Switzer Super Report

Issue 283, 1 May 2014

Stepping off the gas

The banks might be reporting stellar results – ANZ today said cash earnings for the six months to the end of March were up 11% to $3.5 billion – but the market isn't that impressed and neither are the brokers. Charlie is downgrading the sector to neutral, after most of the banks have hit his targets, six months ahead of schedule.

But that doesn't mean you should sell them. I'm certainly not! Dividends are still strong and I'll be holding my banks for some time to come.

Also in the *Report* today, we have Part 2 of our *SSR* investigation into takeover targets by Tony Featherstone. Today we have another six companies including Wotif.com.au, NRW Holdings and LIC Westoz.

Sincerely,

Peter

Peter Switzer

Inside this Issue

SSR takeover targets 2 – Wotif, NRW and Westoz
by Tony Featherstone
06

02 **Australian banks – downgrading sector to neutral**
by Charlie Aitken
Stepping off the gas

05 **Buy, Sell, Hold – what the brokers say**
by Staff Reporter
CBA upgraded

06 **SSR takeover targets 2 – Wotif, NRW and Westoz**
by Tony Featherstone
More heat

09 **Add some fuel to your portfolio with Rolls-Royce**
by Alastair Macleod
Up, up and away

11 **Don't feud over family assets**
by Tony Negline
Get the plan right

13 **FOX mystery and Ron's yield-type portfolio**
by Questions of the Week
Delisting changes

switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
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Australian banks - downgrading sector to neutral

by Charlie Aitken

Firstly, I have to say I totally agree with Peter Switzer that this so called “debt levy” is not the way forward. From my perspective of writing investment strategy, the biggest risk from introducing unexpected new taxes is actually what foreign investors think. In my view, there is nothing surer than foreign investors applying a higher risk premium to Australian equities to reflect the uncertainty new taxes create. This is EXACTLY what happened when the MRRT and carbon taxes were introduced.

Tax risk premium

This is relevant to what I am writing below on the Australian banking sector, which would see short-term foreign asset allocation selling pressure if any new unexpected tax was introduced. Nobody likes political or regulatory risk, but it seems there is some growing risk in Australia ahead of this Federal Budget.

Interestingly, both the banks, as GDP proxies, and listed discretionary retailers have fallen in price over the last two days since the speculation of the “debt levy” increased.

With the ASX200 trading near a six-year high, I am going to continue to look top down at our Australian equity strategy and consider where we do, and don’t, want more exposure, as pure absolute value becomes significantly harder to find.

Ahead of schedule

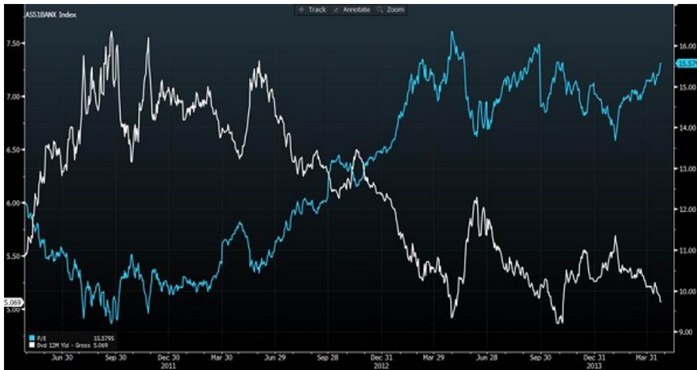
With three of the big four Australian banks hitting our top down driven FY14 price targets of 5.00% fully franked (yield inverted to create share price targets), I thought it was worth broadening out that sector discussion today.

At the top down macro level, I set those FY14 5.00% fully-franked yield-based share price targets on the view they would be hit in the lead up to the full-year bank reporting/dividend season in August through November. As it turns out, they have been hit six months ahead of that estimated timing, as we approach the FY14 interim reporting/dividend season.

No doubt, as we have written in these notes regularly, some of the demand for reliable/growing/fully-franked Australian dividend streams is structural (ageing population, legislated increases in compulsory super contributions, taxation system etc.) and some is cyclical (ultra-low cash rates). Below is a 2.5-year chart of the RBA cash rate target versus the ASX Banks Index to illustrate the cyclical dividend demand element. The cash rate basically halved and the bank sector doubled.

