Switzer Super Report

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Strange days indeed

It's been an interesting week on the local market. During times like these, it should come as no surprise that there's a diversity of views on what's going to happen next.

Today, Charlie's again talking about what's going to happen to the banks when the carry trade unwinds and the US dollar rises. He's underweight and doesn't like what he sees but I'd just like to stress here – again – that I'm not selling my bank shares. I'm not adding to them at the moment, but if CBA slips under $70, I might.

At the *Switzer Super Report*, we think it's really important to share a diversity of views with our readers, which is why we have Charlie. He's very perceptive and experienced. His advice, however, doesn't necessarily suit all kinds of investors, though I'd rather invest knowing his thoughts than not knowing them!

We also think it's really important to give you information you can use and today we have Tony Featherstone explaining three of the things he looks for when buying blue chips. Next week, he'll reveal the other four.

Sincerely,

Peter Switzer

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How to choose great stocks – part 1

by Tony Featherstone

How do you trade a great blue-chip stock? Answer: don't try. Focusing on unpredictable share prices and meaningless market-driven financial metrics is a mug's game. Instead, think like a business owner: concentrate on finding great companies and buying them below fair value.

Granted, the idea of buying "great companies" sounds like simplistic investment preaching. Of course we want to buy great companies. The problem is, the market knows these companies are outstanding and has already (over) priced them for perfection.

But here's the thing: look at the market's great stocks over the past few years: Commonwealth Bank, REA Group, Seek, Domino's Pizza Enterprises, and Slater & Gordon, to name a few. They had obvious traits of exceptional businesses, but many investors resisted them on valuation grounds, confusing price and value. Or they were suckered by market noise and short-term price moves when they should have focused on industry and company fundamentals.

Every stock, of course, has its price. And there's no magical formula for identifying great companies and buying them below fair value. The market is pretty efficient in blue-chip land, much more so than in small caps. If the majority of large-cap Australian equity fund managers struggle to outperform their index over time, what chance do retail investors have? Plenty, if they follow a simple framework for choosing great companies.

Having written on share investing for more than two decades, I'm still surprised at how much over-promotion of low-quality companies occurs. And how too many retail investors scour the market for "hidden gems" and become obsessed with short-term share price moves, when they would do better by narrowing their search to 100 of the highest-quality companies.

I use a seven-part framework to identify great companies. It will not suit all investors: for example, I prefer growth over income stocks, believing companies with a high return on equity (ROE) are better off reinvesting those dollars to magnify growth, than returning them to shareholders as dividends.

My approach is grounded in long-term industry analysis and sustainable competitive advantage – identifying companies that have a so-called "economic moat", and being prepared to pay more for them. Here are the seven steps.

1. Start with the industry

Bad industries can kill good companies. And good industries can make bad companies look better than they are. Start your blue-chip research with analysis of the company's industry. Does it have good long-term growth prospects? Will it grow faster than the economy? Does the industry have favourable characteristics: for example, low or fragmented competition, or other factors, such as regulatory barriers, that make it attractive?

Simple industry analysis can be the difference between huge gains and losses. Those who knew print media would struggle, while online media would boom, would have sold Fairfax Media and bought Seek or REA Group. They might also have sold David Jones and Myer Holdings because traditional retailing has unfavourable long-term industry characteristics. Or they might have bought Japara Healthcare or several other stocks exposed to the favourable trend of an ageing population.

2. Sustainable competitive advantage

Only one thing is better than a great industry: a

sustainable competitive advantage in an industry growing faster than the economy. It means companies can enjoy higher profits for longer, and better capitalise on their "window of opportunity" before rivals erode their advantage. For established companies, sustainable competitive advantage gives a precious commodity: the ability to lift prices. REA is a good example: its price rises weren't popular, but what else could property advertisers and real estate agents do?

Sustainable competitive advantage comes in many forms. For BHP Billiton, it is arguably the strength of its balance sheet. For the Commonwealth Bank, it is its technology head start over rivals. For Seek, REA and Carsales.com, it is a powerful "network effect": more buyers attract more sellers, and vice versa, making their platforms impossible to overtake – or even get close to. For Domino's, it is scale, brand and technology.

What gives the companies in your portfolio a sustainable head start over competitors? If the advantage is hard to identify, you might have a lower-quality company.

3. The business model

A strong business model is the key to exploiting a sustainable competitive advantage and favourable industry conditions. I seek three core characteristics: recurring, annuity-style income with high certainty; a capital-light business model; and high customer switching costs. Put another way, companies that don't need a lot of capital to grow, get paid when they are sleeping, and make it hard for customers to leave for a rival.

