Switzer Super Report

Issue 289, 22 May 2014

Hang in there

Things have been cooling off in the market a little over the past few weeks, and we could even be in for a little bit of a correction over the next couple of months, according to Charlie Aitken.

But don't panic! Charlie, like me, knows that any dips right now are pure buying opportunities and the long-term view is for the ASX200 to keep powering towards 6000. Today he outlines all the things we need to happen for it to get there.

Also in the *Switzer Super Report* today, our *Fundie's Favourite* is on the unloved Lend Lease, which has certainly proved a prudent play for Dalton Nicol Reid, Ron Bewley likes Rio and US exposure for reinvesting his dividends and in *Short 'n' Sweet*, we re-examine our bank view and alternatives.

Sincerely,

Peter Switzer

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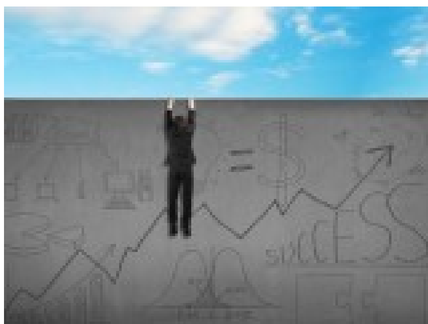

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Be ready to strike when the price is right

by Charlie Aitken

In terms of tactical (i.e. short-term) equity strategy, I remain cautious on Australian equities, feeling a May through July pullback to the 5100 to 5200 range is likely and, potentially, already underway.

We have tried to position investors for this pullback via warning on high growth momentum names, downgrading the bank sector to hold, and downgrading many individual stock recommendations from buy to hold.

I feel the falling iron ore price, weak post budget consumer confidence, domestic data fade, earnings downgrades, falling bond yields and the heavyweight bank sector being ex-dividend will all be factors driving the pullback.

Valuation correction

Around 5500 points I was genuinely struggling to find value. That meant I was struggling to find stocks that I would be prepared to physically buy at the current price. In my career whenever that has happened it has been followed by a pullback, which produced clear and present value again.

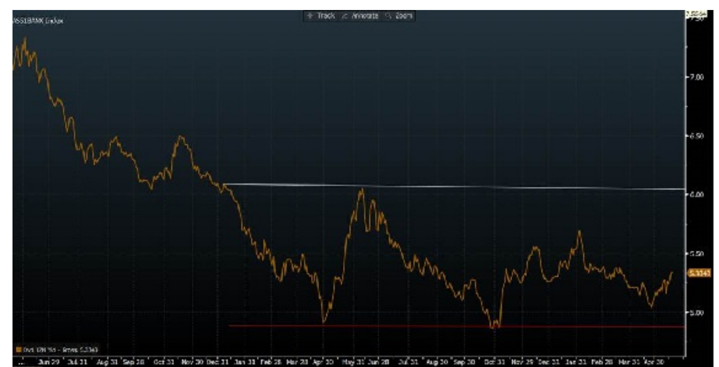
That is all I think is happening or likely to happen in Australian equities: **a short-term valuation correction, not the end of the bull market**.

This valuation correction started in high growth/GAAP stocks and has spread. For it to be the true end of the bull market, I would have to believe that domestic and global interest rates are about to rise sharply. **I absolutely do not think that is about to happen**, particularly in Australia, where in a post-Budget world, interest rates are now likely to remain low for longer than was previously anticipated. This view can be confirmed in the flattening yield curves in Australia post the Budget.

But flattening yield curves are a double-edged sword. While they mean low cash rates for longer, they also mean GDP and, therefore, equity earnings growth will be weaker than previously forecast. I think the second part is what the equity market is dealing with now: lower expectations for FY15 earnings growth, based off slower GDP growth assumptions.