Those structural and cyclical dividend demand forces, when combined with benign bad and doubtful debts (BDD) in the banking sector (EPS/DPS upgrades), have driven pretty much the perfect upside/re-rating storm for Australian banks. Banks have added P/E, PEG and price to book ahead of those EPS growth rates, with the share price re-rating really being an inverse one to prospective fully-franked dividend streams.

The chart below illustrates that P/E versus yield inverse relationship by graphing the AS51 Bank Index P/E versus the index dividend yield. P/E is up by 45%, dividend yield down by 33% over that period.



To my way of observing Australian banks, it seems the trading range in major banks is basically a 6.00% to 5.00% fully franked prospective dividend yield range, assuming cash rates are steady at 2.50%. That 6.00% to 5.00% trading range has worked well in recent times and obviously we are now at the top end of the yield-based trading range. We are also at the bottom of the cash rate setting range.

That is understandable as the sector is about to confirm record earnings and dividends, while at the same time, recent CPI data pushed back the timing of domestic rate rise expectations.

Not bearish on banks

But my point today is, I don't expect the 5.00% fully franked prospective yield to be bid down any further. Cash rates at 2.50% (with upside risks) and grossed up major bank yields at 7.14% (5.00%ff) suggests an equity yield risk premium of under 5.00% versus cash and I would be very surprised if that got bid down any further from here.

Now I don't want anyone reading these notes to think *"Aitken has gone bearish on banks"*. Far from it: what I am doing today is toning down our top down 2.5-year sector bullishness to a more neutral stance. I broadly think, in the true sense, the Australian banking sector is now a "hold" rather than the outright "buy" we have recommended for that entire period. I expect banks to track their physical dividend growth from here, not outpace it. This is particularly so as cash rates eventually rise.

At these share price levels and considering what large parts of portfolios banks have become, I simply believe I don't need to commit more fresh money to the sector or even reinvest dividends.

I don't want to sell the banks. I just don't think we need more of them up here. I am happy to collect the dividend streams, but I tend to want to reinvest those dividend streams elsewhere in multi-year financial laggards (IAG, AMP, CPU, CGF etc.), Telstra (5.65% fully franked), Woolworths (WOW) or even park a bit of it back in the bank in the form of cash and wait for better value to emerge over the next few months.

No doubt, however, for faster tactical money, there might be a quick downside trade in Australian banks once they are ex-dividend. This is particularly so if that ex-dividend period coincides with a broader period of weakness in global equity indices. Australian banks do tend to be a little friendless ex-dividend/ex-franking credits and particularly so if they are not neutralising their DRPs on market. Note the Bank of Queensland (BOQ) example recently ex-dividend.

Nobody has been more consistently bullish Australian banks over the last few years than us, both top down and bottom up. What I am doing today, top down, is simply "stepping off the gas" in the sector a notch to reflect the P/E, PEG price to book and dividend yield re-rating we have been on the right side of. That has all played out how we forecast, but as I mention above, about six months **AHEAD** of when we forecast.

To me, **the major Australian banks are now more accurately described as "fair value" for what we know today and on that basis I am downgrading our top down view of the sector to *neutral*** for the first time in 2.5 years.

Below is the ASX Bank Accumulation Index (XFJ) just to remind you where we have come from/ to over the last 2.5 years.

Go Australia, Charlie

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Banks were front and centre of broker activity this week as we move into their interim reporting season. Like Charlie, many brokers now think they are fair valued and other analysts are moving around their preferred pick amongst the big four.

In the good books

BA–Merrill Lynch has upgraded CBA to Neutral from Underperform. BA-ML is joining the experts in the local share market who've started to re-assess Australian banks following yet another period of market outperformance. The upgrade sees CBA turning into BA-ML's most preferred major bank on the back of an improved outlook for capital and returns.

Resmed has been upgraded to Buy from Hold by Deutsche Bank and to Add from Hold by CIMB Securities. Third quarter results were in line with CIMB's expectations. Price adjustments supported volumes but CIMB notes this was at the expense of margins. Deutsche Bank believes a return to more normal pricing and demand conditions is likely after US competitive bidding mark 2, and sales growth in FY15 should also be boosted by the new product range.

