Switzer Super Report

Issue 329, 9 October 2014

Same same…

It’s definitely a little rough out there. I’m still hoping this is the correction we had to have so we can get it over before Christmas. Time will tell. I do think good stocks are going at cheaper prices, so keep an eye on some of those blue chips.

Today, Charlie Aitken is talking about the new normal and expects volatility to continue and that we should all get used to it. He says this is because interest rates in the US will go up sooner rather than later because of the strength of that economy. But that’s also good news for the long term.

Also in the report today, we look at a change in definition, which means you might get cheaper access to some kinds of investment products in *Short n’ Sweet.* In *Buy, Sell, Hold – what the brokers say,* Westfield and AGL get upgraded and Tony Negline looks at a common misconception around super contributions.

We also have a new takeover target to keep an eye on and Tony Featherstone reveals why Vision Eye has the vision.

Sincerely,

Peter Switzer

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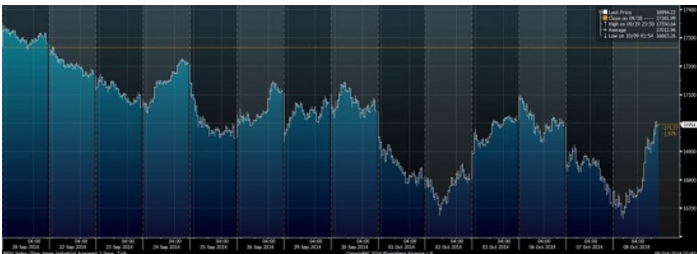
Volatility is the new normal

by Charlie Aitken

The one thing I'm absolutely certain about is that equity market volatility is in the infancy of normalising.

This is a very important development for all investors. As volatility normalises, individual stock prices can swing wildly, as we have seen in recent weeks. This is particularly so in this era of high frequency traders (HFT) being the marginal liquidity provider in equity markets. Note well, the Dow Jones Industrial Average has had five 200 plus point swings in the last 15 days (chart below).



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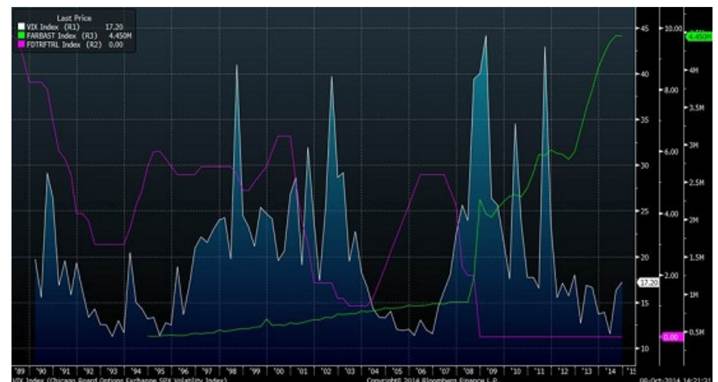
In these periods, everyone needs to realise that stock prices can overshoot, both down and up, as equity risk premium is priced back into equities with associated volatility. Everyone also needs to realise that "research" and "valuations" mean very little in these periods, in fact they can cost you money believing them. This is all about liquidity, risk, momentum, volatility and sentiment.

The new picture

After five years of quantitative easing (QE) and six years of zero interest rate policy (ZIRP) from the Federal Reserve, it's somewhat easy to forget what ***"normalised"*** risk asset price volatility looks like. QE and ZIRP drove up asset prices and drove down volatility.

What "normalised volatility" looks like is what your screens are starting to show over the last 30 trading days with currency, bond and equity prices moving sharply, diverging back to underlying fundamentals (in both directions).

The chart below shows the last 25 years in terms of the CBOE VIX Index, Fed Funds lower band target cash rate (purple line) and total Federal Reserve Balance Sheet assets (green line).



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What it is telling is, that over 25 years, the VIX averaged 19.93. The recent move we have seen to around 15, while +50% from recent lows, remains well below the average levels seen with normalised US interest rates and a smaller Fed balance sheet.

I strongly advise you that if you didn't enjoy the cross asset price volatility of the last 30 days, then you need to reassess your asset allocation. This is not going to be one-way traffic or smooth sailing in equities as I have warned.

Quite simply, benign volatility and the *"buy every dip"* strategy that combined to work so well over the last five years has bred **complacency, concentration risk and over-confidence** in the private investor sector. This is particularly so in self-managed super land in Australia.

Self-inflicted super?

