**Switzer** Super Report

Issue 317, 28 August 2014

# Turn up the volume

It was pretty quiet on Wall Street overnight (the S&P 500 moved practically nowhere, but is at a record 2,000.12), but here at the *Switzer Super Report,* we're anything but, with Charlie Aitken saying he's looking to global growth and rating Westfield Corporation a high-conviction buy. Find out why.

Also in today's report, Tony Negline unveils three issues you need to consider before changing a life insurance policy. Roger Montgomery analyses the impact of the National Broadband Network on the big telco companies like Telstra, iiNet and TPG. And Barrie Dunstan looks at the Buffet/Munger way of investing and the kind of stocks they favour, i.e., the dependable ones that make you money!

ECP Asset Management's Manny Pohl reveals why he's a big fan of LICs in today's *My SMSF.* Plus don't miss *Buy, Sell, Hold – what the brokers say* and the *Questions of the Week* on CBA's PERLS VII and Westfield/Scentre Group.

Sincerely,

Peter

Peter Switzer

## Inside this Issue

Global growth: Westfield Corporation a high-conviction buy
by Charlie Aitken
02


02 **Global growth: Westfield Corporation a high-conviction buy**
by Charlie Aitken

05 **Beware poor risk insurance advice**
by Tony Negline

07 **The NBN's impact on Telstra, iiNet and TPG**
by Roger Montgomery

09 **Buy, Sell, Hold – what the brokers say**
by Staff Reporter

13 **Investing the Buffet-Munger way – banks, Telstra, Wesfarmers**
by Barrie Dunstan

15 **My SMSF – big fan for LICs**
by Dr Manny Pohl

17 **PERLS of wisdom and Westfield/Scentre Group**
by Questions of the Week


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# Global growth: Westfield Corporation a high-conviction buy

by Charlie Aitken

A few months ago in a note titled ***"Frank-ly, you should give a damn",*** I recommended to our Westfield Retail Trust (WRT) shareholders that they should vote "yes" in favour of the demerger. That vote scraped over the line.

I ended that note with *"Through time, co-investing with the Lowy's in various Westfield entities has made our clients a lot of money. It's been a great ride and one I encourage you to continue."*

Fast forward to today and the "yes" vote recommendation has been vindicated, with the demerged entities, WFD and SCG, having a combined market cap of $35b, or **+$4.5b in demerged value creation for the shareholders of the former Westfield Group and Westfield Retail Trust.**

The simplification of the two businesses by geography was **ALWAYS** going to lead to a re-rating. It allows investors to choose their "weapon" in terms of lower growth dominant domestic assets (A$), or higher growth offshore assets ($USD, GBP). It also makes both companies easier to take over.

Today I want to **focus on Westfield Corporation (WFD) as the macro and micro drivers of growth come together.**

WFD has assets under management of $27.7b, with balance sheet assets of $19.2b and a gearing ratio of 35.1%, as at June 30.

In terms of trading conditions, co-CEO's Peter and Steven Lowy said yesterday *"the operating performance of WFD's pre-eminent portfolio of 40 shopping centres in the United States and United Kingdom remains strong, and in line with expectations, with significant progress being made on the $11.6b pipeline of current and future developments. Our strategy is to continue the focus on creating and operating iconic assets in major markets that deliver great experiences for consumers and retailers. We aim to achieve this with an increased focus on digital technology and by bringing together the best of fashion, food, entertainment and leisure."*

**The biggest attraction to me of WFD is they are in the right markets in the right first world countries. If you look where their "flagship" malls are, they are all in high income, high tax paying, high white-collar employment precincts. It is therefore no surprise that on this map of the United States, there is a massive gap in the middle.**

SHOPPING CENTRES – UNITED STATES

Click here *to view larger image*

It's a similar strategy in the UK, with all the assets in Greater London, while the one flagship European asset is in the Italian fashion capital of Milan.

## SHOPPING CENTRES – UK/EUROPE

2014 HALF YEAR UPDATE | 15

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WFD centre management continues to run the assets hard. WFD's portfolio achieved comparable net operating income growth of +5.3% for the six months ending June 30. WFD's flagship portfolio of 11 centres, representing 66% of the total portfolio by value, achieved comparable net operating income growth of +5.5% for the six-month period. WFD's regional portfolio of 23 centres, representing 30% of the total portfolio by value achieved comparable net operating income growth of 5.0%.