However, as that expectation tempering works its way through share prices, we must NOT lose sight of the fact that cash rates in Australia will stay at 2.50% for the foreseeable future. To me, that means that Australian equities will be broadly underpinned by yield support at a point and I think that point is in the 5100 to 5200 range, where the ASX200 dividend yield would be over 4.50%. That index yield also includes low dividend yield mining and industrial growth stocks, which masks the fact that, all things being equal in a pullback, the major banks would be yielding closer to 6.00% fully franked on FY15 estimates, which I think would provide a floor for the banking sector and the market overall.

You can see in the chart below, the ASX Banks Index (AS51 Banks) has been in a clearly defined 5.00% to 6.00% prospective dividend yield trading range since the RBA set the cash rate at the record low of 2.50%.



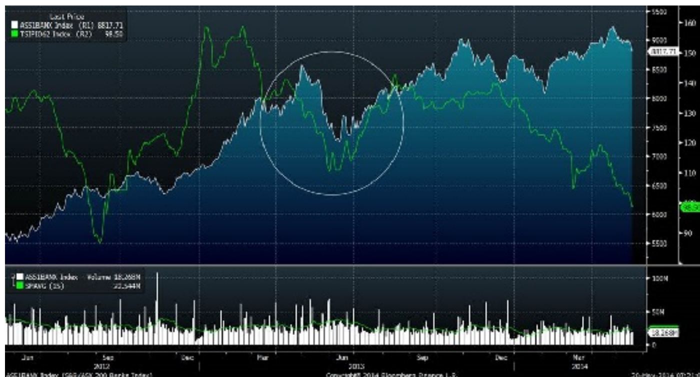
Bank outlook

Now there clearly is a chance Australian bank yields could move in the short-term to the higher end of that trading range. Of course, I would reverse our sector downgrade to neutral, back to buy if that happened.

The reason it could happen in the short-term is simple – seasonality and re-correlation to the iron ore price.

Below is a reminder of where the bank sector has come to/from over the last two years, overlaid by a chart of the spot 62%FE iron ore price (green line) and the Australian Bank Index (white line). That may well seem a ridiculous chart but in my offshore marketing, hedge funds have brought it up before and used it as a macro trading trigger. However, they have wised up, they now only seem to tactically short Australian banks ex-dividend for shortish periods (i.e. no divs or franking credits to worry about). This is right now and for the next few months (CBA cum div August). **Note in the same period last year (circled) with the overlay of falling spot iron ore prices, the ASX Bank Index fell -15.5% from peak to trough.**

ASX Bank Index vs. spot iron ore



Trigger finger

All I am really doing is tactically making sure I am positioned to deploy cash at better risk adjusted value prices in the right Australian stocks over the months ahead. To me, it's like being a sniper on the hill waiting for the perfect shot at your target. That does require a little patience, but first it requires you to have ammo (cash) to put in the magazine.

So while I think the ASX200 could pull back to the 5100 to 5200 level over the next few months, to me that is just another trading pullback and selective stock buying opportunity on the path to my long-term index target of 6000.

Funnily enough, the final 10% of an index rally is often harder than the first 40%, and that is exactly how this is working out, but as I say above, unless there is a clear change in global and domestic interest rate expectations sharply upwards, then I can see this pullback as being nothing more than a classic pullback in a bull market.

The 6000 mark

That then begs the question, what would we need to see to get the ASX200 to 6000 in the years ahead?

1. An extended period of ultra-low cash rates.
2. Banks lowering term deposit rates further.
3. Credit growth.
4. Regulatory stability.
5. The AUD/USD cross rate at 85 US cents.
6. Rising median house prices.
7. New home construction cycle.
8. New infrastructure construction cycle.
9. Consumer confidence rebounding.
10. Unemployment peaking.
11. Iron ore prices finding a level and stabilizing.
12. Earnings growth.
13. Consensus earnings upgrades.
14. Consensus dividend upgrades.
15. More large scale M&A.

The interesting thing is, all 15 of those points are likely over the medium-term and that is why I think what I am predicting in the short-term is nothing more than a short-term valuation correction, not the end of the Australian equity bull market as such.

