Switzer Super Report

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Take a breather

Loyal readers of the *Switzer Super Report* know that we tend towards the bullish side of market expectations. Our long-term view is even if the share market doesn't get to 6000 by the end of the year, we do think it will end higher, with some ups and downs along the way.

Today, *SSR* expert Charlie Aitken continues to be a little bit cautious, but can I again remind you that his (literal!) sell in May and go away is just that. By the time he comes back in a few weeks, he hopes he will be able to buy in again at better prices.

Also in the report today, Tony Featherstone picks out five yield payers all trading for less than $5, Rudi Filapek-Vandyck walks us through his ideal portfolio in *My SMSF* and in *Buy, Sell, Hold – what the brokers say*, anything related to iron ore gets downgraded, as Coca Cola Amatil (CCL) and the new Westfield (ASX Code WFD) post the Scentre split get upgrades.

Sincerely,

Peter Switzer

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Five yield payers under $5

by Tony Featherstone

Income investors could easily ignore the IPO market for yield, believing floats are more about capital growth. But more floats these days have a dividend "sweetener" to entice the yield brigade.

IPOs, of course, have more risk than well-established companies. Yet the quality of floats in the past 12 months has been higher and many have notched solid post-listing gains.

Risks aside, the IPO market has some yield attractions. On a relative basis, it is hard to put new money to work in traditional dividend favourites such as the big-four banks and Telstra Corporation. Income investors who own those stocks could perhaps reduce exposure by winding back dividend-reinvestment plans and investing dividends in stocks outside the top 30.

Another attraction is more established, higher-quality IPOs, albeit with higher price tags, coming to market in this float cycle. Larger companies with stronger market positions have scope for higher dividend payout ratios, and better prospects for sustainable dividend growth.

Intense market pressure on IPOs is a further plus. IPOs that miss even the slightest prospectus forecast are now slaughtered, incentivising firms to deliver on dividends.

The ability of high-quality IPOs to offer yield and growth also appeals. When seeking yield stocks, always choose those with capacity for capital growth as well. What good are a few points of extra yield if capital losses quickly erode gains? Reliable yield and decent capital growth can be magic.

With that in mind, I have chosen five IPOs that offer yield and growth, each trading below $5. These stocks are not household names – another positive in my view, as the last place to put new money is where the "crowd" is parked, and valuation bubbles are building.

These stocks offer a mix of yield and growth and have reasonable defensive qualities (with the exception of the more cyclical SeaLink Travel Group).

1. Genworth Mortgage Insurance Australia (GMA)

Australia's largest mortgage insurer listed on the ASX in May 2014 after raising $583 million at $2.65 a share. At $3.08, Morningstar estimates a 7.5% fully franked yield in 2014-15, based on a dividend-per-share of 23 cents.

Some brokers are forecasting a yield above 8%. Genworth has a targeted dividend payout ratio of 50-70%, suggesting scope for higher dividends in coming years. Its exposure to Australia's strengthening housing cycle should be a steady tailwind for dividend growth over the next three years.

2. Mighty River Power (MYT)

The New Zealand electricity provider listed on the ASX in May 2013 after raising $1.35 billion at $2.01 a share. Producing about 17% of NZ electricity, Mighty River looks a steady, reliable performer. At $2.06, the expected yield in 2014-15 is 5.8%, based on consensus analyst forecasts.

The NZ election in September presents some regulatory risk if there is a change of government, and franking is an issue as NZ imputation credits in Mighty River can only be used to offset NZ income tax liabilities. Even so, Mighty River looks marginally undervalued at current prices: Macquarie Equities Research has an outperform recommendation and a $2.25 share valuation. Potential for 10% capital growth and a decent expected yield would give a

handy total shareholder return over 12 months. As a utility, Mighty River has defensive characteristics that appeal to income investors.

3. Pact Group Holdings (PGH)

The packaging group had a disappointing sharemarket debut, down from a $3.80 issue price to $3.50 after raising $649 million and listing in December.

At $3.45, Pact has an expected 2014-15 yield of 5.9%, according to FN Arena. It also has good judges such as Investors Mutual on the share register. Reaffirmation of second-half dividend guidance at the interim result in February was positive, as were signs that Pact is on track to deliver prospectus earnings forecasts. It, too, has potential for solid growth and yield in the next 12 months.

