Switzer Super Report

Issue 349, 18 December 2014

Seasons Greetings!

In this, our final full report for the year, I'd like to take this opportunity to wish all of our subscribers a Merry Christmas and a Happy New Year! It's a great day to finish up on. Our market has rallied on the back of a strong performance in the US overnight after Fed chair Janet Yellen said they would be patient with rate hikes.

Charlie finishes off the year explaining why he is still big on retail stocks and what he expects for next year, as Ron Bewley tells us what he has already done in his portfolio to get ready for 2015. We have a great *Fundie's Favourite* – Prime Value's ST Wong on iiNet – and in *Buy, Sell, Hold – what the brokers say*, Leighton Holdings and Treasury Wine Estates get upgrades.

We also run over some of our great picks of 2014 and Tony Negline examines what we've all learned about superannuation during the year.

Sincerely,

Peter

Peter Switzer

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Christmas ideas and looking to 2015

by Charlie Aitken

Key points

- *Consumers may respond to recent tragic events by spending more for loved ones.*
- *Key macro theme for 2015 remains a stronger US dollar.*
- *And remember, you'll never overtake anyone by driving in the same lane.*

Consumer spending still strong

I had quite a few questions about whether I thought the Sydney siege would have ramifications for Australian consumer spending in the crucial Xmas retail sales period.

Well, below is a photo I took at the **Apple** store in George St at midday on Tuesday, less than 12 hours after the end of the Martin Place incident.

The Apple store was packed and it is only around 400 metres in a straight line from the Lindt Café. I spoke to the Apple staff and they said it had been like that since 9am.

My point is, while Sydneysiders are shocked and saddened by the dreadful events in Martin Place, the next day they were getting on with it, perhaps even buying a gift for a family member in times that make people consider those closest to them.

Economically, there are <u>no changes</u> to my forecast of a solid retail spending period in Australia this Christmas. What could easily happen is the Australian household response to the Martin Place siege is to get out and spend some money, which in effect defeats the purpose of terrorism. I did this myself personally and I am sure I wasn't alone.

My key discretionary retail trading recommendations remain JB Hi-Fi (JBH), Super Retail Group (SUL), RCG Corporation (RCG) and Automotive Holdings (AHE). In the mall owners I like Westfield Corporation (WFD) which has exceeded my long-held price target of $8.80, yet looks to have further upside on AUD earnings growth translation and potential corporate action.

It's a wrap!

2014 has been a tough year in Australian equities, in fact the toughest I can remember since the GFC. The ASX200 is down (before today) 3.5% in raw terms and 12% in US dollar terms. Individual stock performance divergence is wide.

From the macro strategy down to stock-picking and tactical trading strategy level I have tried my best. In these sorts of markets you will never get everything right and the key is to limit losses.

The key macro call to get right in 2014 was the Australian dollar, which this morning reached a fresh four-year low of 81.07 US cents. The S&P500 is up 20% in Aussie dollars for 2014 and the NASDAQ up 22% in Aussie dollars. Losing the *"home bias"* was essential in 2014 to generate capital growth.

As I look forward to 2015 I see more of the same, namely, cross-asset class volatility. I think we all need to get used to heightened levels of volatility and to capture the maximum available return from equities we are all going to have to trade more, most likely in US dollars.

The trigger for that heightened volatility will be the Federal Reserve starting the US cash rate normalisation process. You can tell the Fed themselves are nervous about the market ramifications of raising cash rates and that is a justified nervousness after more than half a decade of ZIRP (zero interest rate policy) in the world's largest economy. Ending QE has seen cross asset class volatility spike and raising cash rates will continue that event.

More upside for US dollar

With the rest of the world persisting with ZIRP/QE and even lowering cash rates (Australia, Eurozone), the likelihood of a capital surge back to the US dollar remains very high. My core strategic belief is we are in the infancy of a major move higher by the US Dollar.

The biggest risk for 2015 is that the US dollar resurgence causes further emerging market and commodity price contagion. The rouble and oil price collapse are more than likely a warning shot across the bow in all emerging markets and commodities.