On that basis, I am going to be looking for stock specific and sector opportunities at the right risk adjusted prices as the next few months unfold. We need to be patient and disciplined, but ready to strike when the price is right. You will be the first to know when I pull the trigger!

Go Australia, Charlie.

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

This week, broker activity was dominated by potential merger and acquisition activity and speculation. There was the 14.1% stake in Duet Group that was acquired by Spark Infrastructure and the proposed merger between IOOF and SFG Australia. KKR's announced bid for Treasury Wine Estates also prompted both an upgrade and a downgrade.

In the good books

Credit Suisse upgraded ASX Limited to Neutral from Underperform. The valuation is now undemanding and, while there is some scope for further earnings upside, the stock offers less earnings volatility than the broader financial sector, along with a 5.4% dividend yield. Hence, ASX is a relative safe haven investment.

Macquarie upgraded Bendigo and Adelaide Bank (BEN) to Neutral from Underperform. The broker has reviewed its valuation of Bendelaide following the acquisition of RFC Vic. The acquisition demonstrates BEN's M&A discipline, something the broker suggests is "sorely lacking" among peers.

Duet Group (DUE) was upgraded to Neutral from Underweight by JP Morgan and to Outperform from Neutral by Macquarie. Spark Infrastructure (SKI) has acquired a 14.1% stake in Duet for an average price of $2.16 per security via a derivative structure. JP Morgan observes that, while Spark Infrastructure has stated it does not intend to make a takeover bid, this has provoked market speculation regarding further M&A activity. While nothing has fundamentally changed for Duet, Macquarie suggests the company is now "clearly in play" and SKI's actions may yet draw others out of the woodwork.

JP Morgan has upgraded IOOF Holdings (IFL) to Overweight from Neutral following the IOOF and SFG Australia (SFW) proposed all-scrip merger. From IOOF's point of view, the broker sees the price as reasonable and synergy potential as significant, with the broker noting IOOF has a strong track record of extracting solid expense synergies from its acquisitions.

JP Morgan has upgraded Regis Resources (RRL) to Overweight from Neutral. Given the problems that have plagued the Garden Well open pit goldmine that was flooded earlier this year, Regis has been sold down recently. But given a strong balance and strong cash flow from Australian-based low-cost assets, the broker believes RRL is now oversold.

Deutsche Bank upgraded Treasury Wine Estates (TWE) to Hold from Sell following KKR's bid for the group. The revelation of KKR's bid at $4.70 a share suggests to Deutsche Bank that someone sees value in the stock but the current price is well above where the broker's fundamental valuation lies, even assuming a dramatic improvement in the business. The upside risk is the emergence of a higher bid, while the downside risk is for no further interest (see downgrade).

In the not-so-good books

CIMB Securities has downgraded Spark Infrastructure Group (SKI) to Hold from Add, JP Morgan has cut from Overweight to Neutral and Macquarie to Underperform from Neutral. Spark Infrastructure (SKI) has acquired a 14.1% stake in Duet which caught JP Morgan by surprise, although the emergence of another M&A situation did not. Cash flow accretion from the move is modest, but the broker thinks the risk/reward balance has weakened. Macquarie fails to see the strategic benefit to SKI, particularly if a further premium has to be paid. With the stock trading near its fair value ahead of a potential merger,Macquarie downgraded to Underperform.

Macquarie downgraded Treasury Wine Estates (TWE) to Underperform from Neutral. Get out while you can! That's the broker's recommendation following the Treasury Wine board's rejection of KKR's cheeky offer at $4.70. While experience suggests KKR's offer may well not be its last, at 30x FY14 earnings, the broker sees it as pretty fair, particularly given TWE took the opportunity to flag further downside earnings risk.

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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EOFY and SMSFs

by Barrie Dunstan

It's that time of the year when SMSF trustees need to address important duties, such as investment planning (to keep the fund members happy) and June 30 administration of the fund (to keep the ATO happy).