4. LifeHealthcare Group (LHC)

LifeHealthcare raised $77 million through an IPO and listed in early December. Its $2 issued shares have rallied to $2.25 as the market warms to its position as a large independent distributor of medical devices, and its exposure to the more defensive healthcare sector and the ageing population.

Over half its sales come from implantable devices such as orthopaedic and prosthetic products – a clear growth market. An expected 14 cent dividend in 2014-15, based on consensus forecasts, implies a 6.2% yield, most likely unfranked until 2016. Like others on this list, that type of yield and a reasonable share price, at least for long-term investors, make LifeHeathcare another IPO to watch for income-driven investors who can tolerate investing in small-cap stocks and are willing to take higher risk in the pursuit of yield and higher capital growth.

5. SeaLink Travel Group (SLK)

The tourism operator, best known for its *Captain Cook Cruises*, is a good example of income opportunities in the IPO market. SeaLink listed in October 2013 after raising $16.5 million at $1.10 a share. Unlike many floats that are hastily put together, or involve a quick exit by vendors, SeaLink had a decent history of paying dividends, and was a well-established, solid operator. After rallying to $1.80, SeaLink is not cheap. But an expected 4.5% dividend, fully franked, should comfort income investors, and the long-term trend of higher inbound Chinese tourism is good news for travel operators. SeaLink is best bought on any significant share-price weakness.

- Tony Featherstone is a former managing editor of BRW and Shares magazines.

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Wait for the buying opportunities – part 2

by Charlie Aitken

Last week I told you how I am taking my own advice and selling in May and going away. I'm hoping that when I come back, in a couple of weeks, Australian equities will offer better bottom-up value and we can start buying.

In the meantime there are a couple of headwinds that might put pressure on the markets. See my article last week for the macro factors.

Negative FY15 earnings revisions are an increasing headwind for Australian equities. It's unlikely Australian equities can advance when FY15 earnings forecasts are being revised down by analysts.

The Australian Dollar also remains too high and it's worth noting that yield spreads between US two-year bonds and Australian three-year bonds are narrowing sharply. As the Australian dollar's yield advantage narrows, firstly via bond yields and secondly via cash rate differentials (FED will raise cash rates before the RBA and via larger percentages from a zero interest rate policy base), the Australian dollar will lose carry trade (yield buyer) support. In fact the carry traders will most likely be carried out. My medium-term AUD/USD target remains 85 US cents.

Below is the five-year chart of the US/AGB two to three year yield spread narrowing in the US's favour.

Vulnerable stocks

Similarly, I reiterate my list of Australian stocks vulnerable to a valuation correction and suggest many Australian investors are a little too sanguine about what is happening globally in momentum/GAAP stocks. The vast bulk of this list have fallen in price, some very sharply since I first published it in April, but as we sit here today, consensus analyst views see everyone of these stocks as a "buy". I don't agree, I think they all look expensive, growth forecasts are too ambitious, registers are crowded with momentum investors and momentum is reversing. The *"vulnerable MO"* list remains:

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 (AMC), Fletcher Building (FBU), IOOF (IFL), Sydney Airport (SYD) and Transurban Group (TCL).

The banks

And finally that brings us to the Australian banks, which could prove to be the last domino to fall in this trading correction.

I'd be highly, highly surprised if Australian banks remained immune to a broader equity market trading correction. It is almost impossible for that to remain the case, particularly if that correction is triggered by changing investor expectations of the timing of global cash rate rises.

Australian banks are ex dividend and vulnerable to profit taking pressure. Ask yourself who is going to be the new marginal buyer of Australian bank equities at these levels? It certainly won't be foreign investors who can't value franking credits.

Australian banks have been major beneficiaries of short US dollar yield carry trades, but as the Fed's balance sheet peaks, that clearly has the potential to reverse.

Below is a five-year chart of the ASX 200 Banks Index overlaid with the Federal Reserve's total asset base (green line).

Australian banks have never been as widely held by Australians or been a higher percentage of domestic equity portfolios as they are now. They have never been more widely held by global income seekers. That, in itself, makes the sector vulnerable to profit taking.

I realise nobody listened and/or nobody wanted to hear it when I downgraded the bank sector to *"hold"* a few weeks ago (after two and half years of rampant bullishness), but the more I sit here, the more I believe there is more downside than upside in near-term in Australian banks. My advice is sell a bank – you don't need to own all of them – that advice is relevant to both retail and institutional investors.

