Seek, Navitas, G8 Education and others. What are you planning to do with your growth and income portfolios? Will you be making any changes? I am finding it pretty hard this year to know what to do, so I value your advice.*

Answer (By Paul Rickard): I absolutely agree with Charlie that some of the stocks he mentioned are way over priced and very vulnerable to valuation change, and that for the market to advance, it needs to be led by the top 20 stocks.

We are in 100% agreement, that is why I have been warning about stocks like Xero for some weeks – and our portfolios (particularly the income portfolio) are overweight top 20 stocks.

Orora is not one of the stocks mentioned by Charlie – he included CSL, Ramsay, Brambles and Amcor. I am not too worried about the valuations of these stocks – I am more concerned about the Australian dollar, as each of these stocks was included in part to position for a weaker Australian dollar. So far, this is not happening.

At the moment, I am not planning to make any changes to the portfolio. However, it is constantly under review and if we do propose to make some changes, we will let you know.

Question 2: *I have been purchasing a small portfolio of shares [16 companies] – $25,000 for my grandchildren. I have purchased these in my own name. My husband and I have a family trust that currently “owns” a capital loss that will not be used in the short term. I want to transfer the shares to the family trust without incurring a sizable fee; do you have any suggestions as to what I can do at minimum cost please?*

Answer 2 (By Paul Rickard): You will need to do an ‘off-market’ transfer for each share. Most brokers will process these transactions for you for a fee – typically around $55 per share. Also, check directly with the main registries (Computershare and Link Market Services) to see whether they offer the service – and at what price.

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