What I am trying to avoid in these notes is self-managed super becoming *self-inflicted super*, as capital losses rack up in the most widely held SMSF names. Yes, I will make some mistakes along the way in small caps that should have been no more than 1% of your portfolio, and I apologise for that, but the main event is getting the biggest market cap, most widely held stocks right (particularly the banks). That combined with asset allocation is what really matters.

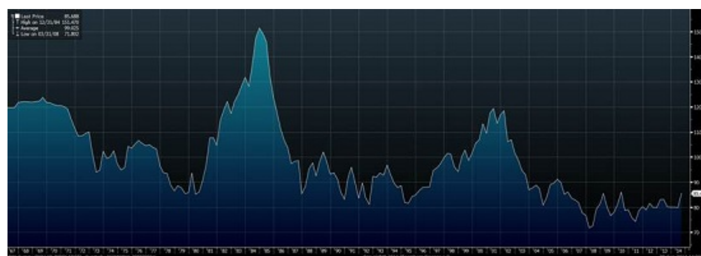
The average SMSF in Australia has in effect a giant carry trade on at the peak of FED largesse and the bottom of the US dollar. The average Australian SMSF is massively over-exposed to Australian yield assets in Australian dollars, which is a carry on a carry and exactly the trade we have witnessed foreign investors exit with gusto over the last month. The ASX200 is now down -3% in US dollars for 2014. Australian banks are down nearly -13% in US dollar terms from their recent peaks.

If you are an Australian SMSF and all you care about is tax-effective dividend income streams in Australian dollars, then please continue to ignore me. However, if you care about the capital side of your SMSF balance in global dollars, then you still need to be very vigilant, as I believe we are watching a major global and domestic trend change event. I can't stress that point enough.

Clearly, you can't have US GDP growing +4.6% and US interest rates remaining 0%. QE ends this month and I believe the markets are trying to tell you, correctly, that US cash rates will rise earlier than previously expected. This view is in a world that is currently short US dollar collateral.

The US dollar itself is normalising and it's taking cross asset class volatility up with it. You simply don't get moves like we have seen this month if the world is properly positioned for them.

To put the recent US dollar move in context, I also think it's worth looking at a 25-year chart of the US dollar Index (DXY). The high is 151.47 in Dec 1984, the low is 7.18 on 31 March 2008, and the 25-year average is 99.02. The current price is 85.26.



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Australian dollar target of 75 cents

My thinking is if the US dollar simply reverts to the 25-year average over the next few years, then that alone sees a +15.5% rise, and vice versa for currencies denominated in US dollars. You can see how I come to my long-term 75 US cents Australian dollar target as we re-correlate to our key commodity export prices.

To my trading eyes, everyone was trying to squeeze the last cent out of the carry trade, waiting for the FED to physically give the green light on cash rate rises, but US data has been so undeniably strong that markets have started moving ahead of the FED, leaving carry traders holding the yield baby as such. Good news has become bad news for markets because it means the Fed is closer to pulling out the monetary policy morphine drip.

In an Australian context, the most remarkable aspect of the carry trade unwind is how little resistance it has run into. There have been pretty much-uninterrupted falls in the Aussie dollar and high yield Australian industrial equities, with marginal buyers hard to find. I suspect this is because most high yield Australian industrial names were already very well held by Australian investors, while it was also underestimated just how big a carry trade parking lot the Aussie dollar and high yield equities were for foreign investors.

Excess builds up over long periods and this FED inspired cycle of carry trading and yield compression has been an unusually long one. It was absolutely right *"not to fight the FED"* on the way up, but now that all reverses, as the process of US cash rate normalisation commences.

September and early October has been a genuine trend change month in my view. It's like all tradable

markets hit some clear air turbulence. My point today is, however, that the volatility we have seen in September is NOT even normalised volatility on a long-term average view. The CBOE VIX averaged 13.43 in September, which, while above the average of June (12.65), remains significantly below the 25-year average of 19.95.

What we have seen in September is significantly below long-term average volatility. However, because it is significantly above recent lows, it feels more volatile than it is. This is the playbook for the next few years as FED support wanes for markets and risk asset markets, particularly equities, bonds and currencies, revert to more normalised trading patterns. You need to adjust to the "new normal" of volatility.

I'll finish today with a simple chart of the US S&P500, the world's biggest and most important equity index. The chart accurately summarises all the above, but you can see in recent times (since June) that volatility has increased and the two-year technical uptrend is being challenged. This chart needs constant watching as if the technical uptrend breaks a full-blown US equities correction (to around 1810 on the S&P500), with associated volatility, will be the result.