All in all I believe the three Vs, that is *value, volatility and volume,* will return to Australian equities and potentially quicker than anyone currently believes.

As this all evolves, remember the words of successful US hedge fund manager Dan Loeb (Third Point) who wrote in his Q1 letter to shareholders: "Four months into 2014 it now seems evident that investment performance will require a combination of ***good stock selection, patience and deft trading".***

That advice is proving 100% correct.

A better buying opportunity awaits us. Be Patient. I believe patience will be rewarded.

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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My SMSF – a tilt to dividend-paying industrials

by Rudi Filapek-Vandyck

Name: Rudi Filapek-Vandyck
Age: 48
Members: Yet to start up fund

When would you start up your SMSF?

I think you preferably would have to have half a million in assets to start one up.

I know that some service providers out there are doing it for as low as $100,000 but when I talk to people whom I regard as less biased, they say you shouldn't even look at it if you don't have $250,000, and preferably more.

Would you use any service providers to help with your SMSF?

If it would be cost effective I would definitely have someone who would do the administration. But I will definitely be involved in the choice of assets given the work I do.

What would be your asset allocation?

Apart from the fact that I prefer relatively solid industrials that pay good dividends, I would definitely have corporate bonds. I'm not a big fan of government bonds at this point in time, but I would have corporate bonds because I believe there are some assets on the share market which are overvalued and at some point, it becomes better value to buy the bond.

But my overall asset allocation would be something like 60% in equities, 30% in corporate bonds, 5% in precious metals and 5% in cash. If the opportunity arose, I would also consider maybe 10% to 15% in unlisted assets like property, which would probably come off my equity and corporate bond allocations.

What specific stocks and investments would you have in your SMSF?

I would have the banks in my SMSF but underweight the index, not overweight. I think most portfolios in Australia have too much in banks.

I would also have Telstra. I would have stocks like Ardent Leisure and Transurban. They are all fairly strong cash-generating and dividend-paying industrials.

I like G8 Education, Breville Group and Invocare – you will see a big swing towards industrials

I would actually have zero, or very little exposure to mining stocks, including the large ones, and I might have some exposure to oil and gas but particularly to Woodside, Origin and Oil Search as they will become dividend payers in the next couple of years (Woodside already is).

My own analysis shows that solid, dividend-paying industrials with loyal customers generate the best investment returns in the long run, and at a lower risk.

If I wanted to add exposure to foreign equities, I'd opt for an ETF rather than trying to pick stocks in far away markets.

What other investments do you have outside super?

I have some precious metals and my business (this is a very important asset for me), and I have some investments in a share portfolio.

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Flight Centre – things to excite investors

by Roger Montgomery

The evolution of the Australian travel agency space is a topic of much debate. In a world in which there is an "app" for just about everything, questions have been asked if the brick-and-mortar travel agency model exhibited by Flight Centre (FLT) is sustainable. First the cons.

The cons

The competition from online travel agents is formidable. International online competitors such as Priceline and Expedia, as well as local competitors Webjet and Wotif do not incur the costs associated with renting physical storefronts. Furthermore, these online offerings primarily use software algorithms to search for flight and hotel reservations that might suit a prospective customer's travel needs. This saves on salary and commission expenses that Flight Centre needs to pay its army of consultants on an ongoing basis. Finally, when it comes to bargaining power with airline and hotel vendors – a key source of profit for Flight Centre – the big international competitors are a serious threat to this too. Consider that, while Flight Centre is almost as large as Qantas with a market valuation of around $4-5 billion, US-based Priceline is worth around $60 billion and Expedia $10 billion.

Flight Centre (FLT)

The pros

On the other hand, perhaps we are being too hasty in our assessment of industry disruption. And perhaps there is something unique about the Australian travel agency space that helps protect it from the onslaught of online competition.

Given how far we are located from the rest of the world, most of our long-haul flights typically require connections. Furthermore, when most of us make such a long trip, it makes sense to spend a bit more time in said location, or travel to surrounding regions to maximize bang for travel buck. All of this results in travel itineraries, which are rather complicated to compile. And few of us have the experience (or patience) to prepare multi-destination travel itineraries, which are both seamless and cost-effective. For these reasons, it is entirely rational to pay a little extra for the services of a Flight Centre consultant who can take care of the headaches associated with working through the near-infinite number of travel options we are faced with.

