Switzer Super Report

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Beat the chill

I'm settling back into the cooler climates down here after my holiday in France and I'm optimistic about a new financial year. June wasn't a great month, but I have a sneaking suspicion that we could be in for a better than expected reporting season, and that's putting me in a positive mood.

Today in the *Switzer Super Report*, Ron Bewley will start to unveil his yield portfolio and Tony Featherstone shares his years of wisdom overseeing the *BRW* rich list. He has identified seven investment trends amongst the really rich.

And don't forget to register for our Webinar this Friday, and send any questions you would like answered to subscriber@switzer.com.au. You can ask Paul Rickard and James Dunn (almost) anything you like. About SMSFs of course!

Sincerely,

Peter Switzer

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How to get rich like the super rich

by Tony Featherstone

The *BRW Rich 200* list was once described as "capitalist porn": a voyeuristic glimpse into the naked wealth of Australia's super-rich. Its stories on fortunes made and lost, billionaires, newcomers to the list, and the lifestyles of the rich and famous attracted a slew of headlines.

As a former *BRW* managing editor, I recall hundreds of copies of the *Rich 200* having prime positions in newsagents at Toorak in Melbourne and Double Bay in Sydney. And stories about the tax office auditing people based on their estimated *Rich 200* wealth, charities hounding rich-listers for money, and Gerry Harvey joking with John Singleton about being a "junior" rich lister.

Those were the days. Today, the *Rich 200* is an insert in the *Australian Financial Review* magazine rather than a standalone issue. But the list, published recently, is still unique and vital information for those who keep tabs on the super-rich.

I always thought the list's true value was not in the published wealth figures. They are, after all, estimates, albeit well considered ones. The real value was the sometimes subtle, changing dynamics of how the *Rich 200* members made more money in the past 12 months – and what average investors could learn from it.

The *Rich 200* has captured key macro investment trends in the last three decades. I recall property entrepreneurs dominating the list in its early incarnation, the rise and fall of tech entrepreneurs around the turn of the century, and the fall of some resource barons in the past decade.

Seven investment trends stood out from this year's list:

1. Invest in the disruptors

It is no surprise that three new entrants on this year's list are from technology-based companies that are disrupting established industries. Matt Barrie, founder of micro-jobs site Freelancer, debuted on the list with an estimated $255 million fortune. Online electronics entrepreneur Ruslan Kogan debuted with $320 million, and online foreign-exchange entrepreneur Owen Kerr debuted with $250 million.

As technology continues to change industries from print media, to travel, banking, law and everything in between, watch for the disruptors to soar up the *Rich 200* rankings. Spotting the disruptors early, and investing in those who list their companies on ASX or other exchanges, can supercharge wealth creation, albeit with high risk.

2. Feed your portfolio some software

I love the line that "software is eating the world". From one industry to the next, software is changing industry dynamics and reducing the marginal cost of production. Atlassian founders Mike Cannon-Brookes and Scott Farquhar, both aged 34, are billionaires, according to the *Rich 200*. MYOB co-founder Craig Winkler, a key investor in Xero, the booming cloud-computing accounting software provider, has an estimated $710 million fortune.

Investors seeking fast-growth micro-cap and small-cap stocks could do worse than consider ASX-listed software companies. Yes, there are not many compared with offshore exchanges. But that will change rapidly in coming years as more tech companies use the ASX to list and raise capital.

3. Make money from the moneymen

This year's *Rich 200* again shows fund management is a wealth goldmine for those rare managers who consistently outperform markets over long periods.

Investors Mutual's Anton Tagliaferro has an estimated $255 million fortune; Paradice Investment Management's David Paradice has $275 million, and Platinum Asset Management's Kerr Neilson has $3.3 billion.

ETF Securities' Graham Tuckwell, whose business offers exchanged-traded commodity funds on global exchanges, is worth $466 million. Others such as retail entrepreneur Naomi Milgrom boosted their fortune by investing in star fund manager, Magellan Financial Group.

The lesson for other investors: identify Australia's great money managers and invest in their funds, or better still, buy shares in their companies if they are listed. Although returns can be volatile, the great moneymen have a knack of creating plenty of wealth for others over long periods.

4. The queen is dead (resources) – long live the king (property)

Well, not quite. Australia's duchess of iron ore, Gina Rinehart, again tops this *Rich 200* with an estimated $20 billion fortune and Fortescue's Andrew Forrest has $5.8 billion. I can't recall seeing so few mining entrepreneurs on the *Rich 200*, which is no surprise given falling commodity prices and the end of the mining investment boom.

