Switzer Super Report

QE3 is dead!

Issue 335, 30 October 2014

It's been a long time coming but the Yanks have finally pulled the plug on quantitative easing or QE3. And I was pleasantly surprised by the lack of movement on Wall Street overnight as a result. I think we may be over the worst of this recent bout of volatility we've been having, though volatility is not dead and buried.

Of course, there's still the spectre of US interest rate hikes at some point in the not-too-distant future, and how the markets will react to that, but I'm feeling pretty good about it all.

Back in Australia, Charlie Aitken might have had an Apocalypse Now experience recently in WA, and the general mood on the West Coast might be sombre, but that doesn't mean there's no value to be found. Charlie points to some of the big miners – BHP and Rio – as good value.

Also in the Switzer Super Report today we have a secret subscriber talk about his SMSF, he doesn't want his friends to get jealous so he's staying anonymous, and Tony Featherstone finds out that you can invest with a conscience and still make money in his article on ethical investing.

Sincerely,

Peter Switzer

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The way to play WA

by Charlie Aitken

Key points

- It's going to remain tough for WA-based mining service, engineering, contracting, industrial service, equipment hire and consumer facing companies.
- In mining services, diversified Seven Group Holdings (SVW) is the only company that has value.
- The big miners – BHP, Rio, Fortescue and Woodside – look cheap – with their dividend yields to provide a floor.

Once upon a time a stockbroker, an investor and a company director went for a trip to the seaside.

Two thousand kilometres from Perth, 100 kilometres from the nearest town, no food, no water, no shelter, no mobile coverage, tide rising quickly, sun setting even faster, snakes in the bushes and tiger sharks in the water… what happens next?

Amazingly, Bear Grylls style, the stockbroker, investor and company director managed to light a fire.

Then, like a scene from Apocalypse Now, just when it seemed we might have to settle in for a long night on the desolate beach, the distant whoop, whoop, whoop of helicopter blades could be heard.

A cattle mustering helicopter swoops onto the beach in near pitch dark, the three financial types jump in, and within 20 minutes are having an ice cold beer back in civilisation.

Welcome to **Western Australia, *land of risk and reward.***

The West Coast story

I have always enjoyed visiting Perth and greater Western Australia. Investors and companies always warmly welcome you because you've "made the effort" to come over from the East Coast, while I also feel the degree of entrepreneurialism and risk taking is higher on the West Coast and something to be admired.

WA now moves into a major step up in iron ore and gas production, yet the capital intense construction phase and its massive multiplier effect through the economy are over.

WA unemployment is rising, GDP growth slowing, house prices flattening/falling, office vacancies rising and overall the mood is quite sombre.

Infrastructure upgrade projects such as the Queen Elizabeth dock area, new Perth Stadium, international airport terminal upgrade and freeway upgrades are underway, but are far less capital intense, materials intense, and labour intense than the major iron ore and gas projects were. The multiplier effect through the economy is also less.

What we all need to remember is production assets are far less labour intense than during their construction phase. I think this can best be

summarised by a regional Qantas 737-800 flight I was on. Only 44 of 180 seats on the Karratha to Perth flight I was on were taken. Rewind three years ago and RIO's/ WPL's expansions in Karratha meant you were lucky to even secure a business class seat on this flight.

People-less power

One of the most stunning features of visiting large scale WA resource projects/assets nowadays is just how few humans you see. Driverless 200t trucks (CAT/SVW) and automation of the production chain are structurally lowering demand for labour. At the big gas plants you hardly see anyone outside of a relatively small control room. It's quite amazing relative to the scale of export revenue they produce.

Wage deflation is real in WA as demand for skilled labour drops. As the big resource construction phase ends you will see skilled labour head back to the East Coast to work in the new housing and infrastructure construction sectors.

The mobility of Australian skilled labour is another reason I think Australian interest rates will remain low for an extended period. It's highly unlikely under this mobile skilled labour scenario that wages will move significantly higher. If anything it will put a cap on any broader wage pressure, which also puts a cap on inflationary pressure and in turn interest rates.