In the not so good books

BA-Merrill Lynch has downgraded Westpac to Underperform from Neutral and says Westpac has simply become over-priced, otherwise known as too expensive. The analysts have lifted estimates on the back of recent housing strength and lower bad debts, but it's insufficient to justify the present share price. Plus the analysts see looming regulatory risks from the 13 May Budget, D-SIB and the Financial Services Inquiry.

Citi has also downgraded Westpac to Neutral from Buy. The broker considers Westpac is the best positioned of the major banks for revised target ranges but special dividends are unlikely for now. The $35.75 target is maintained.

BA-Merrill Lynch has downgraded NAB to Neutral from Buy and Citi has downgraded to Sell from Neutral. BA-ML believes that selling the UK assets is not going to happen this year and thus investors' focus will shift to the operational side of NAB and it's not particularly pretty.

Citi says the banks have outperformed the market over the last three months as a sector but NAB has performed more in line. The rating is reduced because the broker expects poor first half revenue and underlying profit growth amidst lacklustre demand for business lending.

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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SSR takeover targets 2 – Wotif, NRW and Westoz

by Tony Featherstone

The takeover approach for Goodman Fielder this week and the $800 million merger of Roc Oil and Horizon Oil is further proof that mergers and acquisitions activity is quickening.

In Part 1 of our SSR investigation last week, the *Switzer Super Report* predicted a sharp increase in M&A activity in 2014, thanks to improving business confidence, low financing costs, and the need for companies to grow by acquisition.

Add another factor: CEO envy. Watching their peers do big deals will surely get rival CEOs pushing their boards to approve a high-profile takeover – and more boards giving the green light when they see others do the same. Never underestimate the human factor in M&A.

I nominated six possible takeover targets last week: Perseus Mining, Reckon Group, Automotive Holdings Group, iiNet, NIB Holdings and iCar Asia.

Six more stocks are added this week. Several should be considered speculative, as they range from minerals explorers and producers to mining-services companies, biotech firms and even a Listed Investment Company (LIC) for good measure. With some of those sectors under immense pressure, rapid consolidation through takeovers seems a good bet in 2014.

Here are the six stocks:

1. Wotif.com Holdings (WTF)

The former internet star has fallen from a 52-week high of $5.63 to $2.69; reportedly appointed Goldman Sachs, presumably as a precautionary move to advise on any takeover approach; and received an ASX query about its price fall.

Wotif.com is an interesting target. It has an excellent position in the Australian online travel industry, a prominent brand, and a large user base. Although travel margins are under pressure, online travel has stellar long-term potential as people book bigger trips via the net.

Wotif.com looks a good fit for some large US travel companies, and at its current price is reasonably valued – which is a lot more than you can say for most internet stocks.

Also, the “network effect” of a prominent website – where more users attract advertisers, and vice versa – is usually easier for cashed-up predators to buy than build. Like other successful internet businesses, Wotif.com has high returns on capital and high operating margins.

Wotif.com will be a prime target if its price decline continues. Its largest shareholder owns 20%, according to Morningstar data, meaning the register is sufficiently open to facilitate a takeover, possibly a bidding war, if a few offshore players slug it out for one of the market’s better-quality internet companies.

2. NRW Holdings (NWH)

Rationalisation in Australia’s mining-services sector is certain as falling commodity prices and the slowing mining investment boom crunch service providers. The only question is whether cashed-up players buy assets from the receivers rather than on-market.

I wrote last week that investors should approach takeover targets with a mindset of finding quality, undervalued companies in their own right, and treating any takeover as a bonus rather than the sole reason for investing.

NRW Holdings is a good example. It has produced a solid ROE over a long period, has a strong market position, and a healthy balance sheet. It might well be an acquirer, and looks undervalued after falling from a 52-week high of $1.62 to $1.12.

NRW has a reasonably open share register, with stock held by several institutions, and $174 million in cash and short-term investments, versus a market capitalisation of $312 million. The mining-services sector has immense challenges and investors need to tread warily, sticking to better-quality stocks, such as Monadelphous Group and NRW.

My guess is cashed-up predators might wait longer before striking, given this sector has much more pain – and lower asset values – ahead. NRW would be a smart acquisition.

