Switzer Super Report

Thursday 16 April 2015

So close, but yet so far?

We've toyed again with the magic 6000 mark today but that doesn't mean we won't get there. My good friend Charlie Aitken is of the view that it will get there sooner, rather than later, and stellar stocks like Macquarie Group are going to help it on its way. Today he updates his macro view and his call on the millionaire's factory.

Also in the *Switzer Super Report*, you need to read Tony Negline's article to safeguard yourself against any potential changes to superannuation. High balances are definitely on the radar but there are at least three things you can do to reduce the pain.

Ron Bewley takes a look at the best sectors – it's not just about returns – and *Short n' Sweet* reviews the performance of two fantastic *Fundie's Favourite* picks from last year. *Buy, Sell, Hold – what the brokers say*, has an upgrade for Suncorp and downgrade for BHP, and *Questions of the Week* examines dividend swapping and hybrids.

And if you don't want to miss a live webinar I'll be hosting next Friday with John Murray, portfolio manager and managing director at Perennial, you need to register here now. We'll be talking about how to manage market risks while investing for income and growth.

Sincerely,

Peter

Peter Switzer

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The million-dollar 6000 mark and another $100 dollar stock

by Charlie Aitken

Key points

- *The fact the market has baulked at 6000 numerous times is technically bullish. Once it takes it out, it will take it out strongly (like a damn wall breaking).*
- *Macquarie Group has strong positive tailwinds, including a currency in its favour and many deals done in the past six months.*
- *It could reach $100 in the not-too-distant future.*

Once again, the ASX 200 index has baulked at 6000. The reason for the latest failure to clear this important psychological hurdle was the RBA's decision to leave the cash rate on hold. In a knee jerk response, interest rate sensitive sectors were sold off by disappointed traders, only to recover in subsequent sessions.

The big picture is invariably much clearer without the short-term noise. So, from the obscurity of my poolside lounge in far North Queensland, I quickly realised that nothing had really changed to alter my strategy view other than the headlines.

The big picture

Ironically, all the media releases over the Easter break only confirmed my view that **the cash rate is headed lower**. Here's why. In a resource-driven economy reliant on strong commodity prices, China's growth rate is now expected to fall under 7% per annum. This would be the lowest since 1990. Due to peaking Chinese steel production meeting a large low cost supply response, the iron-ore price has fallen below $US50t. It is worth remembering that only 18 months ago, the iron-ore price was over $US130t. At the same time, the oil price remains 50% lower than 2014, while the coal price is at, or near decade lows. The Australian economy is now experiencing the biggest fall in the terms of trade since records were kept in 1959.

If sustained, this fall in commodity prices is expected to reduce tax revenues by a further $5b thereby increasing the Budget deficit closer to $45b. This would represent a 50% increase from the Budget estimate of $30b in May last year and further delay the expected return to surplus by 2019/20. With a gridlocked Senate, and the government committed to fiscal austerity due to rising Budgets deficits, the economic heavy lifting is being left to the RBA and monetary policy.

The futures market is now pricing in a 76% chance of a May rate cut of 25bp. The terminal rate, which reflects the potential cash rate cyclical low, is now 1.63%. I have been saying for months that the cash rate will have a "1 handle" but I am even surprised at the rapidly changing outlook for RBA policy.

The repeated warnings of frothy house prices are basic RBA jawboning. While residential house prices have risen strongly (mainly in Sydney and Melbourne), they will not prevent the RBA lowering interest rates further. The RBA actually wants a stronger housing market. In the aftermath of the mining boom, housing and construction are the only real sectors genuinely supporting economic growth at present. Make no mistake. The RBA is committed to a lower cash rate in order to orchestrate a lower Australian dollar to encourage a rebalancing of economic growth.

As I mentioned previously, with the most recent cut in the cash rate to 2.25% (which is below GFC crisis levels), it's very clear that the RBA has joined the global currency wars. Don't underestimate the

importance of this decision. Given the resilience of the Australian dollar around US75-77c, the only way to initiate a further fall in the currency to the RBA's target range in the 60s, is for another 50bp in rate cuts. The reality is, with fiscal policy on hold and a weakening economy, the RBA simple has no choice.