I do have sympathy for Western Australia. They deserve a greater share of the GST pie. The WA resource sector investment cycle almost certainly saved Australia from a post GFC recession (and a much higher national unemployment rate), while moving forward, slackness in the labour market will play a role in keeping interest rates low. Similarly, the WA-based supply response in iron ore and gas will play a role in keeping global inflation readings low, ensuring global and domestic interest rates remain relatively low.

The iron ore and gas supply response, and associated lower spot prices, are playing a role in lowering the Australian dollar. Again, WA can claim some role in this very important development for the broader Australian economy.

Doing it tough

Unfortunately I think it's going to remain tough for WA-based mining service, engineering, contracting, industrial service, equipment hire and consumer facing companies. I can't see yet what ends the down cycle in both volumes of work, prices and margins. It may not get much worse, but I can't see it getting significantly better anytime soon.

There does seem to be some sort of view forming in WA that the downturn is all "BHP & RIO's" fault. I think that's very harsh. All we are seeing is the end of a once-in-a-generation mining investment boom and the major producers switching from ramping up production to sweating their assets as hard as possible. It's simply a cycle, one that has been seen before (albeit a bigger one than ever seen before).

I wrote in these notes a few years ago that the resource company/mining services relationship was no different to the fund manager/broker relationship. In up cycles the "middle men" see volume, price and margin uplifts, and vice versa in the down cycles. For the "middle men" in WA it's going to remain tough. That's the unfortunate reality of the situation.

The only one I recommend is the diversified **Seven Group Holdings (SVW).** Seven is trading below NTA, 9.1x FY15 consensus earnings, and offers an 8.4% grossed up annual yield at current prices. There is an active on-market buyback program and, from my observation, Caterpillar equipment, particularly autonomous trucks, are playing a crucial role in the big miners getting their C1 costs down. I am also currently reading the Kerry Stokes biography "The boy from nowhere". It's a great read and quite frankly makes you want to invest in the stock he controls nearly 70% of. A bit like backing Gerry Harvey and Solomon Lew in the retail downturn, I'd be backing Stokes over all others in this mining services downturn.

Good value

There are two WA sectors I am interested in from an investment perspective. Resource companies that have invested in low cost production growth and inbound tourism.

I think large scale, low cost, long life, WA-based iron ore and gas producers are now cheap. They have turned up low cost production, turned off capex, driven down operating costs and the result will be a greater share of profits to investors. Prospective dividend yield alone will now start putting a floor share price under B**HP Billiton, Rio Tinto, Fortescue Metals Group and Woodside Petroleum**. Below are current consensus prospective grossed up yield forecasts.

	FY15 grossed up yield
BHP Billiton	5.38%
Rio Tinto	4.94%
Fortescue	7.91%
Woodside Petroleum	7.67%

Investors have been campaigning for resource companies to turn down the capex tap and turn up the dividend payout ratio tap. Yet resource stocks have been de-rated in P/E terms due to falling commodity prices, partly driven by the low cost supply response they are delivering to market.

I think these big WA based, low cost, large scale, long life, resource names who have previously invested in production growth are cheap. From here I think we will see commodity price stabilisation, cash costs lowered further, yet the Aussie dollar continuing to head lower on interest rate differentials with the USA. I also think that we will see large scale M&A.

No doubt **Glencore** has started the "bear hug" on **Rio Tinto.** The day will come next year when Glencore bids for RIO and it might just be hostile. When that day comes, investors will positively reassess the value of remaining large scale, low cost, long life, WA production assets.

The increasing likelihood of a medium-term takeover bid for Rio Tinto is another reason I am recommending buying BHP, Rio, Fortescue and Woodside at current prices. It's always darkest before the dawn and that could well be right now in these names.

The travellers

In terms of inbound tourism, Perth/WA should see a recovery from here as the Aussie dollar fall increases the relative attractiveness of WA's strong tourism offering.

The way to play this theme is firstly through Crown Resorts (CWN) which is investing heavily, upgrading the former Burswood site to a world class destination casino offering. When completed in late 2016, Crown Perth will be the destination of choice for business and leisure travellers. Crown will have Perth's best accommodation, best restaurants and best entertainment. And it's close to the airport, which is important as most Perth taxi drivers don't seem to know where they are going! There is clearly a business opportunity in selling Perth taxi drivers GPS.