I would also encourage you to focus on liquidity. In volatile times liquidity is your friend. Being in relatively liquid investments in a world where the marginal pricer of every risk asset class is a high frequency trader (HFT) can reduce the impact cost of investment mistakes.

However, in volatility there is opportunity and if you buy the right stock at the right price in the right currency you will be able to generate positive total returns in 2015 as 2014 proved.

As for me, it's time for a break with my family and to consider what comes next.

I thank you all for your loyal support in 2014 and wish you a Merry Xmas and safe, happy and prosperous New Year.

Just remember, *you'll never overtake anyone by driving in the same lane.*

SSR – our best picks of 2014

by Penny Pryor

Like Charlie, we admit that we don't always get it right. But we do practice what we preach and because we invested early on – in March 2009 when Peter made his comeback call – we are ahead.

During the course of the year our *Switzer Super Report* experts have also made some great calls and we hope you'll indulge us today by letting us remind you of some of them.

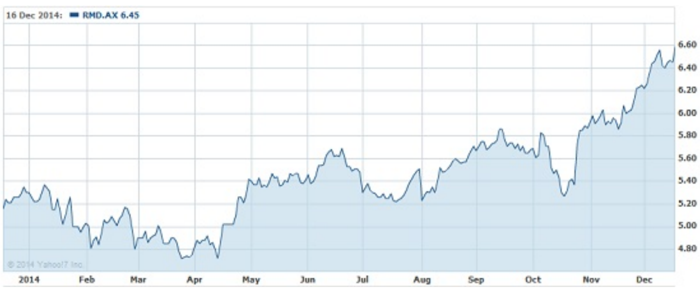
Let's start with healthcare, something we've been predicting for 12 months if not more.

There's:

CSL

Source: *Yahoo!7 Finance, 18 December 2014*

Resmed (RMD)



Source: *Yahoo!7 Finance, 18 December 2014*

Sirtex (SRX)

Source: *Yahoo!7 Finance, 18 December 2014*

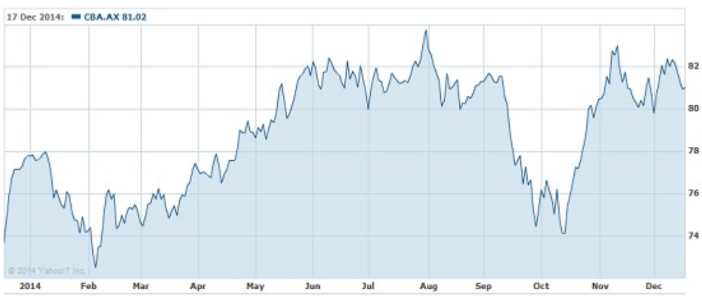
And don't forget Paul Rickard's favourite:

Ramsay (RHC)

Source: *Yahoo!7 Finance, 18 December 2014*

And his call on CBA in this article and again here. With dividends, it will return about 11% for the year, and again it has outperformed the other major banks.

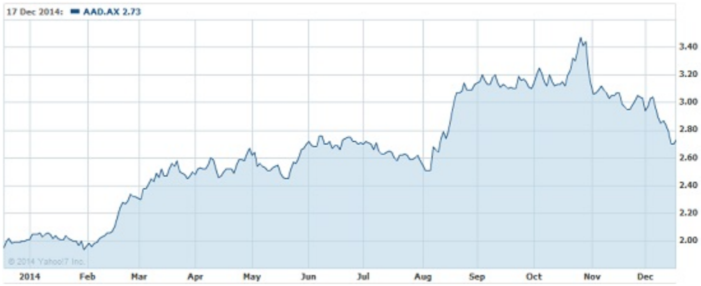
Commonwealth Bank of Australia (CBA)



Source: *Yahoo!7 Finance, 18 December 2014*

There's also Peter's call on Ardent Leisure Group (AAD)

Ardent Leisure Group (AAD)



Source: *Yahoo!7 Finance, 18 December 2014*

And Aristocrat Leisure (ALL)

Aristocrat Leisure (ALL)