Specialty retail sales were +5.8% in the flagship portfolio and +2.1% in the regional portfolio. The flagship portfolio was 95.9% leased and the regional portfolio 93.1%.

It is therefore quite easy to see why WFD is focused on growing its flagship portfolio and reducing its exposure to regional malls. By the end of its $9b development pipeline (WFD share $4.5b), **WFD's expects flagship assets will be 80% of its portfolio and the assets split more evenly between the US and UK/Europe.** That further increase in flagship weighting, with its associated higher returns, will lead to a P/E re-rating of WFD over the next few years. Below is the current portfolio statistics and you can see why the focus is "flagship". The rent difference alone per sqf is the key metric.

## SHOPPING CENTRE PORTFOLIO STATISTICS

| As at 30 June 2014 | Assets under Management ($bn)[1] | % of Portfolio[1] | WFD Interest ($bn)[1] | Yield[1] | Portfolio Leased (%) | Specialty Occupancy Cost (%) | Specialty Retail Sales (MAT/ psf) | Specialty Retail Sales Growth (%)[2] | Average Specialty Store Rent | | Comparable NOI Growth (%)[3] |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | Amount (psf) | Growth YOY (%) | |
| Flagship | 18.3 | 66% | 11.4 | 5.1% | 95.9 | 15.4 | $954 | 5.8 | $117.88 | 5.1 | 5.5 |
| Regional | 8.2 | 30% | 5.0 | 6.0% | 93.1 | 14.7 | $467 | 2.1 | $61.24 | 2.4 | 5.0 |
| Total[4] | 27.7 | | 17.6 | 5.5% | 94.4 | 15.2 | $681 | 4.2 | $87.64 | 4.0 | 5.3 |

Click here *to view larger image*

The balance sheet is strong, with $3.9b of available liquidity provided by committed bank facilities and cash. The average term of mortgages is 5.9 years and bank facilities 4.5 years.

The way to look at WFD, in my opinion, is a mixture of tier one mall owner/operator, developer and currency play. **This is not a vanilla property trust: this is an ASX listed global growth stock with entirely offshore earnings.** It arguably shouldn't have its primary listing on the ASX (NYSE??).

Perhaps that "non-vanilla LPT" status is why the current analyst view on WFD is so tepid. The current BUY/HOLD/SELL ratio is 3/8/4 and median 12 month price target $7.52, below last night's closing price of $7.61.

I think that consensus view will prove too conservative, particularly when I look out to CY15. In CY15, if I am right about a resurgent USD, WFD's FFO could be 44c. I have a view the market would pay 20x for that offshore earnings stream, setting a **12-18 month price target of $8.80 for WFD.**

WFD FFO growth over the next few years should strongly outpace Scentre Group FFO growth. In pretty simple macro terms, Australia has slowing GDP and rising unemployment, while the USA/UK has accelerating GDP growth and falling unemployment. Similarly, SCG's domestic malls are 99% leased, while more tenants can be added to the WFD portfolio.

At the current respective share prices, SCG is trading on 15.3x consensus CY15 FFO, while WFD is trading

on 17.8x consensus CY15 FFO forecasts. I believe those WFD CY15 FFO forecasts will prove too conservative, as I mention above, and on my 44c FFO forecast for WFD for CY15, the stock is trading on 17x. **Either way on just a 2 P/E point premium to the lower growth SCG, I think it's time for active investors to take profits in SCG and switch to WFD.**

**Switching from SCG to WFD** also more aligns us with the Lowys themselves, who own 8% of WFD and 4% of SCG. 8% of WFD currently has a value of $1.25b, while 4% of SCG has a value of $739m.

Co-investing with proven people has been a core investment philosophy of mine, which has served us very well.

In this case, I am now rotating to the global growth vehicle, WFD, and rate **WFD a high conviction buy.**

This is another strategic portfolio manoeuvre to gain more US dollar exposure, lower pure yield compression exposure (via taking SCG profits), and add more structural growth (at a reasonable price).

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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# Beware poor risk insurance advice

by Tony Negline

ASIC has said that risk insurance and poor advice seem to go hand-in-hand.

Peter Kell, one of ASIC's Assistant Commissioners, recently said that many of the cases of poor or defective advice that ASIC reviews involve risk insurance products, such as death, permanent or temporary disability and trauma insurances.

This represents a good wake-up call for SMSF trustees.

