Switzer Super Report

Thursday 23 April 2015

The right point of the journey

Today it's all about the starting point, and not the method, of international travel. My good friend Charlie Aitken has updated his price target on Sydney Airport, off the back of improved quarterly passenger numbers, but Roger Montgomery has a cautionary tale to tell about airlines – something Paul Rickard will agree with, despite Charlie's good call on Qantas.

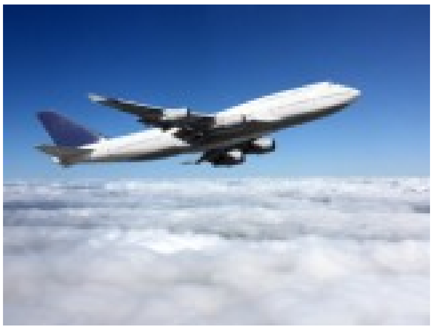
If you want some international share ideas for your portfolio, take a look at what PM CAPITAL fund manager Ashley Pittard is doing with his SMSF. In today's *My SMSF* he explains why he's OK with being overexposed to global and some big international names you might want to think about.

In *Buy, Sell, Hold – what the brokers say*, Fairfax and Fortescue got upgrades and Oil Search, Worley Parsons and Woodside were all hit with downgrades. *Questions of the Week* looks at why it pays to be careful and Tony Negline explains what will happen to your SMSF assets when you die.

Sincerely,

Peter Switzer

Inside this Issue



Up, up and away for Sydney Airport
by Charlie Aitken
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Up, up and away for Sydney Airport

by Charlie Aitken

Key points

- *Strategy is based on the RBA cutting by 25 basis points to 2.00% at the May meeting and the A$/US$ cross rate breaking below 75 US cents.*
- *The Aussie dollar fall is driving international inbound tourism.*
- *The 12-month Sydney Airport price target is upgraded from $5.55 to $6.00*

Reserve Bank Governor Stevens pulled the rug from underneath the Australian dollar on Monday night with more direct currency jawboning, this time in front of a receptive audience in New York.

The A$/US$ cross was trading up (78.5 US cents) after the better than expected March employment data in Australia, perhaps even heading towards 80 US cents on short-covering, when Stevens again took direct aim at the currency, which saw it track back down to 76.88 US cents.

The global game

Make no mistake, the RBA has entered the global currency devaluation war and still has 2.25% of ammunition to deploy.

They will need to deploy some of that cash rate policy ammunition as simply replying on a rallying US dollar and jawboning will not break the Aussie dollar lower from here. US data has hit a soft patch, mainly due to US dollar strength effectively acting as a policy tightening, and expectations of the Fed raising cash rates in June have evaporated.

The Fed's rate hike timing continues to get pushed back and the rest of the developed world is either in QE or near ZIRP mode. To my way of thinking, this increases the likelihood of the RBA having to cut cash rates to 2.00% at the May meeting.

My short-term macro strategy is based on the RBA cutting by 25 basis points to 2.00% at the May meeting (ahead of the Federal Budget) and subsequently the A$/US$ cross rate breaking into a new lower trading range below 75 US cents. My long-term macro strategy is based around the RBA cutting rates to 1.50% and the A$/US$ cross rate heading to 68 US cents.

Being an Aussie dollar bear from 106 US cents has served me well in terms of global asset allocation and being exposed to ASX-listed offshore earners (industrials). I remain a firm dollar bear, particularly versus the US dollar, and continue to set short, medium and long-term strategies off lower A$/US$ cross rates.

The Sydney Airport story

The good news is the Aussie dollar fall, particularly against US dollar and US dollar pegged Asian currencies, is driving international inbound tourism numbers up. A recovery in inbound tourism is extremely important to Australia to partially offset the downturn in our key export commodities. The multiplier effect of tourists spending cash is large through the economy.

Australia as a tourist destination has become a far more attractive proposition. This is particularly so versus the Chinese yuan, New Zealand dollar, Hong Kong dollar, US dollar and British pound.

NZ dollar/Aussie dollar

British pound/ Aussie dollar

Hong Kong dollar/Aussie dollar

Chinese yuan/Aussie dollar

That better relative and absolute value is driving international passenger traffic through our key gateway airport, Sydney Airport (SYD).

In the table below you can see that International Traffic through Sydney Airport performed very strongly during March, increasing +8.9% vs. the previous corresponding period.

Top 10 Nationalities Travelling Through Sydney Airport

Rank	Nationality	Mar-15	YTD-15	Rank	Nationality	Mar-15	YTD-15
1	Australia	+7.7%	+4.0%	6	Korea	+11.7%	+6.9%
2	New Zealand	+0.1%	+0.6%	7	Japan	-11.8%	-6.9%
3	China	+38.8%	+15.4%	8	India	+39.9%	+25.1%
4	UK	+9.9%	-1.9%	9	Malaysia	-1.4%	-2.8%
5	USA	+4.1%	+4.0%	10	Germany	-0.1%	-3.3%

While earlier Easter school holidays, the end of Lunar New Year celebrations and the ICC Cricket World Cup all played a role in the strong March number versus the previous corresponding period, what is interesting is the year to date international number is 3.9% higher than the previous corresponding period.

To quote directly from the Sydney Airport March traffic report: "International passengers grew 8.9% on the previous corresponding period primarily as a result of a 7.5 percentage point increase in load factors. The Australian outbound market performed well, increasing 7.7% and foreign nationalities grew 9.8%. Filipino (42.1%), Indian (39.9%), Chinese (38.8%), Hong Kong (27.0%), Korean (11.7%) and UK (9.9%) nationality passengers were the major drivers of international growth in March."