Source: *Yahoo!7 Finance, 18 December 2014*

And last but not least, we have to give Charlie credit for picking Qantas (QAN) – his best pick of the year

Qantas (QAN)

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Activating the plan for 2015

by Ron Bewley

Key points

- *A new rule to consider is selling when a stock falls by 10% or more below the portfolio return, even if the consensus recommendations are still strong.*
- *Outlook looks good for US markets, therefore an increase to a US ETF is warranted.*
- *US dollar is expected to rise further so US exposure is unhedged.*

I was asked to write about what I would be doing with my SMSF share fund for 2015. Rather than just write about it, I first did it! I find it is so easy to fall into the trap of thinking of what to do when it is not followed by action – only to finish up finding out that one has only done half of the job. There is nothing like making trades to focus the mind.

Readers might recall from my November contribution, I was puzzled by the conflict between good broker forecasts and the poor price activity of Cardno (CDD) in my hybrid yield-conviction portfolio. Well, soon after I wrote that piece, the profit downgrade came – so I sold out. Naturally I made a significant loss but it would have been a lot worse if I had not sold then.

As a result of the apparent conflict, I have decided that, should something similar happen again, I will sell half of my exposure in the relevant stock while I am thinking. Downgrades can cause savage price cuts. My rule will be to consider selling when a stock falls by 10% or more below the portfolio return even if the consensus recommendations are still strong.

Since my hybrid portfolio was a little under a third of my SMSF equity exposure, and it was almost six months old, I was ready for a possible big rebalance.

But the hybrid portfolio was doing very well – returning 3.9% (including dividends) to the close on the 15th December against a total return on the index of 1.9% so I wasn't in a rush to run away from it. Incidentally, the stocks I sold in June to fund the purchase of my hybrid portfolio had collectively fallen 5.0%, also including dividends. I took comfort in the fact that events had supported my rebalance.

Going global

After the success I was also enjoying with my new international exposure via the iShares ETF for the S&P 500 (unhedged) – ticker IVV – which I also wrote about in November, I decided it was time to go international in my SMSF.

While my October 16th investment in IVV was up 14.7% to the close on 15th December, the S&P 500 was only up 7.5%. The difference is the contribution of the Aussie dollar currency fall! But, naturally, I first contacted my accountant to check that this ETF was allowed under my SMSF strategy!

To fund the purchase of IVV, I first got rid of the rats and mice that I had been a bit slow to eject from my portfolio during the year. But the main funding was from sales of **Cochlear (COH), Commonwealth Bank (CBA) and Westpac (WBC)**. I really like these stocks and I had made substantial capital gains – but I needed to sell something 'good' as I had little cash and no 'bad' stocks left. That is the pain that comes with rebalancing. I still have substantial holdings in these three stocks after the sales but a little less than one fifth of my portfolio is now invested in IVV.

That leaves around 4% in cash and around 50% in seven blue chips (**BHP, CBA, Cochlear, Rio, Santos, Westpac and Woodside**). I am not panicking about oil prices. Santos and Woodside are long-term holds for me. Santos has a great long-term outlook and I wasn't quick enough to get out before the recent price fall. CBA and Westpac are great companies but at least I am no longer 'over exposed' to any regulation changes that might affect the big banks. Cochlear has long been a favourite of mine for many years and it could benefit from any future currency falls.

So my New Year should be free from making any resolutions – at least financial ones. If BHP and Rio come back in price during 2015 – which I expect – I will sell down part of my exposures in those two and consider putting the proceeds in IVV – providing conditions still warrant the investment. In mid 2015 I will consider a big rebalance of my hybrid portfolio on its first anniversary which I might add to by selling even more of my blue chips to gain some more yield with growth.

So my **key expectations for 2015** are:-

1. Downward pressure on our dollar to continue – hence my leaning towards unhedged exposure in the US.
2. A much stronger US economy compared to Australia – hence my leaning towards a material exposure in the S&P 500.
3. The high-yield play to still have legs well into 2015 – hence my leaning to building on my hybrid portfolio exposure.