The cash rate is already at historic lows due to sluggish domestic growth. And against a backdrop of global deflation and ultra-low bond yields, I expect the cash rate to fall further and remain at or low levels for an extended period. In this environment, I continue to believe investors will be forced at the margin out of cash and fixed interest into equities. This is a global and domestic phenomenon.

New trading range above 6000

What comes next in my opinion is the ASX200 consolidates in a new higher trading range above 6000. I already feel my twice positively revised ASX200 trading range forecast of 5700 – 6200 is too conservative.

I feel that because in May I forecast the RBA to cut rates to 2.00% and in the same period I expect NAB, WBC and ANZ to report record earnings and declare record interim dividends. Resources are becoming less and less relevant to the overall direction of the index, due to their declining absolute and relative index weights. BHP Billiton (BHP) is now just 6.47% of the ASX200, while the big four banks combined are 31.5%. ANZ nowadays has a bigger index weight than BHP. You can see why it's easy to forecast a 6200 ASX200 (and potentially higher) without any help from resources.

The fact the market has baulked at 6000 numerous times is technically bullish. It's like a build-up and once it takes it out it will take it out strongly (like a damn wall breaking). I like that price action and I think the low end of my ASX200 trading range at 5700 is now too conservative. In a week's time, the new low end could well be 6000.

And finally, I do realise that many other commentators and fund managers are warning on a lack of value and everything looking expensive. I'm not in that camp because I look top down and globally first.

The real question comes down to tenure. How long is this period of cheap money going to last? My view remains for an extended period and that is why I am happy to remain invested in stocks that may well look expensive versus history, but could become a whole lot more expensive as investors position for more of the same macro settings over the medium term.

The fund manager trade

Back on the 14th of March I wrote specifically on **Macquarie Group (MQG)** at $75.39. The conclusion was lifting the 12-month price target to $82.50 and reiterating the high conviction buy recommendation.

Macquarie report FY15 earnings on Friday May 5th. While my view on Macquarie is more based on being way above current FY16 market consensus, it is important Macquarie passes the FY15 EPS and DPS test first.

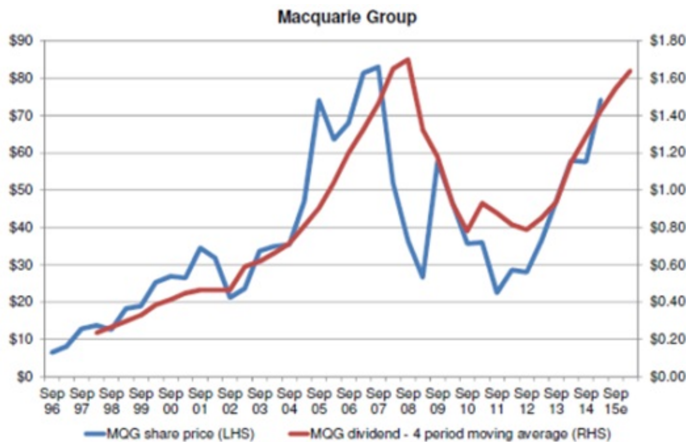
We believe Macquarie will pass that test and both FY15 and FY16 consensus estimates will need positive revision.

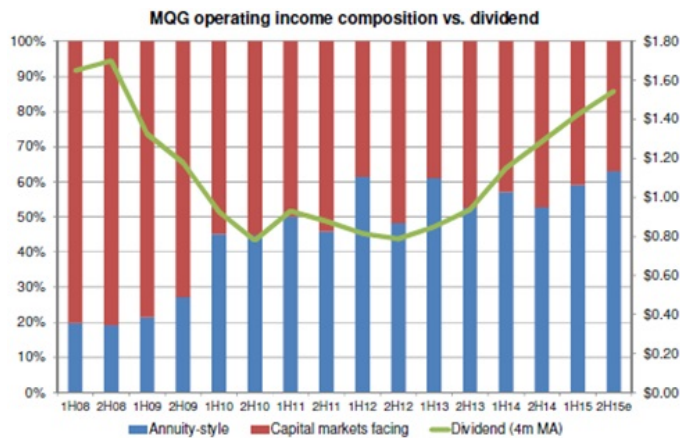
Macquarie currently has many strong tailwinds, including:

