Switzer Super Report

Issue 345, 4 December 2014

All is not lost

The GDP numbers out yesterday sent a shiver down a few people's spines but I'm hardly surprised. Joe, Treasurer Joe Hockey that is, has been harping on about how bad things are for ages, no wonder some out there started to believe him.

Growth is still solid, but there is no denying the oil price is having an impact too. Eventually we should see a lower local dollar and that's good for companies with exposure to the US dollar. Today Charlie Aitken shares his view for 2015.

Also in the *Switzer Super Report* today, we've got two *Fundie's Favourites* for you – on Transurban and Billabong – and our *Short 'n Sweet* takes a look back at two fantastic little medical companies – CSL and Sirtex.

Sincerely,

Peter Switzer

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switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
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The forecast for 2015 and US dollar stocks to buy

by Charlie Aitken

Key points

- *Do not rule out the likelihood of a 2.00% cash rate and 75 US cents Australian dollar.*
- *This year was all about asset allocation and 2015 will be all about asset allocation.*
- *Take lessons from the Future Fund's allocation to international shares.*

What needs to be remembered with the clearly disappointing Q3 Australian GDP data is the iron ore and oil price rout only really gathered steam in Q4. The Q4 GDP print could be negative when it is released next March.

Nominal GDP contracted for the first time since 2009. In per capita terms real net disposable income fell 0.8% in the third quarter. This measure of living standards is now down -2.1% in two years.

The chances of interest rate cuts in 2015 are rising and DO NOT rule out the likelihood of a 2.00% cash rate and 75 US cents Australian Dollar. That is becoming my base case forecast.

Down, down, the dollar goes down

I am in danger of boring you all to wealth with my short Australian dollar macro strategy, but the Aussie dollar is a basic commodity currency being priced as a yield instrument. The concept of buying a commodity currency for yield will prove as flawed as buying a resource stock for yield.

The absolute and relative yield of the Aussie dollar will fall in 2015, particularly versus the US dollar, and that will cut its legs off. The first stop will be 80 US cents and the next stop 75 US cents. Sell it while you still can with an "8" in front of it. As an Australian, being short Australian dollars (or long US dollars, US equities or ASX listed US dollars earners) is one way of hedging yourself against a decline in GDP per capita.

Quite frankly this morning after the Australian Q3 GDP miss yesterday I am even more convinced my broader macro and sector strategy is correct. My conviction is increased and I am putting the foot to the floor in US Dollar earners, non-bank industrial yield, transport, inbound tourism, shopping mall owners, international fund managers and selected discretionary retailers.

Key stock specific recommendations include:

Westfield Corporation (WFD)
QBE (QBE)
Crown Resorts (CWN)
Resmed (RMD)
Brambles (BXB)
Telstra (TLS)
IAG (IAG)
AMP (AMP)
Wesfarmers (WES)
Transurban (TCL)
JB Hi-Fi (JBH)
Super Retail Group (SUL)
RCG Corporation (RCG)
Automotive Holdings Group (AHE)
Qantas (QAN)
Platinum Asset Management (PTM)
Magellan Financial Group (MFG)
NAB (NAB)
ANZ (ANZ)

Forecast for 2015

At this time of year, those of us who make forecasts for a living feel the pressure to make prognosis for the year ahead.

Here is mine: 2014 was all about asset allocation and 2015 will be all about asset allocation.

Australian investors need to lose the home bias. That was the key to 2014 and it will be the key to 2015 as the Australian dollar reverts to its natural place as a commodity currency.

A 100% exposure to Australian assets in Australian dollars was the worst relative and absolute positioning in 2014 and I expect that to be the case again in 2015.

I encourage you to think and act more like the Future Fund who is leading the way in Australian based global asset allocation.

While most SMSF's probably haven't changed their asset allocation despite the growing underperformance of Australian assets, what is of interest to me is that Australia's largest pension fund, the Future Fund, has.

In its latest update the Future Fund confirms US dollar exposure is now at 30%, up from 15.1% in June 2013, while 70% of the $100 billion portfolio is invested overseas.

But where it gets far more interesting is in sub-asset allocation. The fund holds 9.8% in cash, 24.4% in developed world equities, 13.8% in hedge funds, 11.3% in debt securities, 9.7% in emerging market equities, 9% in Australian equities, 8.8% in private equity, 7.4% in infrastructure and timberland, and 5.8% in property.