And I would like to close the year wishing readers a Merry Christmas and a very prosperous New Year.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Citi upgraded Leighton Holdings to Neutral from Sell after the company announced it would sell the John Holland business for $1.15 billion. Citi finds there is little to inspire in terms of new work being won but major loss-making projects are no longer bleeding cash and costs being taken out mean future margins can rise on the lowered revenue.

JP Morgan upgraded Treasury Wine Estates (TWE) to Neutral from Underweight. While JP Morgan believes the wine industry remains a tough industry to be in, the weaker Aussie dollar is going to make Treasury's challenges a little easier to deal with. In addition, the stockbroker believes execution risk for the new managing director's strategy has reduced.

Credit Suisse upgraded Wesfarmers (WES) to Neutral from Underperform. The broker has lowered its coal price forecasts and thus its earnings forecasts for Wesfarmers' coal division and the group. Recent share price weakness is enough for the broker to upgrade to Neutral from Underperform, but given WES still trades at a 20% premium to the index, above its long-term average, the broker does not consider the stock a compelling proposition.

Deutsche Bank has updated its commodity price forecasts with upgrades for:

Evolution Mining (EVN) – Upgrade to Buy from Hold
Newcrest Mining (NCM) – Upgrade to Hold from Sell
OZ Minerals (OZL) – Upgrade to Buy from Hold

Morgan Stanley has also re-based its commodity price deck with upgrades for:

Perseus Mining (PRU) – Upgrade to Equal-weight from Underweight
Whitehaven Coal (WHC) – Upgrade to Overweight from Underweight
Western Areas (WSA) – Upgrade to Overweight from Equal-weight

In the not-so-good books

Credit Suisse downgraded Crown resorts to Underperform from Neutral. Credit Suisse is toying with the idea of a prolonged slow down for VIP gambling, pointing out this segment of high rollers is very important to Crown, in and outside Australia. The analysts are anxiously watching developments in Vegas and Macau for further insights into how deep and how long the current slow down for VIP revenues might turn out to be.

Deutsche Bank has updated its commodity price forecasts with downgrades for:

Alacer Gold (AQG) – Downgrade to Hold from Buy

Mount Gibson Iron (MGX) – Downgrade to Hold from Buy

Morgan Stanley has re-based its commodity price deck with downgrades for:

BC Iron (BCI) – Downgrade to Equal-weight from Overweight
Fortescue (FMG) – Downgrade to Equal-weight from Overweight

Medusa Mining (MML) – Downgrade to Underweight from Equal-weight

Regis Resources (RRL) – Downgrade to Underweight from Equal-weight

Resolute Mining (RSG) – Downgrade to Underweight from Equal-weight

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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Connect with a great opportunity – iiNet

by Fundie's Favourite

Key points

- iiNet is the third largest internet service provider (ISP) in Australia with over 900,000 broadband subscribers.
- iiNet should be able to compete and potentially gain market share in regional areas largely thanks to the NBN.
- Management has grown the company significantly over a long period of time, delivering solutions to its subscribers.

How long have you held iiNet (IIN)?

We have held iiNet in excess of two years. However, we have monitored the company for some time prior to investment.

What do you like about it?

iiNet is the third largest internet service provider (ISP) in Australia with over 900,000 broadband subscribers.

Over the years, iiNet has grown, via both acquisitions and organically, to become a national internet service provider with a broadened product suite that includes mobile and TV subscription services.

iiNet (IIN)

Source: *Yahoo!7 Finance, 18 December 2014*

Our investment in iiNet is representative of our view that the demand for connectivity, improved connection speeds and data will continue to rise. iiNet provides a compelling exposure to the telecommunications theme through its consumer broadband products, particularly as an alternative to the incumbent telecommunication providers.

As the third largest ISP, iiNet is well positioned to extend its products into longer-term prospects in the market. The small and medium-sized companies and regional consumer markets are potentially attractive segments given similar demands for more competitive products and service.

In the past, management have been able to utilise scale to gain operating efficiencies and improve profit margins. However, iiNet's cost base is still high compared to its peers. We expect management to continue to focus on improving profitability that will lead to future efficiency improvements.

