Switzer Super Report

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The good oil

I was scratching my head a bit over the weekend – the Aussie dollar going up on the back of great job numbers in the US had me stumped. But on reflection I think that had a lot more to do with our building approval numbers and there's no way our currency is going to head back to parity anytime soon. I explain what the dollar has got to do with oil and how you can make money off it all today.

Also in the *Switzer Super Report*, Paul Rickard updates our high-income portfolio for the year ahead. This portfolio has outperformed the index for the two years we've been running it and I know Paul puts a lot of thought into each annual review. Find out what we've added for this year today.

If you've been wondering where some of our regulars contributors are – like Rudi Filapek-Vandyck – most of our columnists should be back from holidays in the next few weeks and we'll have our first broker report of the year on Thursday. In the meantime, we asked fund manager George Boubouras for his investment themes for 2015 in *Shortlisted* and Angie Zigomanis, senior manager for residential property at BIS Shrapnel, for his residential property forecasts in an outlook article.

Sincerely,

Peter Switzer

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Oil – how do you play it to make money?

by Peter Switzer

One of the greatest head scratching developments of last week was the US getting great job numbers and our dollar, not the greenback, goes up!

I think part of the reason is because we got record high building approvals in November, which adds to the picture that our economy is on the slow improve and so the chances of a rate cut reduces, and in turn adds, strength to the dollar.

But that's my speculation. There are those who are arguing that the lower oil price will cut costs in China, which should help growth there and that will help the Australian economy, which also gives strength to the Aussie dollar. I have to confess that this analysis surprised me as I don't think the oil pluses will help the likes of China until we're further down the track. However against that we know foreign exchange and stock markets will move six months or more ahead of the real world.

What you need to know about oil

So it got me thinking about how I and therefore, we, should play oil. Here's what you should know:

- Only 1% of employment growth for the US in the past four years has come from oil jobs and 2% if you want to stretch it to oil-related jobs, so oil's price slump should not derail the global economy's best news — the strength of the US economy. Experts say it should add about 0.4% to US growth that already looks to be heading to be above 3%.
- Only about 10% of stocks in the S&P 500 are hit directly by oil's price fall and so 90% of stocks are not directly affected, so we should not be expecting an overall stocks slide because of oil. That's another plus for the country and stock market that leads the world's confidence and share price levels.
- The above arguments and the impact of lower oil prices on the costs of businesses worldwide and the income effects on consumers worldwide, should lead to company earnings upgrades — worldwide!
- The history of oil shocks and lower share prices coincides with demand problems but with the US surging and Japan, along with China, set for central bank and government stimulus programs, I'm not worried about demand. Europe is a more worrying issue and I hope on January 22 Mario Draghi and the European Central Bank delivers a credible QE program. That's a huge watch for me, however, remember India contributes about the same to world demand as Germany and France combined. Furthermore, China plus the US creates eight times more demand for the globe than Europe's two biggest economies!
- That said, the German central bank president, Jens Weidman, says the oil price slide is going to be a stimulus that means QE is less necessary. If both end up happening that will be a bonus.
- For us, the lower oil price is not good for our energy producers and we have plenty of them and related mining services companies. However, we are an importer of oil and that means our oil bill is dropping. It will also affect government revenue but there will be big positives for company bottom lines as costs drop and as consumers, armed with more disposable incomes, head back to the shops and buy more services. Company upgrades should outpoint downgrades and middlemen businesses, such as banks, should benefit until interest rates start rising solidly. That looks at least a year off. Also company tax collections should rise and help the Treasurer, Joe Hockey.

- Also don’t forget our two biggest export customers — China and Japan — and our rapidly growing one — India — are big energy users, so the cost-cutting effect there is not only good for them and the demand they have for our exports but also for us.
- Already in the US, Bloomberg is reporting that lower gasoline costs are resulting in greater car sales and it will happen here too as surely as night follows day.

A new direction?

As I write, our dollar has crept up to 82.21 US cents and it might suggest that my expectation that our dollar will fall to 75 US cents this year could be too excessive. If it doesn’t, the lost benefits of a lower dollar could be more than made up for from the huge pluses from lower oil prices and stronger growth from the world economy and our key export partners.