**Your investment strategy**

For the last couple of years, SMSF investment strategies have had to be in writing and when drafting your strategy, you must consider the insurance needs of at least one member of the fund.

This last requirement isn't designed to force an SMSF to purchase life insurance. It's a catalyst to consider the need for risk insurance.

**Recent NSW Court of Appeal case**

A good example of how risk insurance advice can go horribly wrong has recently been dealt with by the NSW Court of Appeal.

The initial case had been heard by the NSW District Court.

The case involved advice by a Commonwealth Bank Financial Planner to change from a Westpac life insurance death policy to a similar policy with CommInsure, a CBA subsidiary.

Not long after the CommInsure policy was in place, the insured, Mr Stevens, was diagnosed with pancreatic cancer. He died not long after winning the District Court case. CBA wasn't happy and appealed this decision to the NSW Court of Appeal. His appeal was run by his daughter, who was executor of Mr Stevens' deceased estate.

CommInsure denied the claim for the policy because it decided that Mr Stevens hadn't been honest with them about his medical conditions when he initially applied for the insurance.

Under the *Insurance Contracts Act,* when you apply for life insurance, you have a duty to disclose any medical information that an insurer needs to assess whether or not it wants you as a client. This duty of disclosure survives for the first three years after a life insurance policy has commenced. And as detailed in another recent article this duty continues until the insurance company has formally issued the contract.

CommInsure's decision wasn't in dispute in this case. The Court of Appeal justices go to some lengths to show that Mr Stevens hadn't made full medical disclosure.

The problem for the Commonwealth financial adviser was that the Westpac policy was more than three years old and the duty of disclosure 'escape' clause for the insurer had lapsed. This means that even if Mr Stevens had disclosed incomplete medical records to Westpac, his claim couldn't be rejected for that reason.

In addition, the Commonwealth Financial Planner claimed that the CommInsure policy was better from a cost perspective than the Westpac policy. The Court found this to be incorrect for several reasons including the fact that Commonwealth didn't allow their adviser to recommend keeping an existing non-CommInsure policy. (The logic here being you can't claim something is better when you have no information or mechanism to compare one product.)

The adviser had confined the comparison between the Westpac and CommInsure policies to reviewing the difference between the first year's premiums for both policies. The Court found this to be unacceptable.

**Issues to consider before changing life insurance policies**

Here are three issues you need to consider before replacing one life insurance policy with another one:

1. Never stop an existing insurance contract unless you've carefully determined you no longer need it. With this in mind, it's dangerous to stop an existing contract before a new one is actually in place.
2. Remember the three-year non-disclosure rule – if your existing contract is more than three years old and you take out a new contract, then the three-year rule begins again. This may be a disadvantage, especially if you accidentally don't disclose some important medical information.
3. Many life insurance contracts allow you to choose 'stepped' and 'level' premiums. A stepped premium means that the premium is recalculated each year based on your age, whereas the level premium remains unchanged once it has been set. In most cases, the stepped premium is initially cheaper but over time the level premiums will become cheaper. You need to carefully assess what your best option is now and will be over the period of time that you think you'll need the insurance.

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# The NBN's impact on Telstra, iiNet and TPG

by Roger Montgomery

ADSL has for many years been the staple of what retail service providers (RSPs) utilise to offer internet services. This is largely based off of the existing Telstra copper network, one originally designed for telephony services and not the internet. Technology has since developed and more advanced ways of delivering internet capacity are now available, particularly in fibre-based networks, the backbone of the National Broadband Network (NBN).

An NBN had been debated by various private institutions such as Telstra since the early 2000's yet were never able to obtain approval by the ACCC. In April 2009, the Labor government announced plans for a new NBN project that would provide a wholesale open-access network to RSPs and deliver internet connectivity at 100Mbps to 90% of Australian households via fibre to the premise technology (FTTP). This project was estimated to cost $43 billion and would be designed, built and operated by a newly created government business enterprise: NBN Co.

Part of the process would involve the decommissioning of telephone network assets owned by Telstra and Optus, allowing for NBN Co to hold a monopoly in the provision of wholesale internet capacity.