Meanwhile, the *Rich 200's* greatest source of wealth – property – is alive and well. By my count, 16 of Australia's 39 billionaires made most of their wealth from property, or a mix of property and other businesses. As the housing market strengthens, and more foreigners buy Australian property, it's a good bet that other property moguls will join the billionaires' club in the next few years.

5. The world is not big enough

The *Rich 200* members increasingly make their fortunes in other countries. From James Packer pursuing casinos in emerging markets, to Anthony Pratt's global packaging business, to Frank Lowy's global shopping-centre empire, and so on. In fact, 20 of this year's *Rich 200* members are based overseas, according to *The Financial Review*.

The investment lesson: if you want to make serious wealth, look beyond Australia to larger, faster-growing markets in emerging or developed countries.

6. Don't stop when you get enough

I love how the average age of the *Rich 200* members is 64, and that there are two nonagenarians (Lady Mary Fairfax and Stan Perron) and an octogenarian (Michael Crouch, who debuts at age 81) on the list. Those who believe wealth creation is a younger person's game, or that you cannot make millions when you are 70 or 80, need to think again.

Time and again, the *Rich 200* shows that real wealth for many entrepreneurs is made in their "third act" – when others their age are retiring. Hopefully, the *Rich 200* inspires SMSF trustees, who are not content with their retirement savings, to take calculated risks and build serious wealth later in life.

7. Know when to sell

The hallmark of the greatest *Rich 200* members. Think of the late Kerry Packer, or his son James, who sold large stakes in SEEK and Magellan Financial Group to concentrate on casino developments. Surprisingly few of the *Rich 200* members cashed in some or all of their chips last year, which says something about their view on the Australian economy and share market in the next few years.

When the super-rich start selling, it is time to take a closer look at your portfolio. But for now, their confidence to maintain investments or reinvest in their core business is further confirmation that the medium-term outlook for the Australian share market is healthy.

- Tony Featherstone was managing editor of BRW from 2003-2006 and conceived and launched the BRW Young Rich list.

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Setting up a yield portfolio

by Ron Bewley

Readers who have been following my column for some time will know I intended to design a new portfolio for July 1. I can now report 'Mission accomplished'. On Wednesday, Thursday and Friday last week, I bought 16 stocks that I did not already own – but I had previously owned three of them a few years ago.

I will be writing over the next few months about how I made various decisions. But, at the outset, I want to stress that it took me six months of hard work to come to this new framework after a lengthy career in markets.

The process

Since most of the stocks were new to me, and I think resources stocks might have a good run over the next few months, I didn't sell down my whole portfolio to cash so as to buy the new one. Rather, I sold 25% (approximately) a few weeks ago, basing my selling decisions on those sectors I judged to be overpriced using my exuberance measure. As it turns out, I sold six of the eight parcels of shares at prices above today's prices and the other (AGK) did fall but is now a few cents higher following a recent regulatory decision. That means I did not lose by being in cash for about a month. I like to record all of these sorts of actions so I can learn when I make poor decisions!

About every three months I will sell down about 25% of the old portfolio and invest in the (possibly rebalanced) portfolio. Obviously the conditions at the time will have to be right for me and a lot can happen in a few months.

The first decision to make – in my book – is to articulate the objectives for the portfolio. I want to end up with a yield of about 8% (including franking credits) if that is possible. That means I can draw down my pension only from dividends rather than having to sell for capital gains. Under the current pension rules for minimum drawdown, the 8%will be above the minimum for the next 20 years (for me). By the time I am 85 (if I make it), I might be starting to look for some sort of aged care and my slowly growing capital should see me OK.

Better than the banks

The classic way to build a vanilla portfolio is to buy the four big banks, Telstra, a property trust or two and weight them equally. I think I can do better than that – but there is nothing wrong with that approach for investors who are comfortable with it. This new portfolio of mine was designed only for me and it may not suit others. Nevertheless, the decisions that need to be made are common to many types of portfolios. It is just that different choices may be made at each step.

So I want some growth as well as yield. I do not see much growth in the classic portfolio that I just mentioned, as dividends have been compressed down to low – but sustainable – levels. My portfolio 'style' affects the sector weights or loadings I use, the number of stocks I choose, and the companies in which I invest – and the stock weights within sectors.

Let's start with the sector weights. For simplicity (and privacy) I am assuming that I have $100,000 to invest and that does not include brokerage and any other transaction costs. I have set out in Table 1 where that money would be invested if I wanted to hug the ASX 200 index – under the heading 'Index'. These amounts change over time as component stocks change in price and stocks enter or leave the index.