Carsales.com.au is a good example. Like many Internet stocks, it has a capital-light business model because it is essentially a website. Unlike mining-service stocks, it does not have vast sums of money tied up in machinery that depreciates as it sits idle. Or big factories to build, or inventory that is less valuable the longer it is unsold. And it does not have to raise huge slabs of capital to expand offshore.

TPG Telecom, iiNet, and fund managers such as Platinum Asset Management and Magellan Financial Group, benefit from recurring, annuity-like income. Customers sign up for one product, and pay fees on it, month after month, year after year. It makes for beautiful business.

Commonwealth Bank benefits from high switching costs. You open an account, get a credit card and take a mortgage. And because it takes ages to move to a rival bank and open new accounts, you stay put. With customers locked in, these companies have greater scope to lift prices, cross-sell other products, and spend more time attracting new customers than keeping existing ones.

Do your stocks have recurring income, capital-light business models, and high switching costs? They don't need to tick all three boxes. But if your company only makes money every time it sells something, is a price taker, requires huge capital to grow, and can be dumped easily for a rival, it is probably of lower quality.

- Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at September 24, 2014.

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King of the currencies – US dollar

by Charlie Aitken

I strongly advise you that you need to position yourself mentally for a period of increased volatility in global and Australian equities.

The days of buying every trading dip and smooth upward sailing in equity indices are coming to an end as the Federal Reserve comes to an end of its Quantitative Easing (QE) program and starts the process of US interest rate normalisation.

You can see this already occurring in Australian equities, with the ASX200 basically flat for 2014 year-to-date and down 10% in US dollar terms for September alone, led down by the heavyweight banks.

Australian investors are caught in the middle of some major global shifts, led by currency.

The currency trade

As I have written all year, I am a major US dollar bull but being a major US dollar bull has other negative ramifications.

In the chart below, you can see the broad US dollar Index (DXY) has taken off like the space shuttle in the last three months.

This is because the Federal Reserve is ending the US dollar rights issue known as QE, the FED's balance sheet is peaking in size, and the FED will raise cash rates before anyone else, narrowing interest rate spread differentials.

Obviously, anything denominated in US dollars has been under heavy pressure on the other side of this US dollar resurgence. The Australian dollar, Euro, Yen, gold, copper, iron ore, oil, you name it, has tanked inverse to the US dollar.

This makes perfect sense and will continue, as US investors repatriate to US dollars from all forms of multi-year carry trades.

Unfortunately, we are all part of the carry trade. The Australian dollar and high yield Australian equities were a very big part of the short US dollar carry trade that is now unwinding. If you have been wondering why your bank shares have been falling, it's as simple as the carry trade being unwound.

To illustrate this point, here are the last 30 trading days in the Aussie dollar/US dollar and the ASX200 Financials Index (XFJ) which are dominated by the big four banks.

The Aussie dollar and the banks have basically been joined at the hip this month, which confirms carry trade unwinding by global investors.

This, of course, begs the question: when does it stop? It stops when the Aussie dollar stops falling, which isn't anything the Aussie dollar can control. It stops when the US dollar stops rallying and I don't think that is any time soon.

US dollar to regain title

Yes, there will be the odd day of trading bounces, but, to me, it is blatantly clear that the US dollar is moving back to regain its title as the world's reserve currency. I think this is a genuine trend change in the US dollar and inverse in anything effectively priced in US dollars.

Similarly, with the RBA/APRA starting to rattle the macro-prudential intervention sabre in terms of investment property mortgage lending, analysts and strategists will start looking at revising downward credit growth forecasts.

There is a scenario building, where Australian mortgage banks face macro-prudential lending limits, increased capital requirements and rising wholesale funding costs, all of which will lead to consensus bank sector EPS and, dare I say it, mild DPS forecast downgrades.

CBA is our biggest bank and biggest index weight (9.32% of ASX200). To me, this chart is a classic trend change chart. It doesn't mean the share price will collapse, but I suspect the next level of support in the lower to mid $70s will be tested and any rallies will be sold into. Beside the CBA chart is the ASX 200 Financials Index (XFJ), of which, of course, CBA is the largest weighting (20.7%).

The banks

My clear point is that macro, micro and technical forces are all working against Australian banks right now and I don't see that changing. Sure, there will be the odd trading bounce day, but I remain underweight the sector and again remind readers of the clear near-term correlation of the sector to the Australian dollar. This Aussie dollar correlation makes perfect sense. Australia is 2% of global equity markets and far from a "must own" for global investors, particularly as our heavyweight financials are globally expensive to those who can't value franking credits. The currency falling gives them the excuse to be zero-weight. It's an asset allocation play.