3. Westoz Investment Company (WIC)

There is huge interest in LICs this year as big-name fund managers, such as PM Capital, launch LIC IPOs, and as established funds raise capital in well-supported offers.

The boom in SMSFs, reforms that banned conflicted sales commissions for financial advisers, and the chase for dividend yield, have put LICs on the map. Many now trade at a premium to their pre-tax Net Tangible Assets (NTA) after persistent discounts in recent years.

Expect some sector consolidation as better-performing LICs take over those trading at unrealistic discounts to NTA, to achieve sufficient scale and liquidity, and get on the radar of larger financial-planning groups.

Westoz traded at an 11% discount to NTA – meaning you could purchase its assets for 11% less than they were worth – at 31 March 2014, ASX data shows. Its portfolio returns have been patchy in the last three years, probably because of the downturn in small resource stocks, and the fund's high cash weighting last year.

The 2013 annual report of Westoz, a subsidiary of Perth financial-services group Euroz, shows two shareholders owning a combined 30% and remaining shares spread across the top 20 investors.

A good judge of small stocks, WAM Capital, has Westoz as a top 10 portfolio holding. Regardless of takeover, Westoz looks undervalued compared with several similar-sized LICs.

4. Tiger Resources (TGS)

The emerging copper producer has a key drawback for takeover: its location. A prospective bidder would need to take on the sovereign risk of operating in the Democratic Republic of Congo. Doing so would gain exposure to our market's fourth-largest and lowest-cost copper producer, at a sharply lower price.

Tiger has fallen from 61 cents in 2011 to 33 cents, despite significant "de-risking" of its operations, having moved from explorer to producer. Unlike many emerging mining stocks, Tiger does not have the headwind of needing to raise hundreds of millions of dollars to get to production – a turnoff in a capital-constrained market for resource companies.

It produced 41,255 tonnes of copper-in-concentrate in 2013 – 4,000 tonnes above earlier guidance – and is moving towards 50,000 tonnes of high-grade copper annually. Tiger says it has more than $1 billion of contained copper in its stockpiles. The stock is capitalised at $277 million, and Tiger estimates operating cash flow of $114 million in 2014.

Its share register is open: the largest investor, Antares Equities, has 7.2%, and BlackRock has 4.7%. Well-performed small-cap managers, such as Contango Asset Management and Acorn Capital, are on the share register. There is unlocked value in Tiger, but African copper exposure comes with high risk.

5. Gryphon Minerals (GRY)

Still on Africa, Gryphon Minerals is another former star gold explorer that has hit tough times on the market. From $2 in early 2011, Gryphon has tumbled to 13.5 cents in a "perfect storm" of falling gold prices, rising sovereign risk in Africa, and concerns about capital-hungry explorers.

For all its market woes, Gryphon still has a 3.6 million

ounce resource at its Banfora Gold Project in Burkina Faso in West Africa, which complies with the Joint Ore Reserves (JORC) Code. And plenty of funds by junior miner standards: $48 million in cash and short-term investments at January 2014, which compares with its $56 million market capitalisation. The market clearly doubts Gryphon will ever get to production.

Gryphon has moved to a low-cost, start-up heap leach operation that it believes will provide a faster payback on $79 million in capital costs, and get it to production by first-quarter 2016.

Gryphon has looked cheap for the past two years, and keeps getting cheaper. It must be on the radar of North American gold producers, given its low-cost exposure to a large resource. The share register is conducive to takeover with no dominant investor.

Gryphon is highly speculative. But with much of its market capitalisation accounted for in cash and short-term investments, it looks a reasonable bet for a bigger player that can ride out a lower gold price and capitalise when the precious metal eventually turns higher.

6. Reva Medical Inc. (RVA)

High-quality, undervalued life science companies could become takeover targets as the current global rout in biotech stocks runs its course. Medical device maker Reva Medical is an interesting contender. It raised $85 million in 2010 and attracted a strong board of directors for a company its size. The $1.10 issued securities are now 16 cents after commercialisation delays and changes of product focus.

Reva is developing a bioresorbable coronary stent to restore arterial blood flow to the heart. Unlike conventional metal stents that act as permanent scaffolding within arteries, Reva's scaffold stents are designed to be absorbed by the body after the healing process. Permanent scaffolds can cause long-term complications for some patients and are not needed when the artery heals.