"Chinese nationals increased 38.8% in the month, benefiting from Lunar New Year celebration return trips. The Indian nationality also continued its recent strength, up 40% on the previous corresponding period and up over 25% year-to-date.

The home game

"Domestic traffic grew 4.2% over the month driven by both seat capacity increases and load factor improvements. All domestic airlines experienced load factor improvements relative to the previous corresponding period".

Warren Buffett famously said "a monopoly toll bridge is my dream investment". Sydney Airport is a "monopoly toll bridge" that now has strong macro tailwinds for activity and valuation.

Crown and Sydney Airport are now key members of my Nifty 15. They are my two domestic listed plays on the rise of the Asian international tourist.

After the robust March traffic numbers and taking into account year-to-date growth, future airline capacity growth and movements in long bond yields and currencies, I am upgrading my 12-month Sydney Airport price target from $5.55 to $6.00

Go Australia, Charlie

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A wing and a prayer

by Roger Montgomery

Key points

- *When it comes to capital-intensive businesses like airlines, accounting standards can be inadequate for measuring the true performance of the business.*
- *The profit, after such inadequate expenses and depreciation have been subtracted, is artificial and doesn't take into account equipment replacement costs.*
- *Airlines are tough businesses: capital-intensive, labour-intensive, fiercely competitive and ultimately selling something that people want to pay the lowest price for.*

It's true I am getting nervous about the market. I can't tell you what will be the catalyst, nor that the market is wildly expensive – it isn't – and I cannot even tell you when or even if there will be a correction, but I can say that there are many signs – economic, market, corporate, sentiment and the level of unprofitable IPOs – that suggest it is wise to dance close to the door.

My nervousness is perhaps best illustrated by the enormous and arguably illogical gains seen in the share prices of airlines. I suggest illogical because the very long-term economics of these businesses are, more than many if not most others, so unpalatable as to be dangerous to your wealth.

It might surprise you that when Virgin Australia Holdings (ASX:VAH) listed in 2003, it was exactly a year after United Airlines had filed for Chapter 11 protection from creditors. That company was denied $1.8 billion in backing for new loans. The hat went around and came back empty. Remember the hat because I am going to come back to that.

The contrast between the hype surrounding the float of Virgin Blue and the depression surrounding the collapse of United could not have been starker and yet the two businesses operate in the same industry.

So was the difference in fortunes due to the ability of management, the owners of the airline or the country in which they operate? Or is there a fundamental gene in airlines that threatens wealth?

A cautionary tale

Suppose we go back to 1999, and decide to start a business. We reach into our pockets and write cheques for $1.9 billion, using our own money, to kick the business off. That $1.9 billion represents our equity in the business. We also head down to the bank and ask to borrow $3 billion.

So the business in 1999 kicks off with $1.9 billion of our equity and $3 billion of debt, borrowed from the bank. We have a total of $5 billion invested and our loan to value ratio is 60%. Most people reckon that's pretty safe but another way to think about it is that we owe much more than we own. Let's worry about debt later on.

After the first year of being in business, the manager we hired to run it for us reports a profit of $515 million. Pretty good, don't you agree? Half a billion profit on our $1.9 billion of equity is about a 25% return. It is always useful to compare this return to what we can get elsewhere and you can't get that in a bank account! Well done.

Now fast-forward 15 years to the present-day and look back over the past decade and a half. Profits have been as high as $970 million in one year and as low as a loss of $144 million in the last financial year.

That most recent year is substantially less than the profit we made 15 years ago! I am sure you are beginning to think this is not a great predicament and certainly not a great business, especially remembering that inflation over the past 15 years has made the losses of the current year even more painful.

To add insult to injury, and to get the business to this auspicious point, we have tipped in an additional $2.7 billion of our own money and borrowed an additional $3.5 billion from the bank.

So we have a business that we have been running for 15 years. We have tipped in a total of $4.6 billion of our own money and borrowed $6.5 billion from the bank and last year we made just $100 million.

The hidden costs

So do you still think this is a good business? Would you be happy to own it outright? Or would you like to try and get out of it?

Well before you answer that, the company is now forecast to earn some substantial profits thanks to the low oil price and efficiencies extracted by management restructurings, the profits reported in the accounts, however, might just be illusory.

When it comes to capital-intensive businesses like airlines, accounting standards are inadequate for measuring the true performance of the business. The standards allow such businesses to depreciate their property, plant and equipment based on the price paid decades ago. The result is that reported “accounting profits” mask real losses.

And the proof is that darned hat. Remember the hat?

As an investor you use accounting to determine whether to invest. The problem is that it will be the real profits of the business that will determine whether your decision was correct.

An aircraft purchased today costs considerably more than an aircraft purchased two decades ago.

Yet generally accounting standards allow depreciation to provide for the expense associated with the wear and tear of the aircraft and ultimately its replacement. The profit, after such inadequate expenses have been subtracted, is artificial – an accounting invention.

Take a business that bought $10 million of equipment 25 years ago. Over the next 25 years, profits have been reduced by $10 million in depreciation, leaving an assumed total profit of $25 million spread over the 25 years. If inflation has been 4%, the replacement cost of the equipment will be $27 million.

And airlines must replace their equipment. If they don’t, people die.

So just to compete, the business must incur costs that are 2.5 times more than that which has been accounted for – $27 million in replacement costs compared to the $10 million in depreciation.

This type of business effort is akin to running in quicksand and it doesn’t matter how good the runner is, or how much you pay him, he’ll do no good. To keep going, the business will have to outlay $27 million, and the accounting profits have thus been exaggerated by $17 million. The company has made an economic profit over the 25 years of $8 million, not the $25 million it announced.

If debt facilities have already been stretched, lenders will