The other point I want to stress is: who will be the marginal buyer of Australian yield into a correction? It won't be foreigners. They are selling with the currency falling. It has to be Australians, who can value the franking credits. To my assessment, however, Australians have the *"house full"* sign up when it comes to yield allocation.

You can see the recent currency driven selling of Australian banks, for example, has run into very little buying resistance. It's been like watching a hot knife through butter, as the carry trade world gets carried off. Ditto the Australian dollar itself, which is struggling to yet find a natural buyer to take on all the carry trade unwinders.

It's worth noting that from the peak, Australian banks have lost double their prospective dividend yields in capital losses and triple in US dollar terms.

	Capital loss from peak (AUD)	USD terms
ANZ	-10.5%	-16.0%
CBA	-9.0%	-14.5%
NAB	-12.1%	-17.6%
WBC	-9.8%	-15.3%

Prospective does not put a floor under price when there is a major, multi-year trend change, like we are witnessing right now. In fact, there's every chance of a downside over-shoot here in the Aussie dollar and Australian yield equities, as the world presses the sell button and the SMSF world decides it owns enough yield already. The chart below overlays the ASX Financials Index (XFJ) and the AUD/USD cross rate, showing if the correlation holds, which it will, Australian financials (green line) have further to fall (another -5%) in capital terms.

It's only when it starts unwinding do you realise how crowded a trade it was. I think we are all underestimating just how big the short US dollar carry trade has been and how big, in effect, the personal carry trade into yield equities/hybrids has been. That's why this could all overshoot on the downside, as everyone rushes for the exit.

What's going on?

My note today is more trying to explain what is happening and that it could easily continue. As I wrote last week, if you are happy collecting fully franked dividends, ignore me. If you are also interested in capital preservation, then be aware that further capital losses could be ahead. At best, expect increased volatility.

After 20+ years of market experience, I can tell you I do not like what I am seeing on the screens in front of me. I fear further capital losses in Australian yield equities and I fear just about nobody, particularly in Australian private investor land, is properly positioned for what potentially comes next.

This is a major momentum change/inflection point. It's all driven by the resurgent US dollar and its effect on everything else. As an Australian investor, if you are to successfully negotiate the next period in markets, you have to lose the myopic home bias and start to think global, act global. Not thinking local, acting local. You also need to start thinking absolute, not relative, and condition yourself for a major step up in daily trading volatility.

If you don't like the sound of all that, the sideline is the place for you. There's absolutely nothing wrong with locking in some of the massive capital gains of the FED inspired last few years and moving to the sidelines for a little while.

It is certainly not a time for rampant bullishness. Don't fight the Fed. Don't fight the tape.

100% of Charlie Aitken's fees for writing for the Switzer Super Report are donated to The Sydney Children's Hospital Foundation.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Resources companies featured on the plus side of the ledger this week for a change but that was mainly due to a run of actions from Credit Suisse, as it reviewed its forecasts for a range of commodities.

In the good books

Credit Suisse upgraded Fortescue Metals (FMG) to Outperform from Neutral. The shares have now priced in a very bearish iron ore outlook and Credit Suisse now assumes Fortescue will not pay a dividend in FY15. The bad news is now priced in and the stock is trading on a FY16 cash/earnings ratio of 4.6 times.

Credit Suisse upgraded Nufarm to Outperform from Neutral, Deutsche Bank to Buy from Hold and UBS to Buy from Neutral. Credit Suisse upgraded after Nufarm met its cash goals in FY14. Credit Suisse believes the company could generate enough free cash by FY16 to lift its dividend to a yield of 6%. The result fell short of the Deutsche's expectations but cash flow well exceeded on better than expected reductions in working capital and debt. The turnaround in cash flow stood out for UBS. Nufarm's FY14 earnings were above the broker's forecasts, driven by better outcome in European crop protection and the global seeds segment.

Whitehaven Coal was upgraded to Outperform from Neutral. The stock is a tricky one for Credit Suisse, given high quality production growth at a time of low coal prices. The company is expected to be loss making until FY17 and thereafter debt should fall quickly, as Maules Creek ramps up. The broker suspects coal prices are at cyclical lows and will move higher in the next 12 months.

In the not so good books

Credit Suisse downgraded Western Areas (WSA) to Neutral from Outperform following a share price appreciation over the past six months of 46%. The broker applies a modest discount to the target price, reducing it to $5.20 from $5.40, given a 24% fall in FY15 profit estimates, as the assumed nickel price peak is pushed out by six months.

