Switzer Super Report

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Gone fishing

It's certainly looking pretty dreary in the US at the moment, and we may be about to have the correction that you know I've been saying we have to have for some time.

So get ready for a rocky October but also try and remember that any US correction now will most likely be because things are actually getting better in America and interest rate hikes are forecast sooner rather than later. In *Short n' Sweet,* we examine what's going on with the US.

Charlie Aitken takes a look at the kinds of companies you should be adding to your portfolio in this environment – he likes Macquarie and NAB – and we explain why you should sign up for the Medibank Private IPO pre-registration process.

In *Buy, Sell, Hold – what the brokers say,* BHP and Pacific Brands get upgrades and in *Questions of the Week* we discuss the pros and cons of using a wrap platform for administration.

Don't forget to register for our Webinar tomorrow at 12.30pm (AEST). Hurry! We have just a few places left.

Sincerely,

Peter Switzer

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Fishing for GARP – US dollar stars

by Charlie Aitken

In writing investment strategy each week, I have to remind myself to be bold and make *"forecasts"*, not *"back casts"* or "*present casts".*

The *"present"* is extremely efficiently priced in, due to high frequency trading, advances in telecommunications, real time information to investors and financial TV networks that call markets like sports broadcasts. However, the future is highly inefficiently priced and the *"time arbitrage"* in markets remains large and exploitable.

The future is not now

Quite interestingly over the last few months as I have banged the *"be cautious in yield equities in Aussie dollars"* drum, I have had numerous responses about *"interest rates still being very low"* and yield equities *currently* looking attractive versus cash. That is absolutely right *today*, as it was a month ago, but what I am trying to do is forecast what the screens in front of us say in six to 12 months' time.

To put this in context, Australian cash rates were unchanged at 2.50% over the last month, but what happened was that changing US interest rate expectations drove Australian bond yields up 45 basis points to 3.73%, the Australian dollar down 6 US cents (-6.4%) and the Australian financial sector down -7.5%. With local cash rates unchanged, due to carry trade unwinding, you lost in capital terms your annual grossed up dividend yield in Australian financials and you can double that capital loss in US dollars terms. This should remind everyone we are part of global markets and a myopic home bias can be costly when global macro trends change.

I have to look forward, position forward, and hope that 75% of my predictions are right and the 25% of predictions that are wrong are just flesh wounds to the overall forward looking strategy.

To me it's sort of like fishing. You set the bait, then wait for the tide and fish to come to you. In this case, I am *fishing for Garp.*

What I am going to do today is to look for potential beneficiaries of the rotation from yield equities that has started. As yield equities start to relatively underperform and become lower weightings in benchmark indices, what will investors rotate to and see an increase in their index weighting, remembering the overall power of the index fund, quasi index fund and ETF industry.

Growth at a reasonable price

I simply think the capital beneficiaries of rotation with be *growth at a reasonable price* stocks. I think investors will de-weight "dividend yield" as a variable in the investment case, and up-weight "EPS growth". I also think dividend growth, driven by earnings growth, will outperform basic dividend yield. In my strategy, all roads lead to GARP stocks and the best performing GARP stocks will have a high proportion of US dollar earnings.

The first problem in large cap Australian equities when you are *"fishing for Garp"* is actually finding some decent double digit FY15 EPS growth. ASX200 EPS growth is only forecast to be 5% in FY15.

I approach this via running quant ranking screens across the **ASX50 Leaders Index (XFL).** The rankings are based off current consensus FY15 EPS and P/E forecasts from Bloomberg. That takes out any potential earnings biases in our own company forecasting.

The table below ranks the least attractive then the most attractive ASX50 leaders industrials in terms of FY15 price to growth ratio (PEG) (Price Earnings Ratio divided by Annual EPS growth).

Let's start with the least attractive on PEG ratios

		FY15 PEG ratio
CFX	CFS Retail Property Trust	9.5x
APA	APA Group	6.4x
TLS	Telstra	6.3x
ASX	ASX Limited	4.2x
WES	Wesfarmers	3.9x
SCG	SCentre Group	3.6x
GPT	GPT Group	3.4x
CBA	CBA	3.4x
WBC	Westpac	3.3x
CCL	Coca Cola Amatil	3.3x

Now the most attractive on PEG ratios

		FY15 PEG ratio
QBE	QBE	.27x
IPL	Incitec Pivot	.5x
MQG	Macquarie Group	.9x
LLC	Lend Lease	1.1x
JHX	James Hardie	1.3x
WOR	Worley Parsons	1.3x
RHC	Ramsay Health Care	1.3x
CSL	CSL Limited	1.3x
NAB	NAB	1.3x
ORI	Orica Limited	1.4x

Obviously, this is NOT a perfect science and based off the current consensus FY15 forecasts, which history suggests are usually somewhat wrong. However, these tables do give you a guide to where GARP is, and GARP isn't. That is the purpose of the exercise.