Soon after the Coalition's victory in 2013, an independent review of NBN Co was conducted with several key conclusions found:

1. Progress of NBN deployment (as measured by the metric; premises passed) was **55%** behind corporate plan as of September 2013.
2. Fibre to the node (FTTN) networks could be rolled out quicker and a lot more cheaply compared to FTTP (the Coalition forecast the cost at $29.5B however it's difficult to say whether this will hold). This would be, however, at the expense of internet speed, with entry-level speeds falling from 100MB/s to 12MB/s (comparatively, our fastest ADSL connections on copper networks have a theoretical maximum speed of about 24MB/s, 16MB/s more practically).
3. FTTP will comprise 20-26% of the network, FTTN & fibre to the basement (FTTB) will comprise 44-50% of the network and hybrid fibre coaxial technology (HFC) will comprise 30% of the network.

Actual NBN deployments are worse if you consider that the metric — premises passed — does not mean that a particular premise is able to use the NBN. Each premise passed still needs to be activated by NBN Co. Asking whether or not the project will be completed in the next decade or the one after that isn't a bad question.

Of course the real billion-dollar question is: how will the NBN's rollout impact listed RSPs like Telstra Corporation Limited, iiNet Limited, Singapore Telecommunications Limited (Optus) and TPG Telecom Limited? Consider that each customer (as the NBN is activated for their premise) will be able to review the pricing and offers from the spectrum of providers. Naturally, those such as TPG and Dodo, with lower cost plans, will look more appealing and hence possess a competitive advantage over their peers.

Another question we can ask is: "How profitable will each RSP be on the NBN?" We firstly note that the average revenue per user (ARPU) amongst the providers is about $60-$80 per month, and on the cost side? Well this is where it gets complicated…

Connecting a user to the NBN involves several different kinds of costs. Firstly, NBN Co charges a connection fee based on the speed of the connection the user requires. For example, a user wanting a 12/1

Mbps service will incur a connection fee of $24 per month whereas a user wanting a 100/40 Mbps service will incur a connection fee of $38 per month. Next are the connecting virtual circuit (CVC) charges, which are calculated via a complex algorithm but grant the user an allocation of bandwidth capacity in which data can be carried. The average CVC can be estimated but is not currently known (and we won't add to the speculation with our own estimate). Other charges include network-to-network costs and other backhaul charges, which when averaged, vary depending on the location and the number of users.

Estimates of total averaged costs vary widely from $25 per user per month to north of $40 per user per month (noting additional charges for providers such as iiNet whom have to rent their backhaul). At the lower end of the spectrum, the NBN is a boon for the industry. At the upper end, it's the opposite, especially when you consider the projected NBN Co price rises (whether by higher data demand or price increases) and the competitive market, which places downward pressure on RSP ARPU.

I'll finish up with a quick look at TPG and their progress in developing their own FTTB NBN, which is directly in competition with NBN Co. Other RSPs have signaled their intent to develop similar networks should the progress of the NBN's rollout continue to stagnate. On the surface, this does seem like the jolt that perhaps NBN Co needs to "get moving", however the move could be anti-competitive should a premise hooked on to one RSP's FTTB network only have access to said RSP's plan. In response, the Vertigan Review has recommended that TPG be allowed to develop their own NBN provided that they allow other providers to use it. Ultimately the decision will rest with the ACCC, whom we'll be watching very closely.

*Montgomery Investment Management owns shares of iiNet Limited (ASX: IIN).*

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# Buy, Sell, Hold – what the brokers say

by Staff Reporter

While there were many more downgrades than upgrades, the common theme was that some stocks are fully priced and that there is not much blue sky left. One of the stars of 2014, Orora, suffered three downgrades – despite beating brokers' forecasts!

There were some misses on earnings – with Bluescope Steel, Fleetwood Corporation, Mermaid Marine and Pacific Brands earning a downgrade following a disappointing report.

On the flipside, IOOF, M2 Telecommunications and Qube earned upgrades following their reports.

**In the good books**

**Beach Energy (BPT) was upgraded to Neutral from Sell by Citi.** The company's FY14 results were in line with the broker's estimates. FY15 forecast has been moved forward 5.2%, while FY16 forecasts remain unchanged. The broker notes that current capex levels appear high, but are inflated by the one-off Cooper infrastructure expansion program. The price target is lifted to $1.78 from $1.69.

See also BPT downgrade by Credit Suisse.

**Bluescope Steel (BSL) was upgraded to Outperform from Neutral by Credit Suisse.** FY14 proved in-line but guidance for FY15 was some 20% below consensus, observe analysts at CS. They have cut estimates, but left their $6.40 target unchanged. Given a negative response by the market to the company's guidance, this now leads to an upgrade in rating, to Outperform from Neutral.