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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Takeover target – Vision Eye Institute

by Tony Featherstone

Buying turnaround stocks or "takeover targets" is not for the faint-hearted. A company might look "cheap" after falling 70% from its high, but it can be a value trap rather than good value. Investors anchor their expectations to the previous price peak and get burned.

They underestimate how tricky it is to turn around a troubled company. Or they overlook that the franchise has been badly damaged and that the company is different from the one a few years ago, making share-price comparisons less relevant.

But there are occasionally turnaround ideas with merit, if you know what to look for and are prepared to take higher risk. Finding stocks with falling debt, decent cash-flow growth and a reasonable Return on Equity (ROE) is key.

Takeover potential is another plus, but never the sole reason for buying. Always seek stocks that are good potential long-term investments, with or without takeover.

A good idea

Vision Eye Institute (VEI) is an example. It plunged from above $4.25 in late 2007 to 8 cents in mid-2011 and now trades at 66 cents. The ophthalmic services provider expanded too quickly, had too much debt, and almost went bust. Higher fees paid to doctors – a constant challenge in its industry – crunched profit margins.

Primary Health Care lifted its holding in Vision to 21.9% in July 2014 from 20%, according to data compiled by Morningstar. It owned 15.5% of Vision in December 2013. It has been creeping up its share register, and looks like the natural owner of it one day.

Primary Health Care is expanding more aggressively into specialist medical services, notably In Vitro Fertilisation. Ophthalmic services fit that strategy and Vision is trading slightly below fair value.

AMP has also bought more Vision shares this year, lifted its stake to 6.4%.

Vision's problems peaked in FY10, when it lost $58 million. The net debt-to-equity ratio was 140%. By FY11, net debt-to-equity was a staggering 196%. Beneath this nightmare was an interesting business with a reasonable position in the ophthalmic market. Vision has 18 consulting clinics, eight-day surgeries, and seven refractive and laser eye surgery centres in Victoria, New South Wales and Queensland. It provides specialist cataract, refractive, glaucoma, cornea, medical and surgical retina and oculoplastics care, among other services.

On the right track

The results of Vision's turnaround strategy are emerging. Revenue grew 3.3% to $110 million in FY14 and net profit after tax rose to $13.2 million from a $16.9 million loss a year earlier. Earnings per share rose to 7.9 cents from minus 11.5 cents in FY13.

A fully franked dividend of 1.25 cents a share for FY14 was important. Although small, the dividend signals that Vision's management is becoming more optimistic about the outlook. It's usually a good sign when turnaround companies start to pay dividends again.

The balance sheet has also been strengthened. Overall, bank debt was reduced by $9 million. Net bank debt (excluding cash) fell 32% to $27 million in FY14. Vision had $105 million in net bank debt in FY08 and $77 million in FY14. The net debt-to-equity

ratio in FY14 was 34%, which should be considered low to moderate risk.

Vision's big challenge is to stabilise doctor fees. Its net profit margin was crunched between FY06 and FY13, and doctors took an expanding share of the revenue. Its gross margin fell 1.8% in FY14, due to a larger medical staff and a continuing rebalance of profit share with doctors.

In its guidance for FY15, Vision said: "Doctor costs will continue to rise as we rebalance the clinic profit share with doctors in line with market conditions." This rebalance should ease in the next year or two, as Vision pays market-share rates and a floor under how much profit doctors take from the eye clinics emerges. That should help Vision retain more doctors and potentially attract new ones to the business. It needs more bargaining power with key suppliers.

The upside

For all its recent problems, Vision has plenty of growth potential. A strengthened balance sheet provides capacity to buy other clinics and rebuild market share, without taking excessive risk. At this stage, it is an average-quality business with improving recent performance.

Longer term, the specialist medical-services industry should grow faster than the economy over the next five years, due to Australia's ageing population. Business forecaster IBIS World predicts 4-5% growth in this industry over 2014-19 (the industry covers a range of services).

As more baby boomers leave the workforce, and as the population ages, demand for eye surgery should rise. It's not hard to imagine cashed-up baby boomers increasingly looking to fix body parts, such as eyes, when they retire, and having laser eye surgery.

At 66 cents, Vision is on a trailing Price Earnings (PE) multiple of 8.4 times. A fall from the 52-week high of 82 cents during the latest share market correction has brought it into value territory. It's not overly cheap, and suits investors, who are comfortable with higher-risk micro-cap stocks.

Contrarian investors with at least a three-year outlook could do worse than put Vision on their portfolio watchlists.

