Switzer Super Report

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The road less travelled

Overnight the US Fed might have said that rates would stay where they are for a "considerable time" but the median federal funds rate projections from the members of the Federal Open Market Committee is edging up.

So it might be later than some thought, but the Fed will eventually start raising rates and, as Charlie says today, you need to be positioned ahead of the fact. That means finding exposure to US dollar assets. If Charlie is right, it also means an end to the yield trade, and you need to start thinking about whether or not yield at any price is worth it.

Also in the *Switzer Super Report* today, we take a look at the US IPO that everybody's talking about - the Alibaba listing tomorrow. K2 Asset Management head of international equities, Nick Griffin, explains what they like about it in *Fundie's Favourite.*

Sincerely,

Peter Switzer

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Don't fight the Fed

by Charlie Aitken

The Fed is reducing support for the yield trade (QE ends October) and will start raising cash rates in 2015. Your portfolio needs to be positioned ahead of that event. Markets move in anticipation and you can't wait for the "fact" here.

This is a major trend change event and, in my view, the beginning of the end of the outperformance of the yield trade. You only have to look at the Australian dollar for guidance to this starting.

You don't need more banks

On the 29th of April this year, I downgraded the Australian bank sector to "hold" (neutral) on the basis that our long-held FY14 5.00%FF yield-based share price targets had been hit or exceeded. That day proved to be the top for **ANZ** ($35.07), **NAB** ($36.00) and **WBC** ($35.99) for the year to date. **CBA** did trade slightly higher into its FY14 result/div, but is now lower and has cracked the multi-year technical uptrend (chart below).

Since then I have further downgraded the bank sector to *"underweight"* on the basis of rising unemployment, rising long bond yields, regulatory capital risk (Murray report), macro-prudential risk (RBA), weak credit growth, competitive pressure, a view on bad and doubtful debts (BDD) increasing from here (WA led), weakening technicals (momentum fade) and basic over-ownership by Australians.

Yesterday, the ASX200 Banks index broke down through the 200-day moving average, a clear sign of a major momentum change.

Click here for a larger image

Central banks have forced anyone who relies on investment income to move up the risk curve, to the point where I believe people who were buying "yield at any price" are clearly forgetting equities and corporate debt are not fixed interest, least of all a term deposit.

QE and zero interest rate policy (ZIRP) have created the greatest yield bubble in modern history. We rode it on the way up, made great capital gains inverse to yield compression, but now it's only a question of whether the yield bubble deflates slowly, or simply pops. Either way, the absolute and relative price paid for yield has peaked. Simultaneously, volatility in yield equities has bottomed.

My concern has been that these individual investors, who were somewhat late to the "yield compression party", haven't been tested by volatility and capital losses. I also suspect there is more personal carry trade money in risk yield instruments than we all

suspect, again negatively gearing into fully franked yield equities is rewarded by the ATO to Australian taxpayers, but no foreign investor sees it that way. Again, this is outright dangerous when the tide turns.

Quite frankly, Australians are paying a massive premium to the rest of the world for exactly the same earnings/dividend stream. That had worked up until April this year, but the world is changing. What you need to consider is who is going to be the marginal buyer of Australian yield equities (and debt for that matter) as global long bond yields and cash rates normalise?

I can't answer that and I suspect we won't find any foreign buyers of Australian anything until the Australian dollar is down near 85 US cents. In fact, as we have seen in recent weeks, the Aussie dollar falling brings out foreign selling of Australian yield equities, most likely from Japanese insurance companies getting killed on currency carry.

Dividends will still be paid

Funnily enough, I don't have concerns about the physical ability for Australian banks to pay consensus dividends and hybrid payments. If I had those concerns, I would be limit short, not just underweight.

Don't get me wrong. Raw Australian bank annual dividends will continue to rise, albeit very slowly from here, as they are forced to hold more regulatory capital. My concern is what will the world pay for those dividend streams in a more normalised long bond yield and interest rate environment?

If you are only interested in fully franked income streams, then at this stage you should have no concerns about those income streams. Your concerns should be about capital. You will get your income, but the value of your investment will fall in capital terms.

In an attempt to quantify the capital downside in the Australian banks, I am going to do the inverse exercise of the last few years (which made us so much money). I am going to set potential share price targets from prospective dividend yield-based targets, albeit this time around the share price targets are all below the current share prices.

All Australian banks weren't created equal. On that basis, I am going to risk assess each bank and allocate what I think is an appropriate risk-adjusted dividend yield target for FY15. I believe this is a more appropriate approach moving forward than the "one size fits all" yield approach we had on the way up. Bull markets are indiscriminate. Bear markets are more discerning.

I am assuming Australian government bonds 10YR yields move to 4.20% in the period and have applied what I believe would be an appropriate equity yield risk premium to that "risk free rate". These are the FY15 dividend yield targets I have applied.