See also BSL downgrade by Macquarie.

**Cabcharge (CAB) was upgraded to Neutral from Underperform by Macquarie.** Cabcharge's result beat the broker, but the 10c div fell short of the broker's 13c forecast. CAB noted turnover in Victoria had increased some 30% since the surcharge was halved by the government but the revenue loss more than offset. This is not as bad an outcome as the broker had feared, but if NSW-WA follow suit, the broker does not expect similar market share gains. CAB still faces structural headwinds but has improved as a valuation proposition, the broker suggests. A shift in valuation model to PE from sum of the parts prompts a target increase to $5.48 from $3.50. Upgrade to Neutral.

**Federation Centres (FDC) was upgraded to Buy from Neutral by UBS.** Federation Centres' result beat the broker on earnings, distribution and FY15 guidance. The broker had flagged upside on cost cuts and further syndicate acquisitions. Supermarket sales were the only disappointment in an otherwise solid result all round, but the broker expects improvement ahead. On that basis, the broker has increased its target to $2.75 from $2.52 and upgraded to Buy.

See FDC downgrade by Deutsche below.

**IOOF Holdings (IFL) was upgraded to Buy from Neutral by UBS.** IOOF's result beat the broker on lower operating expenses and tax. Organic momentum is building and given IFL's track record of delivery, synergies from the SFG acquisition should help support the broker's two-year compound growth forecast of 12%. IFL has underinvested in growth over the years but is a more defensive proposition than pure-play fund managers, the broker suggests, and offers double the earnings growth of AMP ((AMP)). Target rises to $9.70 from $8.70, upgrade to Buy.

UBS joined Citi, JP Morgan, and Macquarie with positive ratings on IFL. Merrills rates as an Underperform, while both Credit Suisse and Deutsche are Neutral.

**M2 Telecommunications Group (MTU) was upgraded to Hold from Reduce by CIMB.** Earnings were ahead of the broker's forecasts for FY14. CIMB observes the company has demonstrated the value in its organic business model and, on an upgraded outlook, further good growth is still expected in FY15. The stock justifies a higher market valuation now and CIMB upgrades the rating to Hold from Reduce and the target to $7.00 from $5.42.

Citi and Credit Suisse reaffirmed Buy/Outperform ratings for MTU, Macquarie is Neutral.

**Qube (QUB) was upgraded to Add from Hold by CIMB.** Qube's FY14 results were slightly ahead of the broker's forecast. CIMB is confident that management has the ability to drive strong earnings growth into the future and therefore lifts its FY15 forecast by 15%. The broker has upgraded the stock to Add from Hold and the price target is raised to $2.73 from $2.13.

Each of the other major brokers reaffirmed Neutral/Hold ratings on QUB.

**Senex Energy (SXY) was upgraded to Buy from Neutral by Citi.** Senex reported FY14 earnings below Citi's forecast. FY15 forecast has been reduced by 26% and FY16 by 20.6%. The broker has upgraded the stock to Buy from Neutral. Citi believes a greater focus on exploration will add greater value in the long term. Price target is raised to 85c from 84c.

Credit Suisse and Macquarie reaffirmed Outperform ratings, JP Morgan a Neutral rating for SXY.

**In the not so good books**

**Beach Energy (BPT) was downgraded to Neutral from Outperform by Credit Suisse.** Beach had pre-warned, but CS analysts had waited before updating their modelling. They have cut forecasts on a mix of changed assumptions but the key factor is that operations in the Cooper Basin require more capex than previously thought. CS is suggesting Beach might be better off spending money elsewhere and selling its stake in the JV, potentially offering it to partners Santos ((STO)) or Origin Energy ((ORG)). The lower Cooper Basin valuation is partially offset by better than-expected cash conversion and a roll-forward of the valuation model with the end result only a 10c drop in the target, to $1.80. Recommendation downgraded to Neutral from Outperform.

See also BPT upgrade by Citi.

**Bluescope Steel (BSL) was downgraded to Underperform from Outperform.** Bluescope's result appeared to meet guidance but take out a tax effect and it missed the broker's forecasts. First half FY15 guidance remained very cautious, with weak domestic steel demand the primary driver. The broker has slashed forecasts but suggests more cuts might come if there is no evidence of any sort of pick-up in steel demand in the near term, as the broker had previously assumed. Target falls to $5.52 from $6.86 and rating downgraded to Underperform from Outperform.