That second task might seem a matter for the fund's technical advisers, but trustees should never forget that they, personally, are ultimately responsible to comply with all requirements. If you haven't read material from the ATO about trustees' responsibilities recently, it might be useful to re-discover what's required.

The sole purpose

This might also remind trustees that their fund's first and major obligation is to provide income for members' retirement. If the fund is not yet in pension-paying mode, it might be useful for trustees to consider how the fund's current rate of income compares with the legislated minimum payout when pensions are begun. A trap for SMSF trustees is to focus only on the size of the portfolio and neglect to relate this to outgoing pensions when retirement comes along.

For funds paying pensions, for the 2013-14 year, the ATO says a 65-year-old retiree has to receive 5% of the fund's assets in a pension, rising progressively to a maximum payout of 14% for members over 95. A warning: these rates are above the 2012-13 levels following the phase-out of the discounted rates during the GFC.

In pension mode, an SMSF's annual fund earnings ideally should be comfortably above 4% (the minimum payout for 55-64 year olds) if the fund is to be, in the current fashionable phrase, sustainable into the future. That might mean re-assessing assumptions on future living standards or investment strategy. That may also mean forgetting about part-owning a racehorse or holding lots of relatively illiquid, low yielding property.

Risk versus returns

SMSF trustees and members need to remember they have to cope with all the future risks – investments not performing, not enough capital to generate income, living beyond their savings, drawing down too much income, keeping pace with inflation and financing healthcare.

Trustees need to run their own risk assessments on their investment approach and asset allocation strategy – something professional trustees of major funds do as a matter of course. Too many local shares or too few overseas investments? Enough defensive investments (cash or bonds) to ride out a temporary stock market decline? Answering these questions also helps trustees assess their risk tolerance.

But perhaps the biggest risks for SMSFs are changes to the rules and regulations. While there were pre-election pledges not to fiddle with super (and we all know now how politicians regard these promises), the government will be forced to look more closely at tax concessions – though not necessarily in this term of government.

One obvious target is the 2006 decision to make capital gains and income tax-free in pension-paying funds. Clearly, any such changes would need to be prospective but any prudent, pension-paying funds might consider locking in some larger capital gains by selling and buying back the stocks now.

Then there is an SMSF's ability to borrow to buy property assets – something that major super funds aren't allowed to do. If this changed, the government

might also have to consider limiting negative gearing benefits to close off tax-minimising alternatives.

Finally, the transition to retirement scheme – a legislated and much favoured lurk for higher income earners – might also come under scrutiny. As the pension age goes up to 70, the access age to retirement benefits would also be adjusted, lessening the attractions of re-contributing the income back into super. For those other than the rich, the age at which people can access their super is important; Ken Henry notes that one-third of all super savings are drawn down before people reach 65.

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Short 'n' sweet – bank breakdown

by Penny Pryor

As the banks soared ever higher following their interim results, we thought it would be a good time to review our overall view of, particularly, the big four.

So Paul picked apart the sector on Monday.

Banks are very well valued at the moment, but sometimes things are expensive for a reason. And can we remind you again that we have been upbeat on the banks, even when others were calling for caution? In his February article *Chasing dividends – folly or fortune*, Peter was already predicting CBA would reach $80 and now Paul is predicting that for the ASX 200 to get to 6000, CBA will go as high as $88.

Fan love

Ron Bewley is also a big fan of Commonwealth Bank. CBA and Westpac have been the two standout banks for him.

"I have owned both of these stocks for many years and I have never owned the other three," he said in early May of the big four plus Telstra.

"Their current consensus recommendations are not great but, in my opinion, the current ratings are because investors have bid up price to the point at which yields have been compressed to a figure just above 5%. They are both – in my opinion – really good companies with impressive fully-franked dividends."

There are risks, of course, but banks would need some pretty big disruptions – like a big rise in the unemployment rate that prompted an increase in loan write-offs – for there to be any big drop offs in earnings.