UBS downgraded Metcash to Sell from Neutral. UBS has reviewed the discounter model among supermarkets, noting Aldi and Costco are highly efficient and offer compelling value, making it very hard for the major chains to compete – particularly the independent supermarkets supplied by Metcash. The broker reduces Metcash forecasts to assume ongoing market share decline, downgrading FY16-19 earnings forecasts by 3-8% and reducing the target price to $2.60 from $2.75.

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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Costco – disruption in your shopping cart

by Scott Shuttleworth

Starting a business that would compete against the likes of high quality businesses such as Woolworths Limited (ASX: WOW) and Coles (part of Wesfarmers Limited ASX: WES) is certainly not on my bucket list.

Both have enviable competitive advantages in terms of their distributive capacity, store network and unrivalled share of mind, established through years of clever marketing and longevity.

However, even the best businesses are not immune to a changing competitive landscape. Today's incumbents are tomorrow's memories, especially if they can't adapt to new competition (we all remember Kodak).

The big disruptor

Thus, for some companies, competing against these giants is possible. We have noticed this dynamic at Costco Wholesale Corporation (NASDAQ: COST), which established operations in Australia back in 2009.

To provide some context, Costco Australia's FY13 revenue of US$612 million is a fragment of Woolworths and Coles' combined revenue north of AU$100 billion. However, this result was achieved with only three stores (now up to five), compared to the thousands that Woolworths and Coles operate.

Costco (the US listed entity) generated almost US$103 billion over its financial year from September 2012 to September 2013. While Costco's Australian venture is in its infancy, it is clear that it's well financed and backed by a strong business model.

It's a David and Goliath scenario, only this time David has brought along a bigger brother.

Costco's business model is similar to that of other large retailers of commodity goods. Scale is used to reduce costs per unit and achieve a competitive advantage through low prices, but then there are features, which provide differentiation. Costco requires all customers to purchase an annual membership subscription ($60 per annum for individuals, and $55 for businesses); notably an immediate source of working capital for the firm that helps to reduce costs. The membership easily pays for itself in one or more shopping carts.

The price factor

Another differentiator is price. From our sample, Costco products appear to be 20-30% (sometimes more than 40%) cheaper than the same goods sold at Woolworths or Coles. As former CEO James Sinegal was once quoted (by USA Today): "Customers are not going to cross town to save 25 cents on a jar of peanut butter. What makes them come back is saving $20 on this kind of item". It's this kind of thinking that has driven the success of the firm.

In addition to groceries, Costco offers petrol, a car tyre centre and optical accessories (new glasses, contact lenses, etc.) – additional conveniences that are not always available at other stores.

Warren Buffett once said: "I don't look to jump over seven-foot bars: I look around for one-foot bars that I can step over." When you consider the consumer advantages in combination with its profitable track record, it's easy to see why this is the case.

Since 1995, (the past 20 years) the share price of Costco has grown on an annually compounded basis by approximately 15% per annum (notably before we consider any dividends) driven by share buybacks and a similar 15% per annum growth in net income over the same time period, from US$134 million to US$2,039 million. Shareholders equity likewise grew

from US$1,531 million to US$10,833 million, generating a return on equity of 17.5%.

The business was, however, first established back in 1976, so while these results are pleasing, they do take time (noting that time is the friend of a good business).

The way ahead

Like all ventures, there are headwinds present now and in the future. Costco inventory tends to be much more limited than your traditional supermarket, as only those suppliers that can deliver product in specific quantities (some customised for Costco) and at specific prices will be granted contracts.

This helps to keep down costs, but fails to attract customers who are looking for a ‘one stop shop’. In addition, their store network is very small (currently five stores Australia-wide) and the opening hours of Coles and Woolies are more appealing. In order to be truly successful, prime locations will need to be purchased for expansion, many of which are already owned by Coles or Woolworths.

These headwinds, however, aren’t impenetrable barriers to success, and are ones we believe that Costco will be able to overcome.

Does this mean we are bearish on Woolworths or Coles? Certainly not. Competitive landscapes evolve slowly after all, and Costco is likely too small to erode their revenue significantly. Just another space we will be watching.

Scott Shuttleworth is an an equity analyst at Montgomery Investment Management.

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Tax implications of investing offshore

by Tony Negline

An increasing number of SMSFs are investing some of their money overseas. As a result, we are fielding more questions about the tax implications of these non-Australian investments.

So what are some of the issues that typically arise?

Double Tax Agreements (DTAs)

Australia has a number of Double Tax Agreements with overseas governments. These agreements override anything in each country's normal tax code.

We have agreements with most of our major trading partners, which include, I suspect, most of the places that SMSFs might want to invest some of their monies — for example, US, UK, Japan and Germany. You can find a full list of the countries we have them with and the agreements here.