I doubt there is a single SMSF in Australia with an asset allocation like that, but I think it is the future. For example, with volatility increasing and Australia underperforming, the Future Fund has more in hedge funds than it does in Australian equities. Now that is interesting and would have generated the fund genuine outperformance if they have picked the right global hedge fund managers.

The median Australian SMSF would be 100% weighted to Australian equities, Australian property and Australian bank CMT's/Hybrids. The Future Fund and the median SMSF are driving in completely different asset allocation lanes, despite the fact the Future Fund can value franking credits.

If you are in the pension phase of super (tax free) and all you care about is reliable tax effective income streams that you will spend in Australian dollars then there's no need to change your asset allocation. You can happily clip dividends and collect the franking credits, but be prepared for somewhat stagnant capital growth.

Follow the Future…Fund

However, if you are in the accumulation phase of super your focus should be capital growth (compound then protect) in Australian dollars. The way to maximise capital growth will continue to be via asset allocation to offshore asset classes and offshore fund managers. You need to lose the home bias as I have said all year. Simply investing in an unhedged Platinum (PTM) or Magellan (MFG) fund is a sensible first step.

Let's just remind ourselves of CY2014 year to date performances (excluding dividends) in Australian Dollar terms of leading global and regional equity indices.

Market	CY2014 performance in AUD
Dow Jones	+13.85%
S&P500	+18.08%
NASDAQ	+20.18%
HANG SENG	+7.11%
SHANGHAI Composite	+35.1%
Nikkei	+2.8%
NZX 50	+14.9%
ASX200	-1.32%

These are returns from basic index investing. With the right fund manager or via successful high conviction stock-picking, alpha beyond these returns should have been generated.

With speculation increasing about rate cuts in 2015 in Australia the impetus to increase offshore asset allocation increases. As the Australian dollar loses its absolute and relative yield advantage to the world, it will revert to being the commodity currency. It's that simple in my view and having a simple view on the

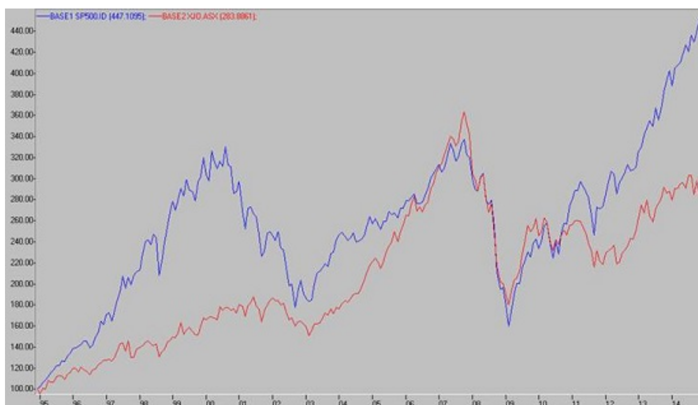
Australian dollar has worked very well for the last two years. I set all my medium-term asset allocation decisions from a 75 US cent target on the Aussie dollar, a further -11.2% fall in the currency from here.

Interestingly, I note yesterday as domestic rate cut forecasts increased for 2015 that a few of my key USD earning ideas did every well. Westfield Corporation (WFD 2.15%),QBE Insurance Group (QBE 2.61%), and Brambles (BXB 3.44%) all performed well and I expect that to continue. Resmed (RMD) has done well in ADR's overnight.

The way forward

Either way, I believe the Future Fund has the future of asset allocation right. For those who care about the maximum available risk adjusted return on Australian dollar capital it is well worth considering. If you are bearish on the prospects of the Aussie dollar you need to act with more urgency. 100% asset allocation to Australian assets in Australian dollars is not the way forward, particularly in a world of highly divergent currency and asset class performance.

And finally consider this chart. It's the S&P500 (blue line) and ASX200 (red line) on a common raw monthly performance base (not currency adjusted, not dividend adjusted) over the last 20 years. It actually shows you it is not unusual for Australian equities to underperform US equities. In fact you could argue it is structural underperformance with the only re-correlation coming during the peak of the GFC.



Click here to view larger image

Go Australia, Charlie

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What the fund managers say – Transurban and Billabong

by Fundie's Favourite

Key points

- *EQT likes Transurban for its exposure to a high quality defensive distribution stream and has a 12-month price target of $8.80 on the stock.*
- *NAOS Asset Management believes Billabong can get back to being one of the best retailers in Australia and has a price target of $1.20 on the stock.*

Paul Kasian, head of asset management at Equity Trustees on Transurban Limited (TCL).