In summary it all feels a bit flat over in Perth and as I said above the mood is quite sombre. However, it is just a down cycle not a depression. It is only a matter of time before the broader business community gets its entrepreneurial mojo back and starts riding the next cycle.

In the interim I believe the way to play WA is via large scale, low cost, long life resource stocks (BHP, Rio, Fortescue and Woodside), Seven Group Holdings as a contrarian value and yield play, and inbound tourism stocks for earnings growth.

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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Make money and feel good

by Tony Featherstone

Key points

- More people are investing in ways that factor in environmental, social and governance factors.
- Core responsible Australian equities investment funds outperformed the ASX 300 index and the large-cap Australian equity fund average over 1, 3, 5 and 10 years.
- When looking for an ESG fund, focus on those that have established records.

The Australian National University's decision this month to sell its fossil-fuel investments sparked an outcry. Although tiny, the $16 million divestment elevated the stakes in ethical investing and brought environmental considerations in investment decisions to the fore.

The move also raises questions about whether a stringent approach to responsible investing sacrifices long-term returns – a critical issue for a growing number of retail investors who want to invest with their conscience, rather than only their wallet.

Responsible investment is an umbrella term to describe an investment process that factors in environmental, social, governance (ESG) or ethical considerations into decisions. Ethical investment funds are a subset of this evolving investment category.

Interest in core responsible investing is rising. Assets under management in ethical, socially responsible, community finance and sustainability-themed companies grew 51% to more than $25 billion in the year to December, 2013, according to the 2014 Responsible Investment Benchmark Report from the Responsible Investment Association Australasia (RIAA).

Growth in responsible investing is being driven by superannuation funds. They are focusing more on ESG factors in investment decisions, which in turn is forcing fund managers to consider ESG in company assessment and valuations, and forcing investment banks to produce detailed ESG assessments in their broking research.

Long-term outperformance

Core responsible Australian equities investment funds outperformed the ASX 300 index and the large-cap Australian equity fund average over 1, 3, 5 and 10 years, RIAA found. It said: "Core responsible investments outperforming the average fund returns in all categories over 5 and 10 years is a further demonstration of the sustainability of responsible investments, both in their returns and also the impact they deliver."

Care is needed with these results. Core responsible investing covers a reasonably broad group of funds. It includes those that screen investments, focus on sustainability-themed investing, impact/community investing, and corporate engagement and shareholder actions. Nevertheless, this "category" provides useful insight for investors who want to invest in responsible companies, without excluding too much of the investment universe.

As an aside, a strict ethical-investing approach that excluded banks (that lend to fossil fuel companies) and resource companies, would wipe out about 60% of the S&P/ASX 200 index. Add to that Woolworths and Wesfarmers, which own poker machines through their hotel investments, and not much of the index is left, by market capitalisation.

Three steps to invest ethically

First, decide on the level of "responsible investing" and trade-offs you are prepared to accept. Investors who want to own companies that have good ESG credentials should focus on broad responsible investment funds. Those who seek more detailed ESG screening should focus on the smaller group of core responsible investment funds. Specialist ethical funds are a good option for investors with a narrower definition.

Second, choose a managed fund rather than build a portfolio of direct investments. The two main advantages of funds – diversification and professional managers – are vital in responsible investing. Such funds screen companies for their ESG credentials and give investors exposure to a basket of stocks that fit the bill. This is especially valuable in ethical managed funds.

Investing directly in small-cap companies that have excellent environmental credentials can be hazardous. The Australian CleanTech Index, which measures 65 clean-technology companies, returned minus 19.5% over three years to July 2014.

The CleanTech index outperformed the S&P/ASX200 index and Small Ordinaries index in FY14. But its long-term performance is a reminder of the dangers in investing in speculative emerging-technology companies, and why a basket investment approach to spread risk is important.

Finally, choose investment funds that have an established record – preferably more than five years – and a long-term commitment to socially responsible investing. Understand their definition of responsible investing, for it can vary across funds, and assess management expertise, fees, long-term performance and the investment strategy, as you would any fund.

Funds that fit the bill

The Switzer Super Report analysed 47 socially responsible funds Morningstar covers. Most are small: the median funds under management was only $39 million. But a few funds stood out.