CBA 5.75%

WBC 6.00%

ANZ 6.25%

SUN 6.25%

NAB 6.50%

BOQ 6.50%

BEN 6.50%

	FY15 DPS est c	FY15 yield target	FY15 yield price target	Current share price
CBA	422	5.75%	$73.39	$77.35
WBC	192	6.00%	$32.00	$32.90
ANZ	187	6.25%	$29.92	$31.43
SUN	95	6.25%	$15.20	$14.02
NAB	210	6.50%	$32.30	$33.18
BOQ	70	6.50%	$10.76	$12.09
BEN	68	6.50%	$10.46	$12.04

Suncorp best pick

While not a perfect science and only an exercise in forecasting, the table above reminds you why **Suncorp** is our no.1 pick and the only "bank" in our high conviction buy list. This also reminds me why we are strategically overweight insurers and underweight banks. It also reminds you, which is 100% right, that the biggest downside capital risk in this scenario is in the regional banks. I can't see any risk adjusted reason to own the two regional banks. The chances of regional banks being allowed to hold less capital

are zero in my view. What will happen is big banks will have to hold more capital and that's where the playing field will be marginally leveled. No bank regulator is allowing any bank to hold less capital at this point of the cycle. The switch from Bank of Queensland to Suncorp remains extremely valid in my view.

My advice remains that you need less exposure to Australian Banks. Whether it's physically selling one of them, or simply recycling dividends into other stocks/cash, my point is you don't need MORE exposure at this stage of the interest rate and asset price cycle.

Let me just finish with a couple of charts that confirm Australian banks are well and truly part of the global yield bubble, a bubble that is deflating.

ASX Banks Index vs. Federal Reserve Total Assets (green line)

[Click here to view larger image]

ASX Banks Index vs. ASX200

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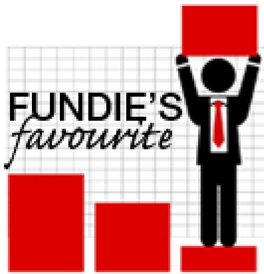

Alibaba – great Chinese exposure on the US market

by Nick Griffin

How long have you held the stock?

Alibaba is due to list on the New York Stock Exchange on the 19th of September 2014. We are bidding for shares in the IPO process. Depending on our allocation of shares from the IPO, we may potentially buy more in the aftermarket, if the opening price is reasonable.

The K2 International Funds, however, have had some exposure to Alibaba primarily via our investments in Softbank and, more recently, Yahoo! Both Softbank and Yahoo! were early investors in Alibaba and they hold 34% and 22.4% of the company respectively. Yahoo! is expected to sell 6% of its holding in the IPO, whereas Softbank is expected to maintain its holding.

What do you like about it?

Alibaba is a company we are interested in, as it is positioned across a number of long-term structural growth drivers that we look for in a company.

The primary driver is rising internet penetration in China. Internet usage is surging, with China now having over 618 million internet users. However, this still represents only 46% of the population, compared to 87% of the population in the US. We expect that with growth in incomes, as well as increased access to PCs, tablets, smartphones, etc. that internet penetration rates will move up over time.

At the same time as this, we expect increasing take up of e-commerce by Chinese internet users. At present, China has 302 million e-commerce users (49% of internet users) and this compares to 61% of internet users in the US using e-commerce. As people become more comfortable with e-commerce, we again expect that the gap with the US will begin to close.

At 279 million active buyers, Alibaba has the dominant position in the Chinese e-commerce industry and hence is uniquely positioned to benefit from the structural growth drivers we've just mentioned.

How is it better than its competitors?

As mentioned, Alibaba has the dominant position in the Chinese e-commerce industry. In the technology space, we always invest in the dominant player. Whether in an incumbent area or as a disruptor technology, the largest company generally wins in tech due to network effects. Take Google as an example. If everybody is on Google, everyone will search with Google and hence everyone needs to be on Google.

What do you like about its management?

Alibaba is led by Jack Ma, executive chairman, who founded the company in 1999 from his apartment in Hangzhou. Ma is a former English teacher and started the company with a group of co-founders, including Joe Tsai, executive vice chairman, who has a background in private equity. The management team has done a terrific job building the company into the leading e-commerce player in China and, to date, management has executed on all growth initiatives and navigated all challenges.

One thing we will have to monitor is the M&A activity that management has been undertaking. Alibaba has been buying into businesses in adjacent industries, with the aim of gathering more data and increasing user engagement. This is a potential bear argument on the stock if concerns arise about management's ability to make sensible acquisitions.

What is your target price?

We expect Alibaba to generate revenues of US$12.5 billion and a net income of US$7.3 billion for the 12 months to September 2015. Based on a peer comparative multiple of ~27.5x (simple average of Google, Baidu, Tencent and Facebook's price-earnings multiples) we value Alibaba at approximately US$201 billion.