- Currency movements (primarily A$/US$) since the February profit upgrade suggest a 1-2% upgrade, meaning Macquarie will likely come in at the upper-end of +10-20% NPAT guidance range, and may even exceed this number.
- Macquarie closed several deals late in the FY15 year (US car rail logistics facility in Texas, US equipment finance business – $500 million, $5 billion AWAS aircraft transaction), which will be positive and a boost to next year's numbers and beyond in the case of the aeroplane leases.
- Markets (and particularly commodities and bond markets) have been volatile and this will benefit Macquarie's FICC business.
- Capital markets have been buoyant with M&A and capital raisings strong in the 2H15 for Macquarie.

The Macquarie business model is substantially transformed since the GFC, while the annuity-style

business contribution to operating income has nearly doubled since 2002, the transformation has never been more apparent – rising from around 20% in 2008 to 60% in 1H15 and generating higher incremental ROE. The correlation between share price/dividends and de-risking, especially since 2011, is also significant.





Let the winner run

As a fund manager, Macquarie remains undervalued: resist the temptation to take profits. This is a classic example of a stock that is in an earnings upgrade cycle yet there is also a concurrent P/E re-rating cycle to reflect the growing forecastability of earnings and dividends due to the increase in annuity style earnings away from the lumpiness of investment banking fees.

ROE is also rising and P/E is a function of sustainable ROE in my opinion. An 18% ROE could well equate to a forward P/E of 18x for Macquarie.

If my EPS forecast of 550c for FY16 for Macquarie proves correct, which would see an ROE of 18%, then, all things being equal, the market would pay 18x for that EPS stream. 18x 550c = $99.00 price target.

My point is it is very easy to see scenarios where Macquarie is a $100 stock. In fact I would argue in these macro conditions, it's just a matter of when.

Macquarie remains a high conviction buy. Macquarie will be one of the stocks that leads the ASX200 to 6200. Let this winner run.

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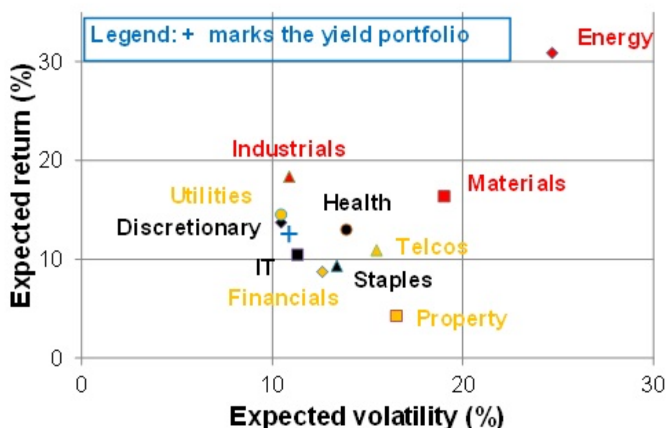
So which is the best sector?

by Ron Bewley

Almost every time I appear on Switzer TV, Peter asks me 'which is the best sector at the moment?' There is rarely enough time left on his show for me to give a full answer. So this time, that's all I want to talk about and try to do justice to this very important question. There are papers on my website that discuss how I calculate my estimates of (broker-based) sector returns (including re-invested dividends), volatilities and a host of other relevant statistics so interested readers, who wish, can follow the whole investment process.

What I want to stress is that the best expected return does not usually imply the best sector. To show this, I have plotted the expected returns for each sector against the relevant expected volatilities – which we often call risk for brevity – in Chart 1. But there is so much more to risk than just volatility!

Chart 1: Risk-return trade off for April 1st 2015



Source: Woodhall Investment Research

The Energy sector (top right red diamond) has by far the highest expected return of all of the sectors (31%) but also the highest risk at 25%. That means, even if the expected return is well constructed on a sound basis, the actual return over the year could finish up almost anywhere because the forecast risk is so large.

About one third of the time, we would expect the actual return to be outside the range from 6% to 56%! There is also a chance of about one in 20 that the actual return would be outside the range 19% to +76%. We can do better than that!