Unsurprisingly, the "least" attractive table is dominated by high yield names. That makes perfect sense as people have bought those names for income and those boards have generally increased payout ratios to feed those investors what they seek. If you buy yield, you are usually sacrificing growth. Yet, this exercise does remind you how *"growthless"* those stocks are.

US dollar stars

The "most" attractive list is dominated by lower dividend yield, high proportion of US dollar earners. NAB and Macquarie are the only large cap banks to make the list, again mainly due to offshore earnings streams.

In my mind, these lists are a correct interpretation of where GARP is and isn't in the top 50. I suspect this list is telling the SMSF world that if you want to maintain dividend yield exposure but simultaneously increase growth (and US dollar) exposure, then you should be switching in financials from CBA and Westpac to a combination of QBE, Macquarie and NAB. Doesn't that idea make your squirm? Which means it will probably be right.

My final point is the current combined ASX200 Index weight of the "least" attractive PEG names is 29.5% while the current combined ASX200 index weight of the "most" attractive PEG names is just 13.7%. This again reminds me how hard it will be for the benchmark ASX200 index to move forward significantly with such a high weighting of yield stocks and low weighting of growth stocks in a rising bond yield environment.

I continue to position model portfolios for *growth* to outperform *yield* and US dollar earners to outperform Australian dollar earners.

I am also positioning model portfolios for an increase in volatility and increase in stock price divergence.

Cash is held in US dollars.

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

Most of the activity in the first half of the week was positive with upgrades across a variety of industries but most being driven in some way or another by the currency falls.

In the good books

Citi upgraded BHP (BHP) to Buy from Neutral, preferring base metals over bulk commodities. The broker believes metals and mining equities will be flat over the next three months but investors should be buying the dips with a view that commodity markets, particularly base metals, could surprise on the upside heading into next year.

UBS has upgraded Pacific Brands (PBG) to Neutral from Sell. The share price has weakened significantly since the year's high of 77c and now, changing to forecasting a positive shareholder return, UBS upgrades to Neutral from Sell. Significant near-term currency and restructuring risks exist, but Pacific Brands will benefit from a five percentage point reduction in the textiles import tariff from January 2015. The broker considers the company is potentially a takeover target as it moves to a cleaner, simpler business model.

CIMB Securities has upgraded Seven West Media (SWM) to Add from Hold. CIMB prefers those TV media stocks that are taking market share and have a superior asset mix. The broker's long-term structural view of the TV ad market remains supportive, given its ability to deliver audience reach.

Citi upgrades Woodside Petroleum (WPL) to Buy from Neutral. Citi has revised oil price forecasts, downgrading 2015 and 2016 Brent by 7% and 5% respectively. Woodside is delivering on a good strategy and Citi believes the 80% pay-out ratio is sustainable throughout the execution of Browse FLNG.

In the not-so-good books

Citi has downgraded Treasury Wine Estates (TWE) to Sell from Neutral. Discussions with the private equity groups have ceased, as the bidders could not justify a $5.20 price for Treasury Wine. The broker believes the outlook is improving, especially with a weaker Australian dollar. Nevertheless, the US de-stocking still needs to be dealt with and there is a risk with the changes to the Penfolds release dates.

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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Medibank IPO – time to register

by Penny Pryor

On the weekend, the government began the process of listing Australia's largest health insurance provider, Medibank Private, by opening pre-registration register. The pre-registration process will close on October 15 and the prospectus is expected to be available by the end of the month with a listing scheduled before the end of the year. You can pre-register here.

On Sunday, when announcing the pre-registration, Finance Minister Mathias Cormann said that Australian residents, who pre-register to receive a prospectus and then apply for shares, could receive a preferential allocation of shares.

And if you're a Medibank Private or AHM policyholder, who pre-registers and then applies for shares, you could receive a greater preferential allocation.

Policyholders need to be permanent residents of Australia and policyholders before 28 September 2014.

The opportunity

When we first heard that the government was looking at privatising a number of national assets *Switzer Super Report* co-founder and expert, Paul Rickard, took a closer look at Medibank Private.

Here's a recap.

Medibank is Australia's largest heath insurer, with 3.8 million customers and a market share of 29%. With its Medibank and AHM health insurance brands, it competes against 34 heath funds. Medibank Health Insurance has won Canstar's award for 'Outstanding Value' for the last four years.

Private health insurance premium revenue of $5.3 billion accounted for 91% of gross revenue in the year to 30 June 2013. It also earned $498 million in revenue from its 'Health Solutions' business, which provides healthcare services to businesses, government and communities across Australia and New Zealand. It has a team of healthcare professionals providing a national network of healthcare clinics, as well as through telephone and online channels. For example, it operates 'The Travel Doctor', NURSE-ON-CALL, Healthline in New Zealand, workplace health services and co-ordinates healthcare services for the 80,000 Australian Defence Force members.

Medibank also provides life insurance, travel insurance and pet insurance, which it sells on a commission basis.