See also BSL upgrade by Credit Suisse.

**Dexus Property (DXS) was downgraded to Underperform from Neutral by BA-Merrill Lynch.** The company is experiencing a deteriorating underlying growth outlook, in Merrills' opinion. Funds from operations guidance for FY15 is being driven primarily by the recognition of trading profits, a low quality earnings source, and the broker does not believe this is sustainable across the cycle. The broker believes there is downside risk to the share price and the stock is moderately overvalued. Rating is downgraded to Underperform from Neutral. Target is steady at $1.16.

**DUET (DUE) was downgraded to Underweight from Neutral by JP Morgan.** FY14 results were slightly above the broker's forecasts, although proportionate cash earnings were well below. JP Morgan is re-examining sector-relative recommendations in the light of this. With the stock trading 11% above the $2.20 target, JP Morgan downgrades to Underweight from Neutral. In relation to M&A, the company has pointed out that there has not been any discussion with Spark Infra ((SKI)) since it acquired a 14% stake earlier this year.

Other brokers reaffirmed Neutral/Hold ratings on DUE, with Macquarie rating as Outperform.

**Federation Centres (FDC) was downgraded to Neutral from Buy by Deutsche Bank.** FY14 results were in line. Deutsche Bank had expected strong FY15 guidance but the growth forecast exceeded expectations. On revised estimates, which are up by 2.5% on average, and while the growth profile is attractive, the broker raises the target to $2.65 from $2.60. The rating is downgraded to Hold from Buy as the stock appears fairly valued.

See FDC upgrade by UBS above.

**Fleetwood Corporation (FWD) was downgraded to Underperform from Neutral by Credit Suisse.** CS saw yet another weak result and though there were some positives, overall visibility remains low and the analysts thus believe the risk remains to the downside. Price target sinks to $2.25 from $2.70. CS states it has a low conviction on any recovery story unfolding in FY15. Earnings estimates have received the chainsaw treatment. The analysts don't believe the share price is low enough to account for ongoing risk.

Separately, JP Morgan reaffirmed an Underweight rating, while Macquarie rated FWD as Neutral.

**Mermaid Marine (MRM) was downgraded to Neutral from Buy by UBS.** Mermaid's result fell slightly short of the broker but featured Jaya acquisition costs. The dividend was a nice surprise and the broker notes MRM's balance sheet is still well positioned. Target falls to $2.40 from $2.42 and given a recent strong run in the share price, rating is pulled back to Neutral. The other major brokers are also Neutral on Mermaid Marine.

**NIB Holdings (NHF) was downgraded to Underweight from Neutral by JP Morgan, and to Sell from Neutral by Citi.** NIB's FY14 results missed the JP Morgan's forecast, and following subdued FY15 guidance, JP Morgan has reduced its FY15 and FY16 earnings forecasts by 10% and 6% respectively. The broker believes the stock still offers potential for very good long term earnings growth. The price target is cut to $3.00 from $3.15.

Citi has downgraded NHF to Sell from Neutral as it believes the earnings multiples the stock is trading at are too high. The broker has also lowered its FY15 and FY16 forecasts by 18% and 7% respectively. Target price is increased to $3.14 from $3.10, but this includes NHF's special dividend of 9c.

Separately, Macquarie reaffirmed an Outperform rating, Deutsche a Hold, and Credit Suisse an Underperform for NHF.

P**acific Brands (PBG) was downgraded to Neutral from Buy by Citi,** following weak FY14 results and a 26% drop in earnings. As a consequence, Citi has cut its FY15 forecast by 16% and FY17 forecast by 15%. The broker believes the sale of the Workware division may be followed by further disposal of key brands. The broker values the company at 73c per share under this break up approach, and places a 25% probability on this occurring. Price target is reduced to 55c from 60c.

Other major brokers remain negative about PBG.

**Scentre Group (SCG) was downgraded to Neutral from Buy by Citi, and Neutral from Buy by UBS.** Scentre's first half results were basically meaningless as the company was formed only recently, but Citi believes progress will be made in the second half, in line with management's guidance. With concerns about the overhang having largely abated, the broker believes the market is better reflecting the value of the business and as a result downgrades the stock to Neutral from Buy. Price target is reduced to $3.52 from $3.55.