Another fact when it comes to the banks is that loan prepayments, on average, are up to 24 months in advance, according to Alphinity Investment Management principal and portfolio manager, Andrew Martin.

"In Australia, you just don't get losses from mortgages," he says.

Although this is good for reducing defaults, and means there would be a buffer if the unemployment rate were to rise sharply, the banks would prefer it if we remained indebted to them for longer.

Most banks have, for some time, left your automatic loan repayment amount unchanged when interest rates fall, which effectively means you are paying back more. But recently, at least one major bank has moved to drop the repayment amount automatically when interest rates fall. This increases your discretionary spending power but it doesn't do anything for prepayments.

Alphinity aren't as positive as we are on the banks, but they don't think they're headed for a crash any time soon. That outlook fits in with Charlie's re-rating of the sector to neutral as well.

The alternative

And a new report from PwC, *Asset Management 2020: A Brave New World*, has the global funds management industry moving to $102 trillion in assets under management by 2020, from the current $64 trillion. Alternative investments – read hedge funds and private equity – are also expected to increase at a greater rate than general funds under management – to $13 trillion.

This means alternative investments will become more accessible for the retail investor, so don't be too surprised if your favourite Aussie manager starts

offering a hedge fund in the not-to-distant future. Just make sure they've got the right people to manage it before you invest.

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Unloved Lend Lease offers value

by Jamie Nicol

How long have you held the stock?

We initially entered Lend Lease towards the end of the GFC, after seeing the company secure a series of major development opportunities. We increased our weighting during the second half of 2013 as it became clear the housing market was accelerating and improvement in financial markets meant there was an increased appetite for its end product.

Lend Lease

What do you like about it?

The business was in a strong financial position during the GFC, especially compared to its peers, and this enabled the group to acquire interests in some very significant projects. In recent years, management has made meaningful progress in repositioning the business to be a more integrated property group with strong quality characteristics. Despite this, Lend Lease has remained undervalued with perceptions towards the company soured by a decade of poor share price performance. Realisation of the value on offer has suffered by inclusion in the property sector, which means it is compared with companies of a very different nature and often covered by property trust analysts more used to valuing passive assets.

How is it better than its competitors?

The fully integrated model of Lend Lease provides a key competitive advantage in securing and delivering large development opportunities. It faces competition in most parts of its business, however there are very few companies that have the same level of expertise across all parts of the development value chain. We see the landmark Barangaroo project as an example of Lend Lease's unique ability to secure, design and construct large scale integrated development opportunities, while attracting third party capital into the funds management platform.

Lend Lease is also uniquely positioned as a fully integrated player in the infrastructure market, with strong capabilities at all stages of the process, from arrangement right down to the physical delivery of the actual infrastructure itself via its construction capabilities.

What do you like about its management?

Management has been very consistent in terms of outlining their strategy for the business going forward and their actions have been consistent with this strategy. We view a consistent, logical strategy as one of the most crucial measures of management quality.

What is your target price on LLC?

We see Lend Lease as trading materially under its intrinsic value and currently have a valuation of above $15.

At what point would you sell it?

Lend Lease is well positioned to generate significant cash flow as it realises the underlying value in the current pipeline of projects and we think the market is not fully valuing this cash flow. The stock also trades at a discount to the market multiple, which we think

underestimates the improvement in the quality of the business over the last few years.

How much has it added (subtracted) to your overall portfolio over the last 12 months?

The overall portfolio has returned around 17% over the last 12 months, which is around 6% better than the index. Over that period, Lend Lease has returned 25%, adding around 1.5% of the 6% outperformance.

Is it a liquid stock?

Yes. Lend Lease has a market capitalisation of over $7 billion and turnover generally exceeds $20 million per day.

Where do you see the value?

We see Lend Lease as a business that is well managed, with a strong earnings outlook and improved competitive position where the market is yet to fully value the quality of the underlying business.