Medibank's financial results for the last two years are detailed below:

	2012	2013
Private Health Insurance Revenue	$5,062m	$5,344m
Health Insurance Revenue	$279m	$498m
Other	$16m	$18m
Total Revenue	**$5,357m**	**$5,861m**
Operating Expenses	$5,195m	$5,676m
Operating Profit	**$162m**	**$185m**
Investment & Other Income	$35m	$130m
Profit before Tax	**$197m**	**$315m**
Less Tax	$71m	$82m
Profit After Tax	**$127m**	**$233m**

Valuation

For a valuation calculation, we drew on a comparison with Newcastle-based NIB Holdings to come up with a PE multiple in the range of 13 to 16. Applying that multiple to a 2014 profit estimate of $225 million, (Medibank has said that investment earnings will be

impacted by the payment of a $300 million special dividend to the Government in August 2013) we came up with a valuation for Medibank in the range of $3 billion to $3.6 billion.

That is at the lower end of what some analysts are understood to be valuing the company at now, which is believed to be as high as multiples of 20 or $4.5 billion.

But even at our lower valuation, we are still positive on the listing and optimistic that a cutting of the fat, that often happens when companies privatise, and a renewed vigour, once the company is freed from government restraint, will give the business a boost.

“I am still confident about this IPO and have already pre-registered. There is no downside in pre-registering, ” Paul says

“It is the government’s first IPO, so they’re hardly going to want to disappoint investors and even with the higher valuations – which I think might be a bit overblown – Medibank has the potential to be one of the better IPOs this year.”

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Short 'n' Sweet – what's up with the US?

by Penny Pryor

The amount of volatility going on in markets over the past week would certainly make anyone nervous. The US does seem pretty jittery, with an overnight sell-off apparently on the back of the first incidence of Ebola virus detected in the US.

The Dow Jones was down 1.4% overnight but as scary as the Ebola virus is, there are still plenty of other reasons to be nervous about US equities.

This morning, Peter listed a multitude of reasons why US equities could be down so much. They include weak European growth, slower than expected growth in Japan, the geopolitical risks of Russia v Ukraine as well as Iraq and ISIS, US construction was less than expected, QE3 is about to end and October is never a good month for equities anyway.

Peter has been saying for a while that a correction is overdue and the collection of all these factors means we might be at the beginning of it.

Switzer Super Report expert from Bell Potter, Charlie Aitken, also points out this morning that "The benchmark US S&P500 index hasn't experienced a technical correction (-10%) in over 2 years."

"The correction is well under way in US small cap equities and my theory is it will now spread to US large cap equities. The small cap Russell 2000 Index officially entered technical correction territory last night after "death crossing" two weeks ago. The small cap S&P600 is also now in correction territory."

You know that we're slightly more optimistic than Charlie on a lot of things but it's always important to share his message.

At *SSR* we'll be keeping an eye out for US job numbers on Friday night. If they're good, that could be bad as it could see the market sell off on the belief that interest rate hikes are on their way. Unfortunately, if they're bad, that's not good either.

As Peter says: "The Yanks need a Goldilocks number — not too hot, but not too cold."

If you're nervous, you can always take Charlie's advice and sit on the sidelines.

"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," he says.

"In terms of value, I reiterate the only clear value I can see is the US dollar, volatility and Chinese equities."

So fasten your seat belts for a rocky month – but do try and remember that any rate hike will mean that the Fed is confident the US recovery is sustainable so it won't be the beginning of the end for US equities.

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Should you use a wrap platform?

by Questions of the Week

Question: My SMSF has a high proportion of mainly bank hybrids. What will be the share price effect if the prices of banks come down in this environment?

Answer (By Paul Rickard): There really shouldn't be too much impact on the prices of bank hybrid securities. Spreads might move out a touch (meaning marginally lower hybrid prices) simply because yields on bank shares will have gone up. So, to retain relative value, yields on hybrid securities need to be higher.

Overall, the impact shouldn't be that material.

Question 2: My financial adviser has recently recommended that we transfer my SMSF administration across to the NetWealth Super Wrap platform. Based on my research online, it looks pretty good but I was wondering if you guys have any experience with this or an alternative platform and what are the fors and against?

Answer 2 (By Paul Rickard): I don't have any personal experience of the NetWealth Platform and haven't heard anything negative about it.

That said, I am not a huge fan of platforms – so make sure that for the fees you pay, you get some real benefit.

Unfortunately, some advisers recommend platforms because it makes their lives easier – rather than doing much for their clients.

Particular traps to watch – how easy it is to exit (costs, can you do an in-specie transfer out?), brokerage costs, corporate action costs, interest rate on any default cash account, etc.

And finally, a comment from one of our subscribers, who is a little frustrated by the local equity market:

In regards to our market, we seem to have the worst market in the world. Our market performance is pathetic. When America goes up, we go down, America goes down we go further down. I have a real feeling that our market is about to have a major drop and I am very close to selling all my portfolio with the exception of the banks and wait until late next year to reinvest.

Response (By Paul Rickard): You are right about our market – confidence evaporates very quickly. As soon as we get some stability in the dollar – the buyers will return just as quickly.

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