More will be known on Vision's outlook when it provides earnings guidance at its Annual General Meeting on November 21. That could be the time to look closer at Vision's unfolding turnaround.

• *Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at October 8, 2014*

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

BA-Merrill Lynch has had a busy start to the week. It has reviewed its position on Scentre and Westfield Group, upgrading Westfield but double downgraded Scentre, based on weaker growth expectations.

In the good books

Macquarie upgraded AGL Energy (AGK) to Outperform from Neutral. At the recent full year result release, AGL management called the outlook flat to slightly negative, but September data suggests improvement for retail electricity and gas. The removal of the carbon tax has not resulted in a margin squeeze. While electricity continues to suffer from technological and renewables challenges, supply discipline is supporting the near term price outlook.

JP Morgan upgraded Alumina (AWC) to Neutral from Underweight. JP Morgan is upgrading to Neutral from Underweight on the back of the recent weakness in the Australian dollar, improved spot alumina prices and ongoing weakness in bulk commodities, which have improved the relative valuation metrics of the stock. The broker considers the stock could be a beneficiary of investors wishing to maintain a mining sector position, while reducing bulk commodity exposure.

BA-Merrill Lynch has upgraded IAG Insurance (IAG) to Buy from Underperform. Merrills finds a compelling growth story in IAG and "double upgrades" to Buy from Underperform. The broker believes IAG has room to deliver further on cost cutting and the former Wesfarmers underwriting operations and the Coles Insurance brand should enable the insurer to outperform its peers.

BA-Merrill Lynch upgraded Westfield Corporation to Neutral from Underperform. The stock offers investors exposure to a number of attractive features in Merrills' view. Approximately 80% of the income comes from US assets and the company is highly leveraged to the uptick in the US economy and potential softening of the Australian dollar. The broker believes the asset quality deserves a premium valuation relative to peers but remains concerned about how the market will value the development pipeline.

In the not-so-good books

BA-Merrill Lynch downgraded AMP to Underperform from Neutral to reflect concerns around near-term regulatory uncertainties. For investors with a long-term view, the company's leverage to rising equity markets and structural growth in superannuation funds are appealing. However, Merrills believes investors should prioritise stocks that offer a more defensive return profile and the valuation leaves little room for disappointment.

BA-Merrill Lynch has downgraded Scentre to Underperform from Buy, on the view that the free funds growth rate is relatively weak and gearing of 37.6% might restrict investment flexibility. Moreover, economic conditions are likely to remain tough in coming months as weak retail sales growth is expected.

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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Short n' sweet – cheaper fees and "not ready"

by Penny Pryor

In early August, the Australian Securities and Investments Commission (ASIC) quietly changed the definition of wholesale investor, which means that many SMSFs are now no longer classed as retail investors.

Previously, SMSFs had been classed as retail investors – and did not have access to wholesale products, with their often-cheaper fees, unless they had more than $10 million in funds under management.

Under the new definition, SMSFs will be deemed to be wholesale investors if they meet one of the six tests in s.761G(7), namely:

- product price exceeds $500,000;
- product/service is used in connection with a business (but not a small business);
- for the last two years, the person has assets of more than $2.5 million (accountant's certificate);
- for the last two years, the person has income of more than $250,000 (accountant's certificate);
- person is acting for a trust but they themselves meets any of the above tests; or
- person is a professional investor.

OR they meet all the tests in s.761GA, namely:

- their financial adviser is licensed;
- the product is not insurance, super or RSA;
- the product is not used in connection with a business;
- the financial adviser is reasonably satisfied that the client is experienced in these products; and
- the adviser tells the client they are so satisfied and the client acknowledges in writing.

(Source: Townsends Business & Corporate Lawyers)

The caveat, of course, is there is an increased 'buyer-beware' requirement, as wholesale investors do not need to be given a financial services guide or statement of advice.

Not ready

And in new research out today, it looks like white-collar workers in particular are ill prepared for their retirement.

An online survey of more than 1,500 household decision makers on finance aged between 50 to 80 years found that one in four white collar workers will live around four years longer than average, which means they underestimate their life expectancy by up to seven years.

The survey, conducted in July, also revealed that redundancy or illness forced 40% of people into retirement before they were financially ready.

"People understand we're living longer, which means we need more money to last the distance, but expectations are disconnected to the reality of how to manage savings through retirement to ensure there's enough to the very end, particularly if retirement happens earlier than expected", Mercer's managing director and Pacific market leader, David Anderson said in a statement.