Judging by its share price, the market has lost patience with Reva and its management. But for all its problems, it still has a high-value portfolio of intellectual property, is targeting a multi-billion-dollar global market, and expects to be in production with an upgraded technology in mid-2016.

A global rival might see Reva's $52 million market capitalisation as a cheap entry point to snap up its bank of patents. It had US$19.2 million in cash at 31 December 2013, and an open share register.

Reva will need a capital injection to get its upgraded product, the Fantom Skaffold, to market, so acquisition by a larger, better-funded rival makes sense at the current share price.

- Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply stock recommendations. All prices and analysis at 30 April 2014.

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Add some fuel to your portfolio with Rolls-Royce

by Alastair Macleod

How long have you held the stock?

Since February 2014. Rolls-Royce, which is listed on the London Stock Exchange (RR:LSE), is down 25% from its highs after issuing a profit warning in February. We used this as an opportunity to take exposure.

What do you like about it?

We encounter few industrial businesses as high a quality as Rolls-Royce's civil aviation business, the second-largest manufacturer of aircraft engines globally.

A combination of long-term servicing agreements, a 50% duopoly market in wide-body jets, and exposure to secular passenger growth, assist in continually driving above-average economic returns through the cycle.

(Note Rolls-Royce does not manufacture motor vehicles as the brand is now owned by BMW.)

How is it better than its competitors?

Rolls-Royce employs a unique sales model in its civil aviation business that differentiates it from its competitors, whereby 90% of its high-thrust engines are sold as part of a 10-15 year servicing agreement.

The beauty of this model is that it locks in the lucrative after-market parts business, which typically posts margins significantly higher than the original jet engine sale. This results in Rolls-Royce often servicing most of their own engines at a given airport (as opposed to the airline operator), which drives significant economies of scale.

What do you like about its management?

We like the fact that Rolls-Royce's management is more interested in generating returns for shareholders, than outright growth. This is reflected in their recent decision to exit the narrow-body jet market, which, while a larger market, does not share the same duopoly market conditions that wide-body jets exhibit (and hence better returns).

What is your target price on Rolls-Royce?

We value Rolls-Royce at £12.70 a share, although we expect this valuation to grow over time as their installed fleet of engines grows. We apply a contrarian value approach to investing, and believe better investments are made when stocks are unpopular or out of favour.

When we analysed the reasons for the profit warning in February this year, the issues appear contained within their defence business, which is significantly smaller than their civil aviation business, and will get relatively smaller as the civil business grows.

In our view, it appears a classic case of the market over-penalising a stock for a small issue, and missing the longer-term attractions of the core operating business, civil aviation.

At what point would you sell it?

Should the stock approach our assessment of intrinsic value of £12.70 in the next 12 months, we would start to exit the stock. However, as we expect

the Trent engine delivery programme to double in the next few years, and hence as these cash-flows become more certain over time, our exit price will likely increase alongside the growth in intrinsic value.

Is it a liquid stock?

The stock is highly liquid with a market cap of £20 billion.

Where do you see the value?

In many respects, the engine manufacturer on an aircraft is the sweet spot of the aeronautical economic food chain. Airlines are highly capital-intensive, competitive, and fortunate to make mid-single digit profit margins.

Aircraft manufacturers, such as Boeing and Airbus, also operate in a duopoly market, but do not require or enjoy the same levels of aftermarket service.

Rolls-Royce, however, is able to lock in this high-margin profit source on a multi-year basis.

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Don't feud over family assets

by Tony Negline

In a salutatory lesson on how family feuds can destroy everything, last December I wrote about an important Victorian Supreme Court case involving an SMSF death benefit and the validity of a Binding Death Benefit Nomination (BDBN). But there have been further developments in that same case that only highlight the importance of making sure all parties are happy with any estate planning measures you take.

The case

You can read that article here: but here is the outline of the case to recap.

Maxwell Morris died in late February 2010. At the time of his death, Morris was married to Patricia Morris, his second wife. His daughters – the executrices of his estate – valued his net assets at over $1.8 million.

Maxwell and Patricia were the only trustees and members of the Morris Family Superannuation Fund, an SMSF, which had been established in August 2005. There were no other members or trustees of this fund.