At what point would you sell it?

We would look to start selling our position as the share price starts to reflect our target price.

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

Given Alibaba hasn't started trading yet, there has been no impact on performance.

Both the Softbank and Yahoo! investments have been positive contributors for our funds.

Is it a liquid stock?

We expect Alibaba to list at a market capitalisation of around US$155 billion. The stock won't be as liquid as other companies of this size however, as the IPO is raising around US$20 billion and the majority of the equity will continue to be held by Alibaba management, as well as Softbank and Yahoo!.

Regardless, we expect the stock to be liquid enough for K2 to enter and exit with ease and we expect liquidity will improve once the lock-up on Jack Ma, Joe Tsai, Yahoo! and Softbank's shares expires and they can sell their shares freely.

Where do you see the value?

Again, we see considerable value in the Alibaba business. It has a dominant market position in an industry that is supported by structural growth trends. In short, it is a fantastic business. However, we need to remain cognisant of valuations. We need to be prepared to sell shares if the price rises above our target valuation. Many tech companies look like exciting prospects, and most have strong growth ahead of them, but if you don't buy them at the right price, then the inevitable bumps in the road on the way to success will have a disproportionate effect on those companies with huge valuations.

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Short 'n' Sweet – everything you need to go global

by Penny Pryor

Today, our fundie's favourite is on one of the hottest international stocks around at the moment – China's biggest online retailer Alibaba – and it doesn't even hit the US share market until tomorrow.

Here at *SSR* headquarters, we've been getting a lot more queries about international exposure, and buying international stocks, and while it's been a little while coming, we're pleased that SMSF trustees are looking at diversifying beyond our shores.

Last week, Charlie Aitken explained why he thinks we've all got too much exposure to Australian tax effective yield assets in Australian dollars. But at under 3%, Australia also represents just a fraction of the global stock markets so it's good investing sense to look beyond our shores, particularly when economies like the US look like they're on the verge of some decent growth.

Dow Jones (DJI)

Source: *Yahoo!7 Finance, 18 September, 2014*

There's a variety of ways to get access to international shares. You can buy an exchange traded fund (ETF) on the ASX or invest via a managed fund. Earlier this year, *SSR* co-founder Paul Rickard went through some of the major funds you can invest in here.

A number of online brokers also enable you to buy directly. Broker fees will be higher than they would be for buying locally. Fees per trade start at around $60, depending on the broker and the country you're investing in. There may also be inactive account fees, if you don't use your international share trading account for some time.

Because some local brokers use an external provider to help them out, like Pershing in the US, there will be a custody fee of anything between $US63 to $USD68 per annum if your account is inactive.

You also need to think about the different tax regimes. On income, like dividends, tax is usually deducted and withheld at a rate of 15% but you need to complete a W-8BEN form – a form from the US Department of Inland Revenue – which certifies you're not a US resident.

You will generally be able to claim an offset in Australia for the tax that has been withheld.

Also as an SMSF trustee, you need to remember to update your investment strategy, explaining why you're investing offshore if your fund has never bought international shares before.

You can read an earlier article on how to buy offshore here.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Energy was a theme of the two upgrades this week, with Macquarie shifting CSR to Outperform and AGL Energy to Neutral. On the other side of the ledger retail-related stocks – Myer and Premier Investments – suffered.

In the good books

Macquarie upgraded CSR (CSR) to Outperform from Neutral. CSR is facing uncertainty over its electricity supply contract at its Tomago smelter now that AGL has acquired MacGen. But there are a number of scenarios, which could mitigate some of the 2017 step-up in power costs, according to the broker. Meanwhile, aluminium prices are improving, although the broker sees the residential building cycle easing in 2016. The broker upgrades to Outperform on a shorter-term call.

Macquarie upgraded AGL Energy (AGK) to Neutral from Underperform. AGL continues to face challenges with regard to any electricity price recovery, and there is also uncertainty with regard to the Tomago aluminium smelter contract with CSR since AGL acquired MacGen. There is nevertheless upside potential from the sale of Qld gas assets and the stock is now trading at a 14% discount to the broker's valuation.

In the not so good books

Deutsche Bank downgraded Myer (MYR) to Hold from Buy. FY15 was supposed to be a "good" year, lament analysts at Deutsche Bank. Now that Myer management has acknowledged more investments need to be made this year, the stockbroker sees all benefits from new stores and refurbs evaporate even before the new financial year has well and truly started. The analysts believe costs will continue rising and that remains a serious problem.

Premier Investments (PMV) was downgraded to Sell from Neutral by Citi and to Neutral from Buy by UBS, mostly on a run-up in the share price. Citi says FY14 results were "good" and forecasts for FY15 are largely unchanged. Citi expects like-for-like sales growth to slow to 1.8% in FY15, from 4.7% in FY14, because there is no New Zealand translation benefit and fashion trends are weaker. UBS downgraded following the strong share price performance and limited expected shareholder returns.