The terms of these agreements are all different. Some tax income in both Australia and the overseas country. Others only tax income where it is earned. Still others again only tax income in Australia for Australian-resident taxpayers.

For example, if you're receiving income from investments in the US, 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.

If a Double Tax Agreement says that your income is only taxed in the source country, then it means any overseas income isn't taxed in Australia and isn't included in your super fund's Australian tax return. (Obviously, this means you have the hassle of dealing with the tax authorities in the source country, as well as the ATO's annual tax and regulatory return for your domestic investments.)

Australian dollars only thanks

If you need to declare foreign income and capital gains or losses in Australia, then our tax system only wants you to use the Australian dollar value of those amounts. Special rules exist for determining the exchange rate you use to convert the income in Aussie dollars.

For income you receive (for example, rental income on property or dividend income for shares), you use an exchange rate that applies on the day you received the income.

For expenses you incur overseas that can be claimed in Australia as a tax deduction, then a similar rule applies.

When preparing your fund's financial accounts and ATO return each year, you use the exchange rate that will apply at the end of a financial year.

The tax laws also allow you to use an average exchange rate for a period of time, which must be no more than 12 months. In many cases, I think this will create unnecessary hassle and paperwork for SMSFs. (Using an average might be helpful if you want to take advantage of unusually large movements in the $A that occur reasonably regularly.) If you do use an average rate, then make sure you keep records of how it was calculated.

Domestic managed funds (including ASX-listed exchange traded funds)

If you invest in an unlisted or listed managed fund that resides in Australia, which includes ASX-listed ETFs, then you don't need to worry about your foreign income calculations.

Your fund managers will convert all income, capital

gains/losses, and deductions into Australian dollars. Most send you a report each year detailing all the important information. All your unit holdings will only ever be valued in Australian dollars.

If you don't want the hassle of exchange rates and DTAs, then this may be the easiest way to invest in overseas assets (however you may not get the control you want over the assets that are bought and sold).

Foreign taxes

If you have to declare foreign income or capital gains on your SMSF tax return (as demanded by the relevant Double Tax Agreement), and that foreign income has been taxed overseas, then your super fund can offset the tax already paid overseas. This is called a Foreign Income Tax Offset or FITO.

FITO is non-refundable and is applied after all other tax concessions. If your fund doesn't pay tax or has no tax to pay, then FITO is lost and can't be carried forward to later financial years.

If your fund's FITO claim is no more than A$1,000, then all you need do is record the amount of foreign tax already paid on your tax return. If your FITO claim is more than A$1,000, then you need to calculate the amount. The ATO explains how here. It's quite complicated and it may be best to ask your fund's administrator and accountant to assist you.

As Australian super fund pension income isn't taxed, the FITO your fund has will be lost and won't be refunded.

If your SMSF has pension and pre-retiree funds, then it must apportion the FITO between the 15% and nil taxed portions and only claim the income for the assets used for pre-retirement purposes.

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The ins and outs of TTRs and floating rate notes

by Questions of the Week

Question: Are contributions and rollovers allowed under TTR rules? I have noticed in the ING Living Super this isn't allowed.

Answer (By Paul Rickard): A Transition to Retirement (TTR) pension cannot be commuted, which means you cannot convert to a lump sum. You can't withdraw more than 10% of the account balance in any year, and you cannot add to it (by contribution or rollover).

So, essentially what ING told you is correct.

You can, however, have multiple TTRs – there is no limit. Subject to any restrictions by the fund and any potential transaction costs, just commence a new TTR with any rollover.

Question 2: I am a subscriber and would appreciate your valuable opinion on the following scenario: a final QE tapering in October, a reversing of the QE program by unwinding the bonds the FED holds, US interest rising in 2015, probably June quarter, upward pressure on US and global bond yields, mixed outlook on Australian Banks by analysts and possibility of RBA tightening in mid to end 2015.

What impact may this above scenario have on Australian Floating Rate Notes (FRNs)?

Answer 2 (By Paul Rickard): Thanks for the question and very plausible scenario.

FRNs, in general, should not be impacted by a rise in interest rates (as per the scenario you outlined.) However, it is possible that spreads may move out a little if the market starts to feel that higher rates are here to stay, sending FRN prices lower (the opposite of the yield squeeze we have had over the last 18 months or so).

In terms of the individual FRNs in your portfolio, capital or other credit issues could also impact their prices. My sense is that this is unlikely.

Bottom line – I think the impact, if any, will be minimal.

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Did you know?

Do you know what the difference between an exchange-traded fund and a listed investment company is? Or when to buy one over the other? Watch my video with Paul here to find out.