Allocations of a $100,000 portfolio under two scenarios

	Sector	Allocations	
		Index	Tilts
Resource-related	Energy	6,029	9,044
	Materials	16,879	0
	Industrials	6,872	10,308
High yield	Financials	39,222	39,222
	Property	6,369	8,258
	Telco	5,278	7,259
	Utilities	1,692	2,539
Other	Discretionary	4,048	6,072
	Staples	8,204	10,281
	Health	4,678	7,016
	IT	729	0
	ASX 200	100,000	100,000

Source: Thomson Reuters Datastream & Woodhall Investment Research. As at 25 June 2014.

So an index-hugger would buy $6,029 of stocks from the energy sector, $39,222 worth of banks and related stocks, etc. Obviously allocations cannot be exact but one can usually get pretty close. I trade on CommSec and find their calculator useful in terms of deciding how many of each stock I want. But a word of caution, I nearly made a couple of silly mistakes when trying to by 16 stocks in three days. It is so important to write down the value, the number of stocks and the price by your calculations – and double check the stock codes!

The tilts

Since I want a yield portfolio, it makes sense to invest more in the high-yielding sectors and less in the resources and others sectors. This process is called tilting. It can be done by just using common sense or highly sophisticated optimisation techniques can be used. The simplest solution would be to put zero dollars in the seven non-high yield sectors and scale up the others in proportion i.e. one might place $74,622 in financials, $12,117 in property, $10,041 in telcos and $3,220 in utilities.

The simple four-sector approach does not have much in the way of diversification or growth benefits. I use a very complex method based on my massaging of broker forecasts of dividends and earnings, and risk forecasts from daily index price changes. Rather than trying to just achieve the highest 'risk-adjusted return' – or the so-called Sharpe ratio – I put limits on the tilts to achieve my hybrid yield-growth goals. For example, I do not allow the four high-yielding sectors to be 'underweight'. That is, I must have at least $39,222 in Financials, etc. – but the optimiser might choose more.

I show the weights I used as a base in my trades under the column headed 'Tilts'. These weights do change from month to month as expected risk and returns evolve – and sometimes they evolve quickly – so beware! Although these weights were my base, I changed them for reasons I will give in the next few weeks.

So, under the 'tilt' heading in Table 1, one can note Materials and IT each got no allocation because of the poor expected returns and high risk. Financials got index-weight but the other three high-yield sectors are overweight. Next time I will discuss how many stocks to choose in each sector and the stocks that passed my 'filters'.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

So far this week, a few old favourites have come under the spotlight – with Crown Resorts, Rio and Wesfarmers all getting upgrades. Many of these ratings moves are based on the belief that some of these companies that have been sold down too much are now good value.

In the good books

Citi upgraded Crown Resorts (CWN) to Buy from Neutral. The stock has sold off 10% over the year to date, relating to slowing Macau data and industry-wide concerns. Citi thinks the issues in Macau such as smoking bans, new transit visa restrictions and union pay have created a lot of "noise" but these are ultimately distractions to the fundamental driver of profitability – gambling. Moreover, June is a seasonally slow month and presents investors with a buying opportunity ahead of the seasonal lift in October.

Citi upgraded Henderson Group (HGG) to Buy from Neutral and Credit Suisse to Outperform from Neutral. Citi is lifting the rating, given the recent pull back in the share price and incorporating the recently announced acquisition of Geneva Capital Management into forecasts. Henderson's revenue growth looks compelling, even though the stock is not cheap compared to its UK peer group. Credit Suisse is, raising the target to $5.00 from $4.80 based on an attractive valuation, strong growth prospects and upside earnings risk. The broker estimates the acquisition will be 3% accretive in FY15 and FY16.

BA Merrill Lynch upgraded Rio (RIO) to Buy from Neutral. Rio is down 12% since its Feb peak, underperforming BHP Billiton (BHP) by 9.5% and the index by 14.6%, driven by the fall in the iron ore price. But the broker believes iron ore is bottoming, as Chinese steel mills will soon need to restock and is confidant Beijing will maintain control over the Chinese property market.

JP Morgan upgraded Wesfarmers (WES) to Neutral from Underweight. JP Morgan is upgrading to Neutral from Underweight following a review of the investment thesis. The broker is increasingly confident in Bunnings and Coles and thinks there is a slight chance of capital management in FY14. Challenges in the industrial division and at Target weigh on the view.

In the not-so-good books

JP Morgan downgraded Nufarm (NUF) to Neutral from Overweight, given reduced valuation support following a rise in the share price in recent months. Improved winter cropping conditions in Australia are being offset by the late start in North America. The broker has revised earnings forecasts for FY14 and FY15 down by 4.6% and 4.8% respectively.