There is also perhaps a demographics argument, which further lends support to the bricks-and-mortar Flight Centre model. As the baby boomers begin to retire en masse, there will arguably be an increase in overseas travel expenditure from this demographic. This is the age group that will be the last to switch to DIY online travel agents for complicated itineraries. Leveraging the expertise of a Flight Centre consultant to book the travel will likely prove to be an attractive proposition for the retiree, notwithstanding the nominal mark-up that is applied to the ticket.

Facing challenges head on

Flight Centre knows what it is up against and is doing its best to prepare for a more intensely competitive market in the future. In the 2013 financial year, the company launched its "Killer Theme" corporate strategy to directly address the challenges it faces. The strategy focuses on a number of themes around

branding, product uniqueness, expert advice, marketing and intelligent information management. The company is also redesigning its customer experience – both in-store and across digital channels. Essentially, Flight Centre is trying to increase its "customer captivity" with an effort to increase the costs for customers to switch to (online) alternatives.

Flight Centre's initiatives are sensible and the company's management is highly capable. The ultimate question, however, is to what extent will customers value expert advice over cost? The experience of regions such as North America, Europe and the UK suggest that many travelers – typically the younger generations initially – prefer the cost savings. Even in Australia, the data clearly shows an increase in the rate of penetration of online travel reservations, though they are rising off a low base.

What cannot be disputed is Flight Centre's business quality when viewed from a historical perspective. The company has consistently generated returns on equity north of 20% – a truly impressive feat. Flight Centre is also in a highly enviable financial position: the company has almost no debt and over $400 million in cash at its disposal. In addition, the business generates around $300 million in additional free cash flow each year. These are great characteristics that should excite shareholders and one would expect significant dividends or share buy-backs going forward.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Commodity prices dominated broker activity this week as the iron ore price continued to fall. Credit Suisse downgraded its iron ore forecasts across the industry but the outlook for Nickel is much more encouraging.

In the good books

UBS upgraded Coca Cola Amatil (CCL) to Neutral from Sell. The broker has reviewed its valuation of the company's Indonesia & PNG business and despite weakness execution by CCL, has upgraded by 36% on an increased enterprise value multiple. That said, the broker expects CCL to post a weak FY14 result and notes the need for the company to cut costs, get its pricing right and diversify away from fizzy drinks.

Credit Suisse upgraded Panoramic Resources (PAN) to Neutral from Underperform. The stock has plenty of nickel leverage given a relatively high cost position. Credit Suisse has made significant upgrades to nickel price forecasts and this means FY14 earnings forecasts swing from a modest loss to a modest profit.

Macquarie has upgraded Westfield Corporation (WFD) to Outperform from Neutral. Westfield Corporation is the new look Westfield Group post the Scentre Group (SCG) restructure. The focus on offshore assets will increase WFD's return on equity above that of the old WDC, although in the near term the market will still have to digest dilutive asset sales. WFD is not a compelling proposition, the broker admits, but offers a return profile sufficient to prompt an "upgrade" to Outperform.

In the not-so-good books

Credit Suisse downgraded Atlas Iron (AGO) to Underperform from Outperform. The broker slashes the valuation because of the fall in the iron ore price and the expansion of quality discounts. The twin impacts reduce earnings forecasts by 60%. The broker has revised iron ore price forecasts down by 7-10% and expects Atlas will incur net debt in FY15 but, provided it withholds dividends and does not incur additional capex, it should return to net cash in FY16.

Arrium (ARI) was also downgraded to Underperform from Neutral by Credit Suisse on downgrades in earnings and valuation, driven by lower iron ore price assumptions. The broker also reduces the steel segment earnings forecasts and mining consumables tonnage. Cash realisation from continuing asset sales is now even more important.

And Fortescue Metals Group (FMG) also got the downgrade treatment from Credit Suisse – to Neutral from Outperform – in the face of falling iron prices and expanding quality discount. The broker's new iron ore price forecasts are 7-9% lower. Credit Suisse cannot see any catalyst to lift the share price in this environment and downgrades the rating. The price target is lowered to $5.00 from $7.00.

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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Hands off it – it's for your retirement!

by Tony Negline

From time to time, and for a myriad of reasons, you might have personal cashflow problems. If you run your own super fund, then using some of its money to solve these problems can be very tempting.

Hubris sometimes arises when you and other members know that your super monies can't be used for personal purposes such as fixing your personal or business cashflow dramas, and none of you think anyone will misuse the super fund's money which leads you to require only one trustee signatory on your fund's bank account.