At 30 June 2010, the fund had assets of over $1.3 million. Patricia's interest in these assets was about $450,000. The balance belonged to Mr Morris.

About $1 million of Maxwell's estate was outside his SMSF. The vast majority of this was to be left to Patricia. For some assets (such as their former family home) she was given a life interest.

Since December 2005, they had both received super pensions.

In March 2008, Mr Morris completed a binding death benefit nomination (BDBN) with **all** his super benefits to be paid to Susan Wooster and Kerry Smoel, his two daughters from his first marriage.

Other parties in the case disagreed about the validity of the BDBN but the Supreme Court told the trustee to pay just over $600,000 of Maxwell's super benefit by 16 April 2013. And then in November 2013, the Court decided that the remainder of the death benefit, plus interest for late payment, could be paid out of the super fund's assets (even if this meant that Patricia's own super account would be reduced).

It also said that **all** costs for the case would be paid by the super fund's trustee and any further money owing to them would be paid by Mrs Morris personally. In other words Mrs Morris potentially lost a substantial sum of money.

Subsequent developments

Since the super death benefit case was handed down in November and since my original article appeared, there have been some further developments.

Patricia Morris sued the trustees of Max's deceased estate – Kerry Smoel and Susan Wooster.

However, Patricia Morris died in September 2013 and the case was finalised by the executor of her estate.

And as her estate was insolvent (prior to this event her estate was estimated to be worth approximately $250,000), the daughters won't receive money they were unable to recover from the Morris Family Super Fund and the Court had awarded to them in the super death benefit case.

The case notes say that the value of Maxwell's estate had fallen to under $200,000 – a drop of almost 90% of its original value.

The judge in this particular case said that, “Mrs Morris’ character and conduct are evidenced in her fierce pursuit of losing litigation against the estate of the deceased and in the superannuation proceeding. She held a stubborn belief in what she considered to be her entitlements, as well as the correctness of her stand, no matter the ultimate financial or emotional cost was to her, to the estate of the deceased or to the defendants … the economic consequences of the positions … has been disastrous, both legally and financially, for her and the estate of the deceased.”

Ultimately, the judge, Justice McMillan, decided that Mrs Morris’ claim should be rejected because the deceased had made adequate provision for her via the assets in the family trust, her superannuation pension and other benefits, such as a life interest in two properties. All that money however was lost due to litigation. The costs she and others incurred were “out of all proportion to any likely gains”.

I’m an outsider and have no knowledge of the family dynamics. But based on the published Court decisions, it would seem that Maxwell Morris made good provision for all his family and their divergent interests. Sadly, most of his efforts and the money he put together seems to have gone to lawyers and other creditors.

Here is a salutary lesson of how your superannuation and your other wealth can be lost.

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FOX mystery and Ron's yield-type portfolio

by Questions of the Week

Question: With the pending delisting of Twenty-First Century Fox (FOX) from the ASX, I would have thought that the share price would come under some selling pressure as it gets closer to the delisted date, yet the stock price is going up.Is there some (unknown) reason for this?

Answer (By Paul Rickard): I think there may be other factors at play that are more important, such as the operating performance of the company. FOX is a global company – most of its shareholders (including the Murdoch family) are domiciled in the US, and as FOX is "dual listed' on both the NASDAQ and ASX, there is arbitrage opportunity if the price gap opens up too much.

As a US company that reports in US dollars, currency changes are also going to impact the effective Australian dollar share price. Another factor that is possibly impacting the price of B class shares is that FOX is currently undertaking an on-market buyback.

Question 2: I have been following Ron Bewley's *How to build a portfolio* with great interest. In his latest article, he mentions he is building a new "yield-type portfolio". Any chance he will inform us of the specific stocks he includes in it? Weighted if possible.

Answer 2 (By Ron Bewley): Thanks for you enquiry. I am still testing various aspects of the software I am writing to generate the portfolios and then monitor them.

I need to be able to produce the portfolios with minimal human input to minimise the possibilities of error. I am close but not yet there.

I also have to check with legal what I am allowed to publish and with what disclaimers. I am shooting for being ready by July 1.

Each month I let the system rip to see if it comes up with any anomalies or surprises and cross check with hand calculations. I have found the results to date really promising so I'm keeping going!

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