By the way, when the global economy kicks up, so do commodity prices — history shows us this — and that will help a few well-known Aussie companies.

And if this be so, the courageous contrarians who are buying energy companies — I like Woodside most because it pays good dividends — and material companies such as BHP and Rio, could be quite happy with themselves this time next year.

But, and this is an important but, if the likes of BHP and say Woodside or Santos don’t repay you in 12 months, it is more likely they will in 24 or 36 months. If you need to get returns in one year, don’t be a contrarian. You stick to our more conservative plays that we have recommended — banks and other dividend payers — but don’t squeal when other more risky companies bring bigger returns over the next couple of years.

So, what’s an easy way to play oil in 2015? Buy the index.

Our high-income stock portfolio for 2015

by Paul Rickard

Key points

- *Our dominant investment themes include continued lower interest rates, lower Aussie dollar and slightly softer growth in Australia.*
- *We have exited positions in Orora, Leighton and Origin.*
- *But added consumer discretionary like JB Hi-Fi.*

The objective of our high-income stock portfolio is to deliver tax-advantaged income, whilst broadly tracking the S&P/ASX 200.

Following above market performances in 2013 and 2014 (24.36% in calendar year 2013 for outperformance of 4.16%, and 8.13% in 2014 for outperformance of 2.52%), we have made some changes to the income portfolio. These changes reflect our view on the dominant investment themes for 2015, which we expect to be:

- Continued low interest rates (yield sectors will continue to perform);
- Lower Aussie dollar – moving down towards 75 US cents;
- Positive lead from the US markets;
- No pick up in commodity prices;
- Growth running slightly below trend in Australia;
- Impact of lower oil prices will lead to a rise in consumer spending in Australia.

The changes to our portfolio include:

- We have exited our positions in Orora and Leighton (both now looking fully priced), and Origin;
- While still biased towards the yield sectors (financials, utilities, property trusts, consumer staples), these biases have been reduced. In fact, we have gone to neutral weight on the banks by introducing AMP into the portfolio and reducing our exposure to Commonwealth and Westpac;
- We have added JB Hi-Fi, which after a horror 2014, stacks up now as a yield proposition (we think the consumer discretionary sector will benefit from the impact of lower oil prices);
- We have neutralised many of our sector biases. For example, we have maintained positions in Woodside and BHP despite the considerable uncertainty in regard to oil prices;
- Our stock selections are, in the main, relatively defensive, with a bias to stocks that are trading on lower multiples.

The portfolio is forecast to generate a yield of 5.14%, franked to 88.7%. Importantly, we expect that this portfolio will moderately underperform relative to the benchmark price index in a strong bull market, and moderately outperform in a bear market.

Construction rules

Before detailing the portfolio, let's recap on the construction rules that have been applied to develop the portfolio. These are:

- We used a 'top down approach' looking at the industry sectors, and introduced biases that favour lower PE, higher yielding sectors;
- So that we are not overly exposed to a market move, we have determined that in the major sectors (financials and materials), our sector biases will not be more than 33% away from index. For example, the 'materials' sector weighting on the S&P/ASX 200 is 15.0%, and

under this rule, our possible weighting is in the range from 10% to 20% (i.e. plus or minus one third or 5.0%);

- As discussed below, we are marginally underweight the index in materials, energy and health care stocks; broadly index weight financials and property trusts; and marginally overweight consumer staples and utilities;
- We require 15 to 20 stocks (less than 10 is insufficient diversification, over 25 it is too hard to monitor), and have set a minimum stock investment of $3,000;
- We confined our stock universe to the ASX 100;
- We have avoided stocks from industries where there is a high level of exogenous risk, such as airlines or general insurance;
- We prioritise stocks that pay fully-franked dividends and have a strong track record; and
- Within a sector, the stocks are broadly weighted to their respective index weight. That said, we have applied some biases – in the financials sector, for example, NAB is now overweight relative to the Commonwealth and in consumer staples, Woolworths is overweight relative to Wesfarmers.