Just 28% of those surveyed believe they will have enough money to retire when they want. So it's time to make sure your expectations are in line with reality.

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Timing is everything with contributions

by Tony Negline

Contributions made late in a financial year can be a complex animal at times.

Take the following question that was asked of me recently.

A self-employed trustee of an SMSF writes a cheque from their personal bank account on 25 June 2014 made out to their SMSF. The trustee holds onto the cheque until 2 July 2014 when they take it to the bank. The proceeds appear in the SMSF bank account on 9 July 2014.

For the purposes of claiming these contributions as a tax deduction:

a) Is the contribution to the SMSF deemed to be in the 13/14 financial year when the trustee received the cheque (from himself)?

OR

b) Is the contribution deemed to have occurred when the cheque was presented to the bank in the 14/15 financial year?"

This is a remarkably common problem. Just by way of background – 25 June was a Wednesday, 30 June was a Monday, which means 2 July was the Wednesday, or five working days after the cheque was presented to the super fund.

A question of when

The major problem here is the desire to claim the contribution as a tax deduction in the 2013/14 financial year.

The Tax Office has dealt with this issue in a number of different ways. In Tax Ruling 2010/1, the Tax Office says that a super contribution made by cheque is deemed to have been made when it's received by the super fund, as long as it isn't dishonoured. (A dishonoured cheque simply means that no contribution has been made).

However, the Tax Office also says that a contribution is deemed to be made using a personal cheque (as is the case in this example) when it's received by the fund, promptly **presented** and isn't dishonoured. There is an additional caveat that the cheque mustn't be post-dated (that is, the proceeds will leave the contributors bank account at some future time).

Be prompt

In my view, the main problem is the time it has taken to present the cheque. Given the proximity of 30 June, promptness is vital. The Tax Office says in TR 2010/1 that when a personal cheque isn't presented promptly, then it will treat the contribution as having been made once the super fund has received cleared funds. In this case, that would mean the 2014/15 financial year.

So what is meant by promptly? In the ATO's view, it means subject to extenuating circumstances, "within a **few** business days consistent with prudent business practise" (my emphasis). The word 'few' means more than two days and less than an indeterminate small number of days.

Given the proximity to 30 June and the desire to claim the contribution as a tax deduction, why did it take the trustee five working days to present the cheque to their bank?

Unless there was some business or personal problem that stopped the trustee from visiting a bank branch, then I take the view that five days was probably too long. No business likes waiting for their money longer than is necessary, so most bank cheques the day they receive them.

Based on what we know, I think the contribution was made in the 2014/15 financial year.

If the cheque had been presented on or before 30 June, then you would want proof of this (such as the bank stamped deposit slip) so we can count the contribution in the 13/14 year.

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Market markers and tax on offshore investments

by Questions of the Week

Question: Given the recent market correction, could I please have your opinion on the likely Australian share market index level at the 1 year, 2 year and 5 year intervals?

Could you also please offer an opinion on other relatively secure investments other than cash and term deposits?

Answer (By Peter Switzer): I am not in the habit of making predictions years' out because there are too many exogenous factors. That said, my expectation is that in the absence of some external shock, the market will re-test its previous high of around 6,800. There is an argument that the high in 2007, adjusted for all the equity raisings in 2009, is more like 6,200 – even so, it is still more than 1,000 points from where we are today.

In relation to the question about relatively secure investments (other than cash and term deposits), you could also consider hybrid securities and some of the bond funds. With hybrid securities, you probably want to diversify across several of the issuers (to minimise that risk). There are a number of bond funds – unlisted funds from the major fund managers, and also fixed income ETFs. One fund that we reviewed at the *Switzer Super Report* and feel is pretty strong is AMP Capital's Corporate Bond Fund.

Question 2: Could you please advise on the tax treatment of dividends and capital gains if an SMSF (in pension phase) invests in either direct purchase of overseas shares or managed funds investing in overseas shares.

Answer 2 (By Paul Rickard): If the fund is in pension phase, them no tax is payable.

Accordingly, there is no Australian tax to pay on any income or capital gains on the offshore investments you have described.

One small caveat – if withholding tax is levied by a foreign government on the investment's income (for example, by the US Department of Inland Revenue – typically at 15%), you won't receive any refund/rebate back from the ATO as your fund won't have paid any Australian tax.

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Did you know?

Did you know that the majority of the questions we get from subscribers are about strategies, closely followed by stocks. Here is a breakup of the kinds of questions that we get here at the *Switzer Super Report.*