Second half guidance for 2014 is slightly below the broker's estimates but UBS remains comfortable with its figures. Distribution guidance is in line at 10.2c per security. Credit conditions have continued to improve and operating income guidance has been upgraded. UBS is downgrading to Neutral from Buy on valuation. The stock remains a preferred A-REIT but the sector screens expansively at current levels, in the broker's opinion. Target is raised to $3.43 from $3.30.

Overall sentiment on SCG remains marginally positive, with BA-Merrill and Deutsche rating as a Buy, JP Morgan at Neutral and Macquarie at Underperform.

**SAI Global was downgraded to Hold from Buy by**

**Deutsche.** Operating results were broadly in line with the broker's forecast. Management anticipates improved profitability in FY15 with benefits from cost cutting. Deutsche Bank downgrades to Hold from Buy on valuation grounds. The target is lowered to $5.18 from $5.25.

**Sims Metal Management (SGM) was downgraded to Neutral from Overweight by JP Morgan.** FY14 profit was well below the broker's estimates. The broker expects a pick up this year but this is dependent on a considerable improvement in underlying market conditions in North America. There is limited upside to the broker's $12.35 target so the rating is downgraded to Neutral from Overweight.

Brokers are mixed on SGM – with Deutsche, Macquarie and UBS in the Buy/Outperform camp, Citi at Neutral, and Credit Suisse and CIMB at Underperform/Reduce.

**Specialty Fashion Group (SFH) was downgraded to Neutral from Outperform by Credit Suisse.** Specialty's weak result was in line with expectation. That opening sentence was from February this year, so not much has changed since. CS analysts do have positive expectations regarding the Rivers acquisition that is currently being bedded down. In the short term, however, higher costs lead to reduced forecasts. Rating has been downgraded to Neutral from Outperform, while the target remains unchanged at $1.00.

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# Investing the Buffet-Munger way – banks, Telstra, Wesfarmers

by Barrie Dunstan

It was just over 10 years ago and I had gone to Omaha, Nebraska, to hear the wisdom of Berkshire Hathaway chairman, Warren Buffett. Instead, the most memorable line came instead from Buffett's deputy, Charlie Munger. It still resounds – even more strongly – today.

Buffett talked in paragraphs; Munger talked in headlines. In May 2004 – still more than three years before the global financial crisis began to rumble – a shareholder sought Munger's advice on investing. He gave a three-word reply: "reduce your expectations."

As a market timer, it turned out he was two and a half years too early: the stock market kept rising until the Dow Jones peaked at more than 14,000 points in October, 2007. Since then, markets have recovered to fresh peaks but caution and lowered expectations still seem investors' almost constant companions. And Australians have had several recent cautions on risk from Reserve Bank governor Glenn Stevens, with financial inquiry chairman David Murray adding his warnings.

With US investors spurred on by zero interest rates and a slowly improving economy, local share prices seem supported and, as long as interest rates remain very low, investors will keep chasing dividend yields. As the Reserve Bank governor noted in his recent testimony to parliament, companies are operating with their eyes mainly on shareholders [and are] "intent on sustaining a flow of dividends and returning capital to shareholders and less focused on implementing plans for growth".

This may not suit the economic policy needs of the Reserve Bank or Canberra but company boards know that as long as they keep doing this and invest just enough to keep profits ticking upwards, investors will continue to buy income plays. This means those boring stocks on everyone's list are: the big four banks, Telstra, BHP, Woolworths and Wesfarmers, which make up much of the ASX index. And who would complain? These stocks may be boring but they also are dependable, especially with dividends and capital returns top of mind with directors.

These often are the sort of stocks favoured by Buffett and Munger – those companies with a monopoly or oligopoly market status or other "moats" that protect their market, and companies that focus on cost control the efficiency.

As for Glenn Stevens' concerns, there's a good argument in favour of putting money back in the hands of the owners of the capital to do what they want with it, rather than retaining it in the company. This means companies then have to compete on the capital market if they want fresh funds for expansion, ensuring capital goes to the most efficient users.

Investors may be able to spread their portfolio a little wider, if they follow the Buffett-Munger approach. For instance, companies running infrastructure assets like Transurban and Sydney Airport have the advantage of monopoly or near-monopoly powers, while groups like ASX, Aurizon, Brambles, Computershare and CSL have "moats" that protect them from competitors.