How is it better than its competitors?

Competition in the ISP segment is extremely high. Incumbent ISPs, such as Telstra, have strong competitive advantages due to their network coverage and high capital expenditure plans. It is therefore quite instructive that providers such as iiNet have been able to gain new customers despite the challenges faced by these companies. We believe the customer experience has been positive for iiNet and has led to net gains in subscriber numbers. Keener pricing is another contributory factor.

iiNet's subscriber gains have largely been in urban areas. We expect iiNet to compete and potentially gain market share in regional areas largely thanks to the NBN, which has opened up the total addressable market for iiNet and other providers. There are an estimated 1.5 million premises in regional areas. We believe the majority of these new regional customers would have been uneconomical for iiNet to enter if not for the level playing field provided by the NBN.

What do you like about its management?

Management has grown the company significantly over a long period of time, delivering solutions to its subscribers. For shareholders, management has created value in three ways: First, acquiring complementary business to enlarge its footprint and gain scale. Second, by acquiring new subscribers organically through brand management, excellent customer service and competitive products. Third, expanding its margins through more efficient operations and by bringing more subscribers on to its own network, which is a more profitable enterprise.

What is your target price on the company?

The stock is trading on a share price of $7.61 putting the company on 14.6 times next year's earnings, which is estimated to grow by 16%. We have a target price of $9.45.

At what point would you sell?

iiNet competes in an extremely competitive segment. We are very conscious of the fact that in a competitive industry, any excessive profits earned by any company will eventually be competed away. Therefore, the pricing regime has the potential to alter our view of the industry structure and iiNet's profitability. Signs of a deteriorating industry structure include declines in customer numbers and falling average revenue per user.

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

iiNet has been a strong contributor to our fund performance in the past 12 months, both on a relative and absolute basis. Our investment in iiNet has contributed 118 basis points to portfolio performance in the 12 months to end November 2014.

Is it a liquid stock?

Yes, iiNet is a liquid stock.

Where do you see the value?

We believe iiNet's growth prospects are robust over the medium term. We expect iiNet to continue gaining net new subscribers in both urban and regional areas, backed by a low churn rate of 1 to 2% per annum. We further expect iiNet to leverage its scale into the business segment where the company has a small national market share of about 5%. The iiNet brand has grown in credibility, increasing the likelihood of business customer acquisitions. Opportunities for acquisitions have declined due to the lack of suitable and sizeable targets, but should not be discounted.

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A year in review for superannuation

by Tony Negline

Key points

- *The ATO should remain the SMSF regulator for the foreseeable future.*
- *The Australian Institute of Health and Welfare (AIHW) found that we're not only living longer on average but we can expect to have healthier lives.*
- *The problems for the collective reputation of the financial advice sector continued to mount throughout 2014.*

As this year concludes, now is a good time to take stock and consider what we learned about superannuation and tax in general and SMSFs in particular.

Superannuation

The rise and rise of superannuation as a major part of financial services and the economy in general has continued. If you want proof of this, then take a look at the Murray Inquiry's final report and the space devoted to super.

We're almost at the point where adverse changes to superannuation would create an inflection point during an election campaign. This means it now has almost the same significance as the aged pension, income tax rates, death duties and capital gains tax on the family home.

This is an important point to note given that 2015 will see the government release a tax white paper that will form an important plank in its re-election campaign.

Self managed super funds

The past year has seen the trend growth of SMSFs continue. The large industry, corporate and retail super funds must be scratching their heads trying to work out how they can hang onto their members because everything they've tried to date has abysmally failed. I think most of them have belatedly realised that full frontal attacks on SMSFs haven't helped their reputations.

What does this mean? It means that SMSFs have finally become an important part of the superannuation sector and can't be dismissed as some esoteric plaything of ignoramuses who are their own worst enemies.

Importantly the ATO will remain the SMSF regulator for the foreseeable future. I don't want to look foolish by making rash predictions but I honestly can't see this changing anytime soon. This is appropriate given how well it has regulated the sector thus far.