If you take money out of your super fund other than in accordance with the super laws, then severe penalties can apply. These can range from having the withdrawals taxed at the highest marginal rate (that is, 45% Medicare Levy which from 1 July 2014 will include the National Disability Insurance Scheme Levy and the Temporary Budget Repair Levy), to having your fund declared to be non-complying to also facing additional penalties under its general tax administration powers.

Below I discuss a recent Administrative Appeals Tribunal (AAT) where an individual pleaded for all these penalties to be lessened because he argued they were excessive and created unnecessary hardship for him.

To solve the first problem the only sensible approach is to know that you can't access your super money early because there is a high probability of getting caught. Don't forget that SMSFs need to be externally audited each year, and if an auditor finds any illegal early withdrawals from your super fund, then it must be reported to the Tax Office.

To solve the second problem the best approach is to make all trustees if individual trustees, or all directors if you use a corporate trustee, signatories to the fund's bank account. This doesn't prevent all trustees agreeing to access money early and it doesn't prevent the forging of signatures. However it shows that you have done all you can to stop one trustee doing something wrong.

Huckle versus Commissioner of Taxation

Mr Huckle is a well-paid mining specialist based in Perth. He had a gambling problem and in the 2011 and 2012 financial years withdrew about $193,000 from his super fund.

Once the ATO were aware of these super law breaches, it imposed tax penalties of over $93,000 plus $4,300 in additional administrative penalties.

These administrative penalties had been reduced by 80% because Mr Huckle had approached the Tax Office about his illegal withdrawal of his super benefits.

For the 2013 financial year, Mr Huckle received a refund of over $24,000 and this was used to reduce his Tax Office debt.

Huckle pleaded for leniency from the Tax Office for the remaining $70,000 owing, however it knocked him back twice, so he took matters to the AAT.

The AAT noted that Huckle had more than $660,000 in debts. Ten per cent of this amount was for a Holden car he had purchased in 2012 for $70,000 but at the time of the AAT hearing, had an approximate market value of $50,000.

He owed almost $70,000 in credit card debts and had an investment property loan of $445,000. The remaining debts (almost $80,000) were personal loans.

He was paid fortnightly and 50% of his income was spent on interest and capital payments for these debts. Based on his expense budget presented to the Tribunal he had about $500 per fortnight more than his overall expenses.

Under the Tax Offices general powers of tax administration, leniency can only be applied when it can be shown that you'll suffer severe financial hardship and the circumstances don't justify the penalties that have been imposed.

The Tribunal denied Huckle's application. It said that by demanding he pay the ATO the amount owing, he would still be able to afford "the basic necessities of life" even if these repayments might temporarily reduce his standard of living.

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It's going to be all right

by Questions of the Week

Question: I hope France is nice and by the way, Marty is doing a really good job with the TV show. Gary Stone said the other night that he is 100% cash now (about 100pts ago). I am basically only in the top 20 stocks and have done well over the last two years (no mining stocks). I am retired with an SMSF and like dividends, but not capital losses. How far down does Gary (or yourself) think we might go and when would you buy back in?

Answer (By Peter Switzer): Thanks for your comments about the TV Show and the great job Marty is doing.

If you read my comments in Monday's *Switzer Super Report*, I am still pretty positive about the market and feel that there may be a little bit of a dip before the market moves higher. I am not betting on it – like you, I am close to fully invested – however I am just not adding more monies into the market at the moment.

If there is a dip, my sense is that it is going to be fairly shallow – if you looked at Lance Lai's chart that we published on Saturday, I would suggest about 5250.

Question 2: Can you please tell me if there is a bill going through parliament regards dividend washing? If so will it be backdated?

Answer (By Paul Rickard): Yes – the 'Tax and Superannuation Laws Amendment (2014 Measures No. 2) Bill 2014'. It has passed both Houses of Parliament (19 June), however it has yet to receive Royal Assent.

The effective date for the changes to "distribution washing" is 1 July, 2013 – yes, it is being backdated.

From my perusal of the legislation, it appears it is not being applied earlier than this date. You can review the legislation here.

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Did you know?

Co-founder of small-cap fund manager Eley Griffiths Group, Ben Griffiths, is a regular contributors to our *Fundie's Favourite* and during the week he shared his favourite stocks with viewers on Switzer TV show on Sky Business .