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Reinvesting dividends – RIO and US exposure

by Ron Bewley

Some companies offer Dividend Reinvestment Plans or DRPs. Investors who take up this option forgo the standard dividend cheques. The main advantage for ‘small’ investors is that there is no brokerage or administration fee associated with the purchase.

In this way, an investor can steadily build up his or her holding over a period of time. The downside – for me – was all of the extra paperwork when I sold the stocks to determine capital gains tax. Another negative, for my part, is that one agrees to buy the shares without knowing the price.

Strategy

I treat my dividends and any new cash in the same way. I like to accumulate sufficient cash to make a share purchase cost effective. I then use my measure of exuberance – which I publish each week on my website – to look for sectors that are cheap.

In between rebalancing dates, I typically buy more of any of my existing stocks that happen to be in a cheap sector. While that temporarily unbalances my portfolio, I prefer to take what I anticipate to be a relatively quick capital gain.

Obviously, if I had a substantial new amount of cash from, say, the sale of an investment property, I would seek to bring forward a full rebalance. If no sector is cheap, I leave the excess cash where it is until opportunities arise.

As share prices evolve at different rates, the value share for each stock departs from the original weights. This unbalancing is fine under normal conditions but really big swings in price might necessitate an early rebalancing.

Sector view

To take an example, I set out the exuberance statistics for last Friday’s close in Table 1. Discretionary is the cheapest, being underpriced by 3.1%, but I don’t own any stocks in that sector (I haven’t yet rebalanced my portfolio into my yield play). The adjusted capital gains forecast of +16% would otherwise attract me.

Sector statistics

	Sector	Exuberance	12 month forecasts	
			yield	cap gain
Resource-related	Energy	0.9%	3.7%	13%
	Materials	-2.1%	3.5%	5%
	Industrials	0.7%	4.0%	19%
High yield	Financials	0.4%	5.4%	4%
	Property	2.1%	5.7%	2%
	Telco	2.8%	5.5%	1%
	Utilities	2.8%	5.4%	8%
Other	Discretionary	-3.1%	4.0%	16%
	Staples	-0.8%	4.4%	9%
	Health	-1.8%	2.4%	14%
	IT	2.2%	2.8%	9%
	ASX 200	-0.4%	4.6%	7%

Source: *Thomson Reuters & Woodhall Investment Research*

JP Morgan just upgraded the mining sector to overweight, but Macquarie is underweight and Goldman is neutral. The gains’ forecast is not strong for materials, but I might otherwise top up RIO, which looks a little cheap.

Although Atlas and Mount Gibson look to have been sold off too much, perhaps this is not the time to dive into smaller iron ore plays until there is more clarity on the ore price.

With the Budget focus on healthcare, it may not be the time to get into that sector until it is clear what will get through Parliament. I still hold and like Cochlear. Industrials – although not cheap at +0.7% – attract me with a strong gains’ forecast and only minimal

overpricing. Those stocks with exposure to the US growth story are of potential interest but telco and Utilities are a bit on the pricy side at the moment for me.

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Know your property taxes

by Tony Negline

Most people will already know that various Federal and State or Territory taxes apply when buying, owning and selling real estate in your own name. Land tax, stamp duty, capital gains tax and income tax are just some examples.

But do you have any idea which of these taxes apply when your SMSF owns property, or how they're calculated? Here I'm going to explain the details.

State and Territory taxes

Land taxes

Most States and Territories will apply land taxes. Your SMSF – because it's a separate entity to you – has its own threshold.

Typically, land tax is payable annually and in the majority of cases is worked out on 31 December and payable not long after then.

All jurisdictions have excellent websites which detail when this tax is payable, how the tax is calculated and when your super fund might be exempt or eligible for a concession.

Stamp duty

All States and Territories charge stamp duty – based on the larger of the market value or sale price of a property – whenever property changes hands. This is often called ad valorem stamp duty.