Comparing Industrials (red triangle) with Materials (red square), the former has both a better (higher) expected return and a better (lower) risk – and so Industrials dominate Materials. The high yield sectors in yellow are clustered well below the red resource-related sectors in terms of expected returns. The black sectors 'Other' are also relatively tightly clustered as a group of relatively defensive sectors.

Property stands as a sector with no apparent useful attributes, having the lowest expected return and the third highest risk. However, when a professional builds a portfolio, he or she looks into how the sectors fit together. To produce my Hybrid Yield-Conviction portfolios that I update each month, I use the information contained in Chart 1 plus the correlations between all of the sectors together with the limits or 'tilts' that I want to place on possible exposures to each sector. Without such tilts, I could finish up with all of my eggs in one basket and how would that go if the expected return for a particular sector turned out not to be a good representation for the relevant sector?

So there are two quite separate risks I am writing about here. One is expected volatility – or variation around a 'good' forecast – for one or a combination of sectors. The other is the risk that our expected return might turn out to be misleading for whatever reason. Appropriate diversification across sectors helps reduce both of these risks – and often by a very large amount.

(If you want to read what I've done in my portfolio this month, click here).

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Buy, Sell, Hold – what the brokers say

by Switzer Super Report

In the good books

UBS upgraded Mirvac Group to Buy from Neutral and raised earnings estimates over the forecast period to 2019. Sydney is the strongest residential market by far and critical to Mirvac, comprising around 63% of estimated residential earnings over the next three years.

Suncorp was upgraded to Outperform from Neutral by Credit Suisse. While Credit Suisse remains cautious regarding local and global general insurance markets, the situation is factored into Suncorp's share price. The broker believes Suncorp is in a better position than its rivals Insurance Australia Group and QBE to hold on to its margin. In addition, 35% of Suncorp's earnings are outside of general insurance and there are growth opportunities in the medium term.

In the not-so-good books

BHP was downgraded to Neutral from Buy by Citi. Citi expects the bear market will continue in iron ore with large-scale supply growth set to add pressure to weak demand. The broker expects iron ore prices to fall slightly over the first three quarters of 2015, then slowly rebound. Diversity has previously saved BHP but the broker is now bearish on the three biggest earnings drivers – iron ore, coking coal and oil. With debt rising further after the South32 de-merger, Citi expects further cuts to capex may be required.

UBS downgraded Computershare to Neutral from Buy and Credit Suisse downgraded to Neutral from Outperform. While organic revenue growth has challenged the company for some time UBS was encouraged at the February result by the renewed focus on costs. The US property rationalisation project remains the key structural catalyst for cost cutting, in the broker's view. First quarter activity trends were generally positive, Credit Suisse observes, and the company has demonstrated its ability to generate underlying earnings growth in FY15 through a focus on cost savings. The stock is trading at a discount to its historical market premium and with earnings growth reliant on M&A and currency, a downgrade is justified in the broker's view.

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 – CSL and Credit Corp

by Penny Pryor

Some of our most popular articles here at the *Switzer Super Report* are our *Fundie's Favourites*, in which we ask the professional stock pickers to talk about one of their picks. But how clever are the fund managers really? Let's take a look back at two picks from last year.

In August of last year chief investment officer at Platypus Asset Management, Don Williams, [wrote about CSL](#).

He said that he likes "everything really" about CSL, including its superior management and high growth rate.

"Since it listed in 1994, CSL has grown its earnings per share on a compound basis by 23.3% p.a. (26.2% p.a. in US dollars). The company has managed to successfully expand offshore and become the leading player in plasma-derived therapies globally," he said then.

And how has it done since then? Take a look at the chart below. It's up by over 30% in those seven months.

Source: ASX

A few months earlier, in July, Australian equities fund manager Rhett Kessler at Pengana Capital [wrote about](#) debt collector Credit Corp and why it's the gift that keeps on giving.

By then, he'd held the stock within the Pengana portfolio for five years but had held different weightings during that period. He liked management's ability to develop better systems than its competitors.

"When we originally bought it, it was about $2 on a multiple of just under 10 times earnings. It's now $8.70 and its earnings multiple is still only just over 10 times earnings. This is in spite of paying large fully-franked dividends and growing its earnings every year in excess of 20%," he said.