How long have you held the stock?

We've had an overweight position versus benchmark since June 2013.

What do you like about it?

Transurban is a toll road developer and operator that provides exposure to a high quality defensive distribution stream, through their portfolio of toll roads across eastern Australia as well as two toll roads in Virginia, USA. The company also has the capacity for growth over the medium term as current expansion projects ramp up. The business has been de-risked post the GFC and is able to support its distribution from internally generated cash.

Transurban (TCL)

Source: *Yahoo!7 Finance, 4 December 2014*

How is it better than its competitors?

The company has extensive experience in developing and operating toll roads since 1996. In addition, it is the only major toll road operator listed on the ASX with a diversified portfolio of Australian assets and a yield above 5%.

What do you like about its management?

Experienced senior management and board have taken a disciplined approach to investing capital and have delivered consistent earnings growth and strong shareholder returns since listing in 1996.

What is your target price on Transurban?

Around $8.80 in the next 12 months.

At what point would you sell it?

We will look to review our position if the current expansion projects start to wind down with no replacement growth projects.

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

Transurban is up around 15.7% over the past year and, not surprisingly, has outperformed the broader ASX 200 benchmark, which is flat over the same time period.

Is it a liquid stock?

Yes. It is a very liquid infrastructure stock for both global and domestic investors.

Fund manager and managing director of NAOS Asset Management, Sebastian Evans, on Billabong

How long have you held Billabong?

Around 12 months.

What do you like about it?

Billabong is an excellent brand with solid consumer recognition in its desired target market. Its large revenue base does not need to grow to achieve significant returns for shareholders. Billabong has a great opportunity to benefit from a weaker Australian dollar, and it is close to being debt free.

Billabong (BBG)

Source: *Yahoo!7 Finance, 4 December 2014*

How is it better than its competitors?

Billabong owns its brand and is not a re-seller of other companies' products. It is a global brand with significant scale.

What do you like about its management?

Billabong has a proven management team that has turned around a number of companies such as Eddie Bauer, and Bath & Body Works.

What is your target price on Billabong?

$1.20

At what point would you sell it?

When the cost-out strategy in Billabong has completely unfolded.

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

Billabong has been a significant contributor to our portfolio performance over the last 12 months.

Is it a liquid stock?

Yes.

Where do you see the value?

Billabong's value is in the ability of its management team to take the $1 billion in revenue and focus on operational and productivity drivers to potentially get the company back to the +9% NPAT margins that once made Billabong the largest retailer in Australia.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Most broker actions in the week so far have been on the back of the oil price falls as analysts revise expectations and their forecasts for share prices with them.

Citi upgraded BHP (BHP) to Buy from Neutral. Post a general revision, including the impact of lower priced oil on commodities in general, Citi analysts have taken an axe and cut forecasts for BHP by double digits for the years' ahead. The analysts do see support from dividends, which they believe will not be cut, and from initiatives such as the spin-off of non-core assets.

Morgans upgraded Fortescue (FMG) to Hold from Reduce. Fortescue has responded to the plummeting iron ore price by halving capex in FY15 while keeping production guidance steady. The broker hopes this does not mean the deferral of the detrital processing plant, which would improve ore quality and thus reduce export price discounts. The reduction in capex increases the broker's net present value calculation for FMG but the broker has applied a 20% risk discount in light of iron ore price risk. Fortescue has seen a substantial share price fall nonetheless, thus the broker upgrades to Hold, although the broker is no longer forecasting dividends for FY15-16.

Citi upgraded Origin Energy (ORG) to Buy from Neutral. Citi expects FY14 will be the low point of earnings for Origin, with a step up over the next couple of years from monetising the legacy gas contract position and first production at APLNG.

Citi upgraded Oil Search (OSH) to Neutral from Sell. Citi has revised oil price forecasts lower, again. The broker believes at current prices, returns from PNG are sufficient for a stable cash flow. The broker's rating is upgraded but Oil Search remains the least preferred large cap oil stock.

Citi upgraded Qantas to Buy from Neutral. The broker believes there is further upside on the expectation that all domestic carriers are actively striving for profitability and adequate returns. The oil benefit will be skewed to the second half while domestic yields were positive for the second month in a row.