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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Government should back off

by Barrie Dunstan

While the Federal Government is on the warpath over entitlements, it's not clear from longer-term numbers if the figures justify some of the rhetoric. Indeed, in the superannuation policy area, the government appears set on an ideological line, which contrasts with long-term needs.

There's not enough

This has been highlighted recently, not by partisan players, but by David Gruen, the Treasury's top superannuation official and a key policy advisor. In a speech, Gruen said super costs and fees were too high and that there needed to be more emphasis on providing retirement income rather than just the accumulation of savings in super accounts. The challenge was underlined by a report from Deloittes, which highlighted the huge potential gap between super savings and the capital needed to fund retirement income for average workers.

If investment returns remain constrained in the immediate future, retirement savings can only be boosted by higher contributions and/or lower fees. But the Abbott government appears determined to water down the provisions of the Future of Financial Advice reforms to favour the banks and other big institutions – after earlier imposing a temporary freeze on the increase in compulsory SG contributions. Both policy moves favour the business and financial sector at the expense of superannuation fund members.

After all, the bank-dominated financial sector is already doing quite well from super. Treasury and the Reserve Bank in their submission to the Financial System inquiry said total super fees of super were three times those in the UK and, at more than $20 billion a year, represent more than 1% of GDP.

Reducing this by a few tenths of 1% of GDP "would be a significant and worthwhile reform" and "significant reductions in superannuation fees would have widespread benefits for society as a whole," Gruen said.

The recent Senate report on the CBA and ASIC has re-ignited debate about financial advice, but those hoping for a tougher stance to protect individual investors in superannuation need to factor in Coalition politicians' historical aversion to super.

The ideologues

Some of this is ideological; compulsion (as in the SG contributions) doesn't sit well with many Liberals and there is a view that the super system is a love child of the unions. However, over a quarter of a century, the compulsory system has grown to $1.8 trillion and is too large to ignore – as is the $500 billion of self-managed funds in the hands of fiercely independent entrepreneurs.

Superannuation is now too important to be a pawn in an ideological game. Nor should it be treated with benign neglect or treated as a convenient honey pot to finance infrastructure spending or to underwrite the growth of financial institutions.

David Gruen emphasised that the key focus of superannuation should be on providing retirement income "rather than primarily on wealth accumulation." But for a quarter of a century, successive governments have neglected the word "pensions" and despite calls from the industry, the question of creating income products for Australians' retirement always seems to remain a matter for the next inquiry.

And the debate has been hobbled by advocates at both extremes. At one end, some in the super industry have excessive faith in annuities as a solution. Others want to force people away from lump

sums and have part of their savings compulsorily converted into income. Both ignore the fact that it will take a few more decades before the majority of retirees have enough saved for such policies to work. At the other extreme, critics argue that, even after decades of super savings, most retirees still rely on the age pension.

The evidence

However, the recent Melbourne Institute report *Household, Income and Labour Dynamics in Australia* (or HILDA) scotched a few long-standing views. For instance, the Treasurer's allegations of welfare dependency don't entirely stack up: the HILDA report showed people's share of income from government benefits fell from 24.4% to 21.3% over the decade to 2013.

And reliance on the age pension may be waning: HILDA showed the percentage of people on the government pensions showed a perceptible fall over the last decade – from 80.9% to 77.9%. Among those over 65, income not from the age pension rose from 32.2% to 40.2% and for those 65 to 70, the share of non-pension income is now more than half total income. In other words, the combination of a rise in super income and later retirement (for men it has risen from 59.8 years to 62.6 years over the decade) have begun to reduce dependence on the age pension.

It's a slow movement – as are most demographic trends – but it is moving in the desired direction. Imagine how it might improve with a little more sensible encouragement from government policy.

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Short 'n Sweet – A-REITs and Dominos

by Penny Pryor

It was a hard market to play in June. The S&P/ASX 200 accumulation index fell by 1.5%. On a positive note, the index ended the financial year up 17.43%. The Midcap 50 i.e. the smaller 50 companies of the ASX 100, outshone its larger counterparts for the financial year, ending up 20.8%.

Property power

A-REITs were one of only two sectors (the other being Utilities up 0.9%) that ended June higher. Property trusts rose 3.3% over the month.

James Dunn wrote about A-REITs just over a week ago. One of the metrics he looked at was discount to analysts consensus target price. The Astro Japan Property Trust (AJA) had the largest discount to target price at 14.5% and its share price has risen considerably over the past week.

"To be comfortable investing in Astro Japan Property Trust you have to have a confident view on Japanese property: JP Morgan, for one, has such a view, placing a recent "overweight" recommendation on AJA," Dunn said.