The Perpetual Wholesale Ethical SRI was the largest fund with $795 million in net assets. It had the best performance over 10 years to September 30, 2014, with an almost 13% annualised gain. Other Perpetual SRI funds performed well over five years.

The Australian Ethical Smaller Companies fund also warrants consideration. It had $274 million in net assets and an annualised 10-year return of almost 10%.

The AMP Capital Sustainable Share Fund and the BT Wholesale Australian Sustainable Share Fun returned almost 8% annually over 10 years.

Double-digit returns that are broadly in line with the Australian sharemarket's return over 10 years show that ethical investing need not sacrifice investment performance.

Australian shares returned 9.2% annually (on a before tax, after-fees basis) over 10 years, according to the 2014 Long-Term Investing Report from the Australian Securities Exchange and Russell Investments.

Consistent long-term outperformance by funds with a narrow ethical investing mandate is harder to find, given a smaller investment universe in Australia compared with US and European exchanges.

But achieving a similar return to the market, by investing only in responsible companies, will appeal to those who want to invest with their conscience and wallet.

- Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at October 29, 2014.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Brokers continued to look for unloved favourites to upgrade this week with AMP and Qantas getting upgrades. Disappointing announcements drove downgrades.

In the good books

Credit Suisse upgraded AMP to Outperform from Neutral. AMP continued to enjoy strong funds flows into its North platform during the September quarter, exceeding outflows in legacy platforms. But for the broker, the big news was on the insurance side where lapse experience is matching assumptions and claims experience is performing ahead of assumptions. Given it is the September quarter when AMP has typically announced a "life downgrade", the broker sees this as very positive. With AMP now trading in line with the market and below its historical PE, the broker upgrades to Outperform.

Credit Suisse upgraded JB Hi-Fi (JBH) to Outperform from Neutral. The sell off in the stock has come to a point where Credit Suisse believes it is too low. The broker expects the recent improvement in trading conditions to be maintained and the valuation is now compelling. (See downgrade.)

UBS upgraded Qantas (QAN) to Buy from Neutral. The stock has retraced despite evidence of positive earnings momentum. Jet fuel prices in Australian dollar terms have fallen and the domestic market recovery is underway. UBS calculates a net $270 million annualised benefit from fuel and currency moves over the past two months will be spread across FY15 and FY16. Free cash flow generation should drive a reduction in capital employed and improve the balance sheet and gearing.

In the not-so-good books

JP Morgan downgraded Ardent Leisure Group to Neutral from Overweight and UBS to Neutral from Buy. The first quarter was weaker than JP Morgan expected, although there was strong growth at Main Event and health clubs. JP Morgan adds all factors in, but only comes up with the current price as a valuation. UBS says a solid increase in revenue was not matched by earnings in the September quarter given ongoing investment in various areas including new MainEvent centres. MainEvent has been well-received by the market, but further upside for Ardent will depend on more confidence in Australia growth, particularly for bowling and theme parks. The broker believes Ardent's strategy is sound, but will take time to pay off.

JP Morgan downgraded JB Hi-Fi (JBH) to Neutral from Overweight. Trading is ahead so far in FY15 and the company has reiterated guidance at its AGM. Nevertheless, JP Morgan downgrades, noting operating costs and capex are likely to rise, and gross margins remain in line rather than expanding. JP Morgan would become more constructive on the stock when the costs growth is clearer. (See upgrade)

The following 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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My SMSF – better than any other fund

by My SMSF

Age: 67

Family – are they members of the SMSF? Yes, two adults over 65 and two adults just over 40.

Where do you live? Eastern suburbs, Sydney

How long have you had your SMSF? 13 years

Why did you start it up? As a fall back from the hopeless returns of a managed fund, and reflecting on the lack of wisdom of the fund managers.

How big is it? Presently between $3 million to $4 million, but when we take the next step it will grow by more than another $1 million.

Is it more or less difficult to manage than you thought it would be? Not hard to manage, in fact, it is fun. 100% glad I established it. The fund yields far more than any other public fund I have found and more than friends who also have SMSFs.

Are you pleased with its performance? Very happy… it has outperformed the market in every period. A tax advisor put me on to a super industry advisor, because the accountant said our super fund was too complex and the advisor could help us do better. The advisor could not believe the yield, and in fact copied some of the structure/holdings.