JP Morgan upgraded Ramsay Health Care (RHC) to Overweight from Neutral. The market has had its doubts about the investment in France but JP Morgan has recently visited the country to obtain a better understanding of the private hospital sector. Generale de Sante is a well-regarded group with a portfolio of 75 hospitals/clinics. The real upside, in the broker's view, comes from the ability to leverage global size for purchasing medical consumables.

UBS upgraded Virgin Australia (VAH) to Neutral from Sell. UBS has made a number of changes to forecasts, which leave FY15 broadly unchanged with a pre-tax loss of $115 million and push FY16 to a profit of $130 million. Jet fuel price assumptions have been lowered. The broker expects the company to become profitable in FY16, one year behind Qantas (QAN).

In the not-so-good books

Deutsche Bank downgraded CSL (CSL) to Hold from Buy. The company provided news of progress across a number of developments but this was offset in the broker's view by a disappointing result from the fibrogen trial in aortic surgery. Management intends to keep R&D spending at 8-9% of revenue.

UBS downgraded Santos (STO) to Neutral from Buy. In the wake of the OPEC decision not to cut production, UBS has reduced oil price forecasts and expects there is more pain to come for investors, with a bottom yet to be sighted for the oil price. Santos is

the most affected of the major stocks and the broker suspects high debt plus low oil prices means its credit rating will probably come under pressure.

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 – medical miracles CSL and Sirtex

by Penny Pryor

The Medibank float has certainly put the medical and healthcare industry front and centre, but while the IPO ride has been interesting to watch, the real action might be in the biotechnology and pharmaceutical sectors.

In an update to investors yesterday, biotechnology company CSL detailed hopes for approval for a new drug for haemophilia next year. That approval alone could add millions of dollars to the company's bottom line. Biotechnology companies need to focus on research and development (R&D) if they want to stay ahead of the pack, and CSL will spend $US500 million on R&D this year.

At the *Switzer Super Report* we've had our eye on CSL for a while – it's in our model growth portfolio. As a US dollar earner we like its exposure to a rising US currency. And fund manger Don Williams, at Platypus Asset Management, wrote about it in August.

He had a price target of $82 (it's trading well over that now) and said they would consider selling it if it got over a PE of 26 times (it's sitting at just over 23 on present foreign exchange values).

CSL

Source: *Yahoo!7 Finance, 4 December 2014*

"CSL appears to be more innovative; they have the largest portfolio of high margin specialty products and are the lowest cost producer of plasma products. They invest heavily in R&D, not only in new products where the returns are long dated, but also in improving business efficiency where the returns are more immediate."

If you had bought CSL back in August, you would be up by 34% today.

Another biotechnology/therapeutic company that we like at the *Switzer Super Report*, and that has paid off for anyone that invested in it when we first mentioned it in our report, is Sirtex (SRX).

This is another favourite of Platypus Asset Management. Analyst Jelena Stevanovic wrote about it last July (2013) and Roger Montgomery has also been a keen watcher of the stock with an updated view in March of this year.

Sirtex manufactures, markets and sells SIR-Spheres, which is a medical device used in interventional oncology. It delivers a highly-focused radioactive dose to liver cancers.

The real difference that such an innovation can make was recently brought home to me when a nurse friend of mine told me she was implanting the SIR-Spheres into palliative patients and the difference it made to their lives.

While currently used in palliative care, it is hoped that one day the device may be able to shrink cancer tumours to a size at which they can be removed. A study into the effectiveness of the treatment on a range of cancers is expected to be released early next year.

But if you'd invested in Sirtex 12 months ago your one-year return would be almost 140%.

Sirtex (SRX)

Source: *Yahoo!7 Finance, 4 December 2014*

These are just two companies that are going to be riding the major theme of healthcare and pharmaceuticals over the coming years. Demographics are a key driver of this industry, as more Australians reach retirement they are demanding more from the medical industry.

But it's important to remember that Australia is a world leader in many of these industries. Cochlear might have put us on the map, but there are plenty of other companies growing up in its wake.

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What you need to know about lump sums and transition to retirement pensions

by Tony Negline

Key points

- *All pensions have a minimum income requirement based on your age.*
- *TTR pensions also have a maximum income rule.*
- *Stopping and starting another TTR pension to get the maximum income is a complex strategy for which you should seek specialist advice.*

Transition to Retirement Pensions (TTR) have been in the media again this past week, primarily about minimum and maximum income amounts.