Old age and health

In my view the most important research released this year was by the Australian Institute of Health and Welfare (AIHW).

It found, after analysing Australian Bureau of Statistics published and unpublished data, that we're not only living longer on average but can expect to have healthier lives.

The AIHW said "not only are people living longer, but … older people, on average, gained more years of life without severe or profound limitation than with it."

It found that our active years later in life have been growing at a faster rate than the increases in average life expectancies.

This helps to explain why the government proposed increasing the age pension age.

Estate planning

The usefulness of binding death benefit nominations was emphasised by several court cases involving disputes about the payment of death benefits.

Generally longer lives and potentially reduced mental capacity, and how a SMSF can continue to function properly, have gained traction as an issue that needs to be addressed.

Excess super contributions

The former Labor government had put in place measures to limit the number of taxpayers who would face excess contributions tax on concessional contributions.

The Abbott Government has announced measures to limit exposure to this tax for non-concessional contributions. The amending legislation is before the Parliament.

ATO SMSF supervision

The ATO's supervision of SMSFs has stepped up a notch with its new ability to apply penalties automatically for breaching a wide range of superannuation laws.

It can also send you back to school to complete an approved course that details your various trustee obligations. Once that course is completed it would be hard for you to claim you don't know the super laws.

On two occasions the ATO asked the Federal Court to impose monetary penalties against trustees who had ignored the super laws requirements.

Pensions

There were a few changes here:

- **Deeming** – You would need to be hiding under a rock to not know that pensions commencing after December 2014 are going to be deemed under the Age Pension and Commonwealth Seniors Health Card income tests.
- **Minimum Pension Payments** – the ATO reminded everyone that minimum pension income payments must be made each financial year; a failure to meet this requirement might see you fined.

Financial advisers

The problems for financial advisers continued to mount throughout 2014. The Abbott government sought to water down some new and stricter rules for financial advisers introduced by the Gillard government. Initially it seemed that the Coalition would get its way but it was then side-swiped in the Senate when two senators unexpectedly changed their minds and voted the government's reforms down.

In addition, throughout 2014 there was an almost constant negative stream of reporting about the financial advice industry coming out of Court cases and Parliamentary inquiries.

Until the financial advice industry effectively self-regulates and removes all real conflicts of interest, including perceptions of conflict, especially from a remuneration perspective, the negative press will continue.

Limited recourse borrowing arrangements

Everyone seems to have an opinion about LRBAs. The Murray Inquiry has recommended they be banned and the government has called for feedback. Presumably an official decision will be made sometime in 2015.

The real estate, property development and investment banking industry are running hard on the opportunity presented by these borrowing arrangements. For how long will it continue? I don't know but I think a blanket ban would be an extreme reaction. Can the government, for once, amend some useful rules without using a sledgehammer? I certainly hope so.

International investing and oil price optimism

by Questions of the Week

Question: I manage my share investments through ETrade and would like to invest in iShares Global Energy ETF (IXC) how do I do this? What are the tax implications in investing in international ETFs?

Answer (By Paul Rickard): You need to open an international share trading account. ETrade offers this service.

As far as the Australian Tax Office is concerned, any income you make, or capital gains you receive, are classified as assessable income. Against this, you may also be subject to taxation from the US Dept of Inland Revenue. Should US taxes be levied, under a double taxation treaty with the US, the ATO will recognize any US taxes paid.

Question 2: With Woodside's price crashing, but also oil crashing, is it considered a strong buy at present – seems to now have a great dividend yield?

Answer 2 (By Paul Rickard): The brokers have gone decidedly neutral on Woodside, seeing it as one of the energy stocks that will be less impacted by the oil price decline. According to FN Arena, the consensus target price is $38.11 compared to a price of $35.62 around midday.

That said, it looks like we will continue to see some further declines in the oil price, so it is hard to imagine that Woodside will not be impacted. Brokers have downgraded their 2015 earnings forecasts, and are now factoring in a dividend cut in FY 15. While buying in the "gloom" is the obvious strategy – I would only be nibbling at the moment – my sense is that there is more share price weakness to come.