And how has it done since then? It's up by over 26%.

Source: ASX

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How to split your superannuation and avoid pension changes

by Tony Negline

The removal or lessening of super tax concessions seems to be currently aimed at higher account balances.

What is a high account balance? Everyone has his or her own idea and I suspect the Government will settle on a figure at some stage.

In the meantime, it's a good idea to remember that superannuation has always been about a person's account balance, not about the combined retirement assets of a couple.

There has always been good reason to split super between a couple and the threat of attacking the tax concessions attaching to individual account balances adds to the urgency to do something about this now.

There are a few of options available to you:

1. Split contributions with your spouse

This involves taking recent contributions and moving them into your spouse's name. It's a remarkably simple procedure and in many cases simply involves you completing a form that you give to your super fund's administrator (which may charge you a fee to implement it).

Further details about this can be found at the article I wrote about it here.

For what it's worth, I've been using this option myself for the last few financial years and will aim to continue doing so until my wife's and my account balances are roughly equal.

2. Withdraw lump sum money from super and deposit it in your spouse's super account

This is a well-known strategy and has been used for more than two decades to eliminate or reduce income tax.

Before implementing it, the following issues need to be carefully considered:

- Lump sum tax on super withdrawals if you're aged under 60.
- Contribution caps – especially concessional and non-concessional contribution caps.
- Ability to contribute to super – especially relevant if your spouse is aged at least 65; remember that contributions aren't permitted if someone is aged at least 75 (except for a very short-time period after their 75th birthday).
- Age pension eligibility – withdrawals that are then given to your spouse – who may be younger than you and ineligible for the aged pension – would generally be considered a gift and may impact your ability to claim the aged pension.
- Taking lump sum money from a super fund pension? Don't forget that the pro-rata minimum income payment must be worked out and paid before the pension can be commuted.

Most SMSF administrators should know all the issues to consider, like the proverbial 'back of their hand'. A good financial adviser will also know the issues and what options are best.

3. Withdraw lump sum money from super and deposit into your own account as a non-concessional contribution

This is very similar to the second option, however this involves contributing the withdrawn money back into super. All of the issues discussed above are relevant.

The purpose here is to maximise your tax-free component. Before July 2007, this was a very common strategy but since then many people aged at least 60 haven't seen the point of it because it wasn't going to save them any tax.

In my view, maximising your tax-free component is plain common-sense, as you don't know what future changes might be made to super.

Start planning now

It takes time to implement any or all of the above and time to decide what the best strategies for your circumstances are.

Thankfully I think you have adequate time to decide what is best before any nasty changes might be made.

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Dividend swapping and hybrids

by Questions of the Week

Question: Would chasing dividends by swapping shares around in any financial year increase returns, as opposed to holding a core portfolio without undue trading?

Answer (By Paul Rickard): There is no right or wrong answer to this question. It depends on just how good you are at "swapping" and what your timing is like.

Obviously, there are also transaction costs in swapping to be considered.

In my experience, most personal investors aren't very good at trading because either they don't have the commitment (time, willingness to undertake research etc.), patience or they become distracted by some other market event.

My advice is to hold a core portfolio – analyse it – and make changes when necessary (which includes cutting underperformers and reweighting).

Question 2: We have a bank term deposit maturing in a few days and would like to reinvest the funds into something other than shares. Our SMSF is over-weighted towards shares and would like your opinion on the bank hybrids. What are some with safe, reliable and decent returns?

Answer 2 (By Peter Switzer): There is very little to choose between the bank hybrids. They now have largely identical structures, and in a relatively efficient market, are trading on the ASX at around the same margin.

I would look at stocks where liquidity is strong – perhaps two more recent issues:

a) NABPC – issued at a spread of 3.5% over the 90-day bank bill, trading (with accrued interest) marginally below par; and/or

b) CBAPD (PERLS VII) – issued at a spread of 2.80% over 90-day bank bill, trading at a material discount at around $95.20.

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Don't miss this!

Ever wanted to invest in the US but weren’t sure how? Then you need to watch my latest *Switzer Super Session*s video with Paul Rickard here.