These pensions are potentially very attractive as they might enable you to reduce salary and make super contributions whilst receiving pension income that is paid with a rebate (if aged between 55 but under 60) or tax-free if aged at least 60.

The current media coverage about these pensions, often called TTR pensions in the super industry, is about taking lump sums out of a pension.

Minimum pension income rules

All pensions have a minimum income requirement based on your age each 1 July.

For example if you're aged at least 65 but under 75 then your pension must pay you at least 5% of the market value of the assets (determined at the start of each financial year).

You can meet this minimum income payment by making small lump sum withdrawals from your pension. Technically these are called partial commutations and are only allowed if the rules governing your pension permit these payments.

In most cases you can't take small lump sum payments from a TTR pension because most of your super money will be deemed to be "preserved" and can only be paid as a lump sum when you satisfy a Condition of Release.

However for TTR pensions it's possible, but rare, that some of your money might be classed as a preservation component known as an unrestricted component. Any money in this component can be paid as a lump sum at any time even if you're still working. If your TTR pension contains money in this preservation component then you can take it as a lump sum and that payment can be used to satisfy the minimum income requirement.

Non-TTR pension maximum income rule

For all non-TTR pensions there is no maximum income payment that can be paid. This means you could pay the whole pension account balance out as income in one amount.

TTR pensions unique payment requirements

For TTR pensions, the maximum pension income that can be paid each financial year is 10% of the market value of the fund on 1 July.

This 10% maximum pension rule also applies in the year the TTR pension commences. For example if your pension commenced on 1 January the maximum 10% income rule applies in the period of time between the date the pension was commenced and the end of the pension's first financial year (ie it is not pro-rated).

This is a different rule than that applying to the

minimum income formula, which is pro-rated for the period of time between the pension's commencement date and the end of the financial year. If you start your pension six months into the financial year, the minimum income that has to be paid in that first financial year would be 2% of the market value of assets on that date (the normal minimum income amount is 4%).

An important point to note is that any lump sums paid from your TTR pension aren't used to satisfy this maximum income rule. Technically this means you could get more money out of these pensions if necessary if your TTR pension has some Unpreserved Component.

Playing tricks with the maximum income rule

You often see strategies that involve commencing a TTR pension taking the maximum 10% allowed as income payments, then stopping that pension and commencing a new TTR pension that can be used to receive another 10% maximum income payment.

Typically this strategy is suggested for people who have a need for money and their superannuation represents the easiest source of funds.

In my view this strategy potentially has a number of barnacles from a tax and super law perspective. You could be seen to be illegally withdrawing preserved money from your super fund and face high tax penalties.

In addition if you run an SMSF then the ATO might consider that you're not running your SMSF appropriately which might lead to additional penalties. If you're interested in using this strategy then I suggest that you should seek robust advice from a superannuation lawyer or the ATO before proceeding.

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Who is shorting BHP and the best LICs

by Questions of the Week

Question: Is there any where I can find out have many people have shorted BHP? Also I have some and would like to add some more at these levels. Should I follow the stock down or wait for it to start going up and then start buying?

Answer (By Paul Rickard): You can view ASIC short sales reports here. The reports are based on "trade date" – so the most recent report is still only as at close of business on 27 November.

With BHP, the recorded short sales are (so far) fairly negligible – about 0.4% of the stock outstanding. If you see BHP as a core stock for your portfolio long term, then I would be buying in weakness. I think we are going to be in for a pretty rough ride on commodity prices – so I wouldn't be in a super hurry – however you would probably say that the last few days was a touch overdone.

Question 2: I am thinking of buying Argo (ARG) or Australian Foundation Investment Company (AFI) shares. Which do you think could be the better to buy? And do you think it would be all right time to buy now?

Answer 2 (By Paul Rickard): I would be buying the stock at the smallest discount/premium to NTA. Performance records are fairly similar which you can see here.

AFI's last reported NTA (28 Nov) was $5.68 – it is probably now up to around $5.72 – so at $5.95, it is trading at around a 4.1% premium.

ARG's last reported NTA (31 Oct) was $7.51 – it is probably down now to around $7.30 – so at $7.88, it is trading at a premium of 7.9%.

Both Argo and AFIC are relatively expensive.

Maybe you should consider an exchange traded fund, perhaps SPDR's STW.

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