On a sector basis, our portfolio compares to the S&P/ASX 200 as follows:

Sector	ASX 200 Weight*	Portfolio Weight	Difference
Consumer Discretionary	3.8%	4.0%	0.2%
Consumer Staples	7.4%	10.0%	2.6%
Energy	5.2%	4.0%	-1.2%
Financials	40.3%	40.0%	-0.3%
Health Care	5.9%	4.0%	-1.9%
Industrials	7.3%	8.0%	0.7%
IT	0.8%	0.0%	-0.8%
Materials	15.0%	12.0%	-3.0%
Property Trusts	6.5%	7.0%	0.5%
Telecommunications	5.9%	7.0%	1.1%
Utilities	1.9%	4.0%	2.1%

** ASX 200 index weights as at 31 December 2014*

Portfolio

Our income-biased portfolio per $100,000 invested (using prices as at the close of business on 31 December 2014) is as follows:

Sector	Stock	Price 31-Dec	Value	PE (F)	Div (F)	Franking
Consumer Discretionary	JB Hi-Fi	$15.79	$4,000	12.3	5.41%	100%
Consumer Staples	Wesfarmers	$41.72	$4,000	19.4	4.79%	100%
	Woolworths	$30.68	$6,000	15.3	4.67%	100%
Energy	Woodside	$38.01	$4,000	16.7	5.64%	100%
Financials	AMP	$5.50	$5,000	16.1	4.73%	100%
	ANZ	$32.09	$5,000	12.1	5.78%	100%
	CBA	$85.65	$10,000	15.6	4.89%	100%
	NAB	$33.60	$10,000	12.2	6.12%	100%
	Westpac	$32.38	$10,000	13.4	5.71%	100%
Health Care	Primary	$4.71	$4,000	14.8	4.59%	100%
Industrials	Brambles	$10.63	$4,000	20.1	3.22%	30%
	Toll Holdings	$5.89	$4,000	14.2	4.92%	100%
Materials	BHP	$29.37	$8,000	13.2	5.11%	100%
	Boral	$5.30	$4,000	20	3.57%	100%
REIT	Dexus	$6.97	$7,000	12.9	6.03%	0%
Telecommunications	Telstra	$5.97	$7,000	18	5.03%	100%
Utilities	AGL Energy	$13.36	$4,000	14	4.87%	100%
			$100,000	14.91	5.14%	88.70%

Forecast returns

Using consensus analyst forecasts from FN Arena (and making a couple of adjustments for the commodity based stocks), the portfolio has the following characteristics:

Forecast PE for 2015: **14.91**
Forecast Dividend Yield for 2015: **5.14% pa**
Franking: **88.7%**

For an SMSF in the accumulation phase, the **5.14%** dividend yield will translate to an income return of **6.12% per annum** (after tax), and for a fund in pension phase, the income return will increase to **7.09% per annum.**

In a bull market, we expect that the income-biased portfolio will **underperform** relative to the standard S&P/ASX200 price index due to the underweight position in the more growth-oriented sectors and the stock selection being more defensive, and conversely in a bear market, it should moderately **outperform**.

We will monitor the portfolio and report back each month in the *Switzer Super Report* on its performance.

Next week, our growth-oriented portfolio.

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.*

Short-listed – investment resolutions for 2015

by George Boubouras

Fund manager George Boubouras has recently joined Contango Asset Management and we asked him for some investment resolutions for 2015.

Where do you think interest rates are headed?

Domestically there will continue to be a bias towards income, which has been a long-standing theme. The lower rate environment will remain for some time and the SMSF sector will continue to search for yield. The market continues to price in the prospect of a rate cut. This will help households repair their balance sheets and eventually help drive additional credit growth by year-end. Dividends with franking will remain compelling in the year ahead. Telcos, infrastructure, banks, diversified financials and REITs will continue to be in demand for equity income portfolios.

What about the Aussie dollar?