It will apply when you contribute a commercial property in-specie into your SMSF (because the owner of the property has changed). Some States and Territories provide stamp duty concessions for these transactions.

If you have entered into a Limited Recourse Borrowing Arrangement (LRBAs) then you will need to have the mortgage document stamped, which might see nominal duty applied. You might also need to get the Holding Trust deed stamped for nominal duty.

Just a note about LRBAs – if you complete the paper-work for these transactions in the wrong order or in the wrong way (and this process varies from State to State) then you might incur ad valorem stamp duty up to three times.

In some States and Territories, you need to register commercial leases, which may be subject to duty.

Federal taxes

Capital gains tax

CGT will apply if your super fund sells a property for a profit and those assets aren't being used for pension paying purposes.

This tax applies regardless of when your super fund bought an asset. For individual taxpayers, any asset purchased before September 1985 is exempt from CGT but super funds were taxed for the first time in July 1988.

The rate of CGT varies depending on when the asset was acquired (if the asset was purchased before 21 September 1999 then you have a choice as to how you wish to calculate this gain). If you have any questions then I suggest you get some advice to make sure you make the right decision.

In most cases, you will probably assume that two-thirds (that is, 66.66%) of the profit (sale price less purchase price and all costs of buying and selling the asset) will be taxed. As super funds are taxed at 15% then the effective tax rate becomes 10 per cent.

If the assets are being used to pay a pension, then any gain will be CGT free.

If your fund is using the unsegregated asset approach then your fund's actuary will determine what percentage of any gain is exempt for tax. If your fund uses the segregated assets approach then CGT won't apply if the property has been specifically set aside for one or more pensions.

Income tax

Any rent from a non-pension property will be income in the fund each year and will be subject to tax at 15%. (Rent from properties used exclusively or partly to pay a pension will be tax-free).

The costs of acquiring the taxed rental income will also be deductible. Typical rules apply here – agent fees, interest costs (for LRBAs), maintenance costs, depreciation, building allowances and so on, are all allowed as a tax deduction to the fund.

Any costs of acquiring rental income for pension assets are not tax deductible in your super fund.

Local government and utility rates

Finally, don't forget that for all properties your local government will charge rates and you will also have to pay utility access fees (for gas and electricity).

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Credit cards and bank valuations

by Questions of the Week

Question: Can I use my personal credit card to pay SMSF expenses, for example, insurance premiums, auditor fees, accountant fees, etc. and treat these expenses as post-tax contribution to my SMSF. Is this legally allowed?

Answer (By Tony Negline): It is not best practice to pay fund expenses in this way. For auditing purposes and simplicity, you are best to have fund expenses paid by the fund itself.

Frequent flyer points from a credit card use in this case, whilst probably seen as incidental, are a potential hassle from a sole purpose test perspective. The credit card debt might be seen as your super fund borrowing from you, which it isn't allowed to do.

Question 2: If one is to consider, say investing $100,000 in the banks CBA and Westpac, then, as an educated guestimate, what would you expect the investment to be worth, inclusive of dividends, to the end of December 2015.

Answer 2 (By Paul Rickard): Thanks for the question – however, it is one I am only going to answer in part.

CBA will pay three dividends – payable on Oct 14, April 14, and Oct 15 – on a forecast yield of 5.0%, assume $7,500 in dividends on $100,000 invested.

Westpac will pay three dividends (they have just gone ex-dividend, so you will miss the July 14 dividend) – payable on Dec 14, July 14 and Dec 15 – on a forecast yield of 5.4%, assume $8,100 on $100,000 invested.

Averaging these out, $7,800 in dividends, plus franking credits.

In terms of the prices of both stocks, I expect the market to move higher over the next six to nine months and we will see 6000 on the S&P/ASX 200 – this will require both the CBA and Westpac to move higher in price. What this means for 2015, I am not sure yet – and I'm not prepared to place a 'guesstimate' on Dec 2015.

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