Astro Japan Property Trust (AJA)

Another REIT that Peter called out in May was the National Storage REIT. It has had a good run since it listed last year and small cap manager Eley Griffiths started buying the company earlier this year too.

"National Storage is able to offer Australia-wide choice to the customer base and able to tweak facility yields, via a dynamic pricing tool, that permits storage rate movement up/down depending on available supply," Eley Griffiths co-founder Ben Griffiths said.

National Storage REIT (NSR)

The fast food lovers

Back in March this year, Manny Pohl, from ECP Asset Management said he liked Dominos' Pizza because it had good capital management.

"It is a high growth business, with revenue growing annually around 8% over the past three years and return on investment above 20% over the past three years – it is very capital efficient," he said.

It is another company that managed to push through the June malaise and has almost doubled in price over the past year.

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Changes to superannuation in 2014/2015 – are you up to date?

by Staff Reporter

Are you across all of the changes that have occurred to superannuation in the 2014/2015 financial year? There are a few key changes that every SMSF trustee should know about for the new financial year, including increases to the super guarantee, contribution caps, the bring forward rule, ATO penalties, and changes to insurance within an SMSF.

Increase in super guarantee

The rate at which employers pay superannuation has increased from 9.25% to 9.50%. It will be frozen at this rate until 1 July 2018.

Increase in thresholds of contribution caps

There are changes to both the concessional and non-concessional contribution caps. Pre-tax contributions, or the general concessional cap, has increased to $30,000 from a previous limit of $25,000.

However, if you are a person who was 49 years of age or older as of June 30, you can take advantage of a higher concessional cap of $35,000. In the previous financial year, trustees were only able to access a higher threshold at 59 years of age or older.

Financial Year	Concessional cap (general cap)	Non-concessional cap
2014-15	$30,000^	$180,000
2013-14	$25,000	$150,000

^ $35,000 for those 49 or over on 30/6/14

In the new financial year, the non-concessional cap has increased to $180,000.

The 'bring forward' rule

Under the bring forward rule, persons under 65 can effectively make three years of non-concessional contributions in the current year. With the increase in the non-concessional cap to $180,000, the maximum amount that can be contributed under the rule is now $540,000.

To avoid penalties, it is important to note that if you activated the 'bring forward' provisions during the 2013/2014 year – by contributing $150,000 or more to non-concessional contribution – you are still under the old cap of $450,000.

ATO penalties

The ATO now has increased powers to regulate superannuation funds. These penalties are generally comparable to the severity of the rule violation, and can therefore range widely. Depending on the SMSF type, penalties may also be applicable to every trustee within a fund, so the fines can be produced in multiple amounts.

Insurance policies

From 1 July 2014, an SMSF will only be able to hold insurance for a member if it aligns with a 'condition of release'. Conditions of release may relate to life insurance, a terminal illness benefit, or temporary incapacity benefits, etc. It is important to check if your insurance policies do align with these conditions of release outlined by the ATO.

Insurance like trauma, or income protection for example, might not fall under the condition of release from 1 July. However, if an SMSF fund held an insurance policy prior to July 1, that policy will be grandfathered into the future. See Tony Negline's article for more details.

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Hybrids and Hansen Technologies

by Questions of the Week

Question: I have an SMSF of about $630,000, all of which is invested in mainly dividend blue chip stocks i.e. TLS, CBA etc. I have just been made redundant and will receive a termination payment of about $150,000. Also I will be transferring my company super fund benefit ($1,500,000) into my SMSF.

Can you recommend about three hybrid securities that you consider worthwhile investments?

Answer (By Paul Rickard): Hybrids are very expensive at the moment as spreads have narrowed, and getting set on the ASX (where you may need to hit the offer) could be pretty expensive. That said, you could consider some of the older issues – perhaps ANZPA, CBAPC, ORGHA.

Depending on how much you wish to invest, I would be spreading my risk further and investing in more than three issues.

Question 2: Would you invest in Hansen Technologies (ASX Code HSN) at the present time?

Answer 2 (By Paul Rickard): With a market cap of circa $200 million, Hansen Technologies is very much in the 'micro-cap' category. Unless I know something about the industry or the people involved with the company, I leave these sort of companies to the small cap fund managers.

Hansen is actually a bit of a rarity in this part of the market in that it actually has quite a decent track record. Notwithstanding that, I don't have any insights about the "billing market", or the recent acquisition of Banner CIS. History suggests that most Australian companies don't make a good fist of offshore acquisitions – so this is also a 'red flag' for me.

If the question is "would I invest" – the answer is no.

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