The lower Aussie dollar will, in aggregate, help corporate Australia repair its balance sheet. Companies from various sectors such as Brambles, Amcor, Westfield, Resmed, CSL, Ansell, Macquarie, Computershare, and James Hardie generally benefit from a falling Aussie dollar. It's important to reflect that a sharply falling Aussie dollar implies excess global market volatility, therefore impacting equities more broadly. The lower Aussie dollar acts partly as a cushion. Looking forward an Aussie dollar trading around 75 cents appears to be a consensus level that also reflects the longer-term purchasing power parity (PPP) valuations.

And will there be plenty of volatility?

The year ahead will continue to see pockets of excess volatility as markets adjust to the sharply lower oil prices with the implications for earnings for the sector, fiscal impact for the countries that are net exporters and viability of future investment within the sector. There will also be a high likelihood of a credit market correction as some risk aversion builds.

Where will the best residential opportunities be in 2015?

by Staff Reporter

Key points

- *Sydney market will still have momentum but rate of growth will slow.*
- *Melbourne will slow at a rapider rate and some areas, like Perth, will go backwards.*
- *Best prospects are in areas like Newcastle and the Sunshine Coast.*

Angie Zigomanis is senior manager for residential property at BIS Shrapnel and just before Christmas he updated his forecasts for major Australian cities.

	BIS Shrapnel forecast price growth FY15
Sydney	8%
Melbourne	3%
Brisbane	6%
Adelaide	1%
Perth	-1%
Canberra	-1%
Hobart	1%
Darwin	1%
Newcastle	7%
Sunshine coast	6%
Gold coast	4%
Cairns	5%

Source: *BIS Shrapnel*

Here's what he says about each market.

Sydney

We still think there will be momentum in the Sydney market. There will be growth in 2015 but not the kind of double-digit growth we've seen. There should be 8% growth in this financial year and then progressively slowing after that.

Melbourne

Melbourne will slow, down to around 3%. It has had a longer period of strong construction and we don't think there's as much pent up demand. It has more economic headwinds than Sydney has.

Brisbane

The Brisbane market should strengthen. There has been underbuilding for quite some time and vacancy rates are low and that says to us that activity should pick up.

It's probably still being stymied by muted economic conditions and the Newman government had a bit of public sector cull.

Adelaide

Things will continue to be tough.

Perth

We think prices will start to fall with a 1% decline, and further declines in 2016 and possibly in 2017. Investment will continue to drop over the next two or three years.

Canberra

We've also got a 1% decline factored in for FY15 and it could be potentially weaker. Public sector employment has also been hit.

Hobart

Tasmania is doing it tough economically. We think migration out of Tasmania has improved but probably because there is nobody else left to leave. Economically it doesn't have a huge amount of opportunities.

Darwin

We forecast a 1% rise. Mining investment is around its peak level. It's also experiencing a slow down in big infrastructure projects and we're starting to see that reflected in the property market.

Newcastle and Wollongong

Both of these markets have started to pick up now and they are benefiting from the Sydney market. Probably more so Newcastle, because Newcastle gets a lot of commuters into the city.

There is always a bit of an outflow from Sydney once housing becomes less affordable. For now we're picking 6% to 7% growth, but growth will be strong beyond the next 12 months.

Gold Coast and Sunshine Coast

They have been starting to pick up. Both these regions have been basket cases for the last four or five years. We're starting to see migration pick up into those areas and economically they are starting to look a bit better. There's the Sunshine Coast hospital, which was completed last year and on the Gold Coast you've got some Commonwealth Games related activity, as well as the extension of Pacific Fair.

Where will the opportunities be over the next 12 months?

I think most of the opportunities are probably in South East Queensland – Brisbane probably more so than the Sunshine, Gold Coast because it has a broader economic base. Within Brisbane the inner suburbs are starting to do well.

We've still got the strongest growth in Sydney. The more affordable areas are the outer Western suburbs but arguably they could potentially get ahead of themselves beyond the next 12 months. Liverpool and Penrith are the more affordable areas.

Inner city Sydney suburbs have struggled a bit. Prices in inner Sydney really rely on the stock market doing well, and businesses doing well. Your normal salary earners need to be on a very good wicket to be able to afford some of the top properties in Sydney.

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Don't miss!

If you weren't able to tune into our webinar on Friday, don't despair! You can hear it all here on our webcast. Paul and I answered some great questions to start the year off.