Macquarie downgraded Westpac (WBC) to Neutral from Outperform. Macquarie's cooperation with RFI, a global provider of customer and business intelligence focusing exclusively on financial services, has led to the publication of an in-depth study into banks in Australia, titled "Quality and Quantity". It also led to the downgrade of Westpac to Neutral from Outperform. Apparently, the data analysis has revealed Westpac has a lower quality of customer base and less of the higher value loyal customers in comparison with CommBank (CBA), which is once again being confirmed as the highest quality franchise in Australia.

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Why you need to start a pension before the end of the year

by Tony Negline

The deeming of pension income for both the Aged Pension and Commonwealth Seniors Health Card (CSHC) holders is big news. Although these changes are not yet law, for many it might be best to assume they will become law.

What are they?

CSHC recipients need to pass an income test. This test counts taxable income, reportable fringe benefits, salary sacrifice super contributions and personal super contributions claimed as a tax deduction and net investment losses.

From 20 September 2014, singles can earn up to $51,500 per annum and a couple $82,400 per annum. (These income thresholds have now been indexed because of legislation that recently went through Parliament.) Special rules apply if you have dependant children or a couple who lives apart due to illness.

Income from super pensions is currently exempt because it doesn't form part of taxable income for those aged at least 60.

But deeming of account-based pensions for this income test will change this. Pensions that commence after December 31, 2014 will have their assets deemed and the income counted in this income test.

Pensions that commence before then will remain exempt from this test.

Lost CSHC eligibility

You will need to carefully weigh up your situation to determine when it might be best for you to commence an account-based pension as the deeming of post-December 2014 account-based pensions will see some people lose access to the CSHC.

So for some, it might be better to consider commencing a pension before New Year's Day in 2015 to maintain access to this card.

CSHC recipients also receive a senior supplement. The last of these payments will be made on 20 September 2014, assuming the government can get its legislation through Parliament.

But in some good news, the government will allow CSHC holders to keep their card if they're out of Australia for up to 19 weeks (at the moment you can only be abroad for up to six weeks). This change commences on 1 January 2015.

Age pensions better off pre-Jan 2015

Age pensioners will also have their account-based pensions deemed if the pension commences after December 2014.

Age pensioners need to work out if they're better off under the new deeming rules or under the existing arrangements.

Initially, most retirees would be better off under the pre-January 2015 rules. However careful analysis is required. For example, if the account balance of your pension will decrease (because you will be using that account balance to give you retirement income) then it is highly likely, assuming all other rules remain the same as now, that at some point you will probably be better off having your pension subject to the deeming rules.

If you intend not to use your pension's capital for income payments (and this is a very wise decision), then it's likely that the pre-January 2015 rules will leave you better off.

Reversionary pensions

A reversionary pension is one that will continue to pay income to a nominated beneficiary (typically a spouse) after your death.

The advantage here for pensions that commence before January is that they will continue to be exempt when it begins to be paid to your spouse after death. This exemption is part of the age pension changes, however, it’s not contained in the current version of the CSHC amendments. But the Department of Social Security has said that it will administer the age pension and CSHC consistently.

Post December 2014 CSHC applicants

Any new applicant for the CSHC after December 2014 will have their pension deemed even if that pension commenced before January 2015. (It’s my understanding that this doesn’t apply to new age pension applicants.)

This will apply to all new applicants, including those who have a spouse who is eligible for the CSHC and receives the current account-based pension income exemption.

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Stock specifics – Telstra, Challenger, Invocare

by Questions of the Week

Q: Would you reduce your holdings in Telstra if you had a good profit? And what is your opinion on Challenger (CGF) – is it a buy at $7.50?

A (By Paul Rickard): You can never go wrong taking a profit. The question is – where will you invest the cash?

With Telstra, I don't think that you are going to see any real selling pressure until interest rates start to go up. Even up near $6.00, the yield is still relatively attractive.

I am not buying at these levels – and the next move for me is to lighten off a touch – however I am in no real hurry.

If you have a material position, perhaps you sell 20% to 25% at these levels.

Challenger (CGF) has had a great run. I am not a buyer at these levels.

Q: I have been looking at the purchase of Invocare (IVC). I like it, but is it fair value?

A (By James Dunn): Let's look at what some of the analysts are saying.

Invocare is trading at around $11.00. On the Stock Doctor reckoning, Invocare, at $11.12, is trading 5.4% below the analysts' consensus price target of $11.60.

On the FN Arena reckoning, the analysts' consensus price target of $11.30, puts Invocare at a 2.7% discount.

Morningstar says Invocare has just passed from 'hold' to 'reduce' – it says fair value for the stock is $10.00.

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