What is your asset allocation? All Australian equities (listed and unlisted), very little cash. A very broad spread covering banking, services, retailing, mining, transport, IT etc. From some we have done super well.

What are your favourite investments/stocks and why? No particular favourite. Each acquisition is focused on improving our yield and getting the best bottom line and tax outcome.

What investments do you have outside of superannuation? Shares, Australian only, both listed and unlisted. Real estate which is rented.

Do you use an advisor or any kind of service provider? Given my past experience, I would say you would be crazy to use an external advisor. However, in the right circumstances and depending on the advisor, it can no doubt make sense.

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- [illegible]

- **Notice of non-compliance** – very serious breaches of the super laws will see your fund be declared a non-complying super fund. In the first financial year this occurs your fund will face a tax rate of 45% (47% while the Temporary Budget Repair Levy is in place) and this tax rate applies to the market value of your fund's assets, less non-concessional contributions. This tax rate then applies to the taxable earnings of your fund for each subsequent financial year that it remains a non-complying fund. Declaring an SMSF non-complying is a very serious step and the ATO has established procedures that it uses to determine when a fund should be declared non-complying. Fortunately this rule is used sparingly.

- **Disqualifying an SMSF trustee** – under the super laws the ATO can disqualify you from being a SMSF trustee. If your fund has a corporate trustee then that corporation and yourself may be disqualified. This will typically occur when you've breached the super laws and the ATO believes you'll probably continue to infringe these laws. Once you're debarred from being a trustee then you must resign this position as soon as possible.

- **Civil and criminal penalties** – prior to the introduction of the SMSF administrative penalties mentioned above, the ATO's only way of imposing monetary fines (other than non-compliance) was to ask the Court to impose a civil or criminal penalty. These provisions have been used rarely but are still available to the ATO for various super law breaches.

- **Freezing an SMSF's assets** [illegible]

Need to know

More than one power can be used for the same breach – for example, if you've been particularly naughty, the ATO might enter into an enforceable undertaking with you and once you have complied with this, they might also ban you and declare your fund non-complying as well as seek monetary penalties from the Courts.

These rules have nothing to do with tax issues. If your fund breaches the tax laws then there is a list of penalties that can apply in these situations.

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What to do with dud shares and grandkids

by Questions of the Week

Question: I have Ausdrill ASL (Paid $3.55), Grange Resources GRR ($0.36), Regis Resources RRL ($4.47), and Troy Resources RY ($1.485) in my SMSF in pension mode. I'm also wanting to get as much income as possible from my stocks. The stocks have gone down a lot and my broker recommended that I hold them. I have lost confidence in his advice. Have they gone down to far to sell off?

Answer (By Paul Rickard): I don't know how big a proportion of your portfolio these stocks represent, nor your investment objectives. I know that you are in pension mode.

Legally, I can't provide you with personal advice. That said, let me offer you the following comments:

a) None of those stocks (with the possible exception of Ausdrill) would be in my SMSF portfolio – particularly if I was in pension phase. I don't like (for investment purposes) gold stocks or second tier iron ore producers;

b) According to FN Arena, broker sentiment (scale -1.0 most negative to +1.0 most positive) and consensus target prices are:

- ASL -0.2; $0.91
- GRR 0.0; $0.14
- TRY +1.0 (one broker only); $1.10
- RRL 0.1; $1.81

c) In reflecting on whether to keep a stock or not, what you paid for that stock is not relevant. I know it is hard to disregard – however in pension mode, you have no capital gains impacts to consider; and

d) If the same broker suggested you buy these stocks – then yes, I would probably sack him/her. If on the other hand, they are just advising you on the portfolio going forward, then they might be doing you a favour.

Question 2: I have 12 grandchildren, aged from two to 12 in three separate families. I don't want the expense of setting up trusts for each of the three families, but I do want to buy them a long-term share that will help fund their tertiary studies. Any suggestions?

Answer (By Paul Rickard): If you are looking for suggestions around how to do it, you might like to review a couple of articles we published on this (see links attached). Insurance bonds may also be a good alternative.

Please let me know if you need any further help in regard to the shares.

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Did you know?

Still not sure about whether or not to take up the Medibank offer? Watch my video chat with Paul Rickard and be careful of the hype.