Most stockbrokers continue to search for growth stocks, which will provide capital gains, but more SMSF trustees increasingly are focused on the boring income stocks, simply because more than half SMSFs are now pension-paying funds and trustees are under constant pressure to maintain the level of their income.

There's still scope to find and invest in growth stocks; what is important in the new, low growth era is that investors don't over-reach and chase returns

from areas or assets outside their risk profile or outside of what Munger calls their circle of competence. He also suggests investors learn from past history, quoting Roman philosopher Marcus Cicero that a man who doesn't know what happened before he was born goes through life like a child.

If lower economic growth (with the occasional burst of stagnation) is possible in the medium term, then the advice of Buffett and Munger to maintain lower expectations for investment returns may well channel SMSF investors in low risk investments. But this accords with Buffett's two investment rules: the first rule is don't lose money; the second rule is don't forget the first rule.

***Important:*** *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

# My SMSF – big fan for LICs

by Dr Manny Pohl

**Name:** Manny Pohl
**Age:** 60
**Other members of the SMSF:** My gorgeous wife Gail

**How long have you had your SMSF?**

It was established on 11 March 1996.

**Why did you start it up?**

I wanted to have control over the investment of my life savings.

**How big is it?**

I would estimate that we are approximately 75% of where I believe we need to be.

**Is it more or less difficult to manage than you thought it would be?**

I never thought it would be difficult and this has proven to be the case. It is made easy with access to the right systems and good information.

**Do you enjoy managing it?**

Absolutely – it's my life passion.

**Are you pleased with its performance?**

It has been exceptional with a since inception performance of 13.6%.

**Can you give us some numbers around performance over the last 1, 3 and 5 years?**

The 1-year number is 19.4% and the three-year number is 11.0%.

**What is your asset allocation i.e. what percentage is in domestic equities, international equities, fixed income, cash and other?**

I have no exposure to overseas investments because I wanted to align the currency of the fund assets with the currency of the liabilities and remove any unnecessary risk to the return expected from the assets. Furthermore, Australian investments have historically performed very well over the long term. The major asset allocation is to equities due to the fact that one shares in the economic value that businesses create over time. Direct property is approximately 20% of the fund and there is no exposure to bonds.

**What are your favourite investments/stocks and why?**

I am a big fan of LICs because they are very efficient and transparent and don't need a lot of attention. More importantly, they have been solid performers.

**What investments do you have outside of superannuation?**

I have a major stake in three LIC's and a few private equity investments as well.

**Do you use an advisor or any kind of service provider?**

None, other than the accountancy firm that prepares the annual financial statements.

**Is there anything else you would like to tell us about your SMSF?**

SMSF legislation is one of the better ideas to have come out of Canberra but the concern is that they forget the intention, which is to alleviate the burden on the state to provide old age pensions and meddle with what is a great structure.

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# PERLS of wisdom and Westfield/Scentre Group

## by Questions of the Week

**Question:** In my SMSF at 30 June 2014, we held 2,000 Westfield Group (WDC). Under our entitlement, we received 2,492 Scentre Group, plus 2,000 Westfield Corp. Having since sold the 2,492 Scentre, I need to know the cost base for the entitlement. Have tried reading the 400-odd page Westfield document but still none the wiser. Can you help please?

**Answer (Paul Rickard):** Thanks for the question.

If you look at page 329 in the Explanatory Memorandum, there is an explanation of the general taxation principles.

In essence, your existing cost base for your former Westfield Shares will be apportioned between the 2,000 new shares in Westfield Group (WFD) and the 2,492 units you received in Scentre (SCG).

Westfield/Scentre are awaiting an advice/ruling from the ATO about this – which is allegedly due at the end of August.

This advice will be communicated when received (and available on their websites), and hopefully, will have a reasonably straight-forward method of apportioning your previous cost base.

**Question 2:** Thanks for your good cover on PERLS. I would like to ask, as you have not covered it, if it is worthwhile to convert PERLS V to VII? And what if we don't?

**Answer 2 (Paul Rickard):** Thanks for the question.

If you don't convert the stock, then Commonwealth Bank will redeem the PERLS V from you by paying you the face value of $200 per Note. You will receive this, plus the quarterly distribution of $2.1367, on 31 October.

You are under no obligation to convert your PERLS V to PERLS VII – however if you don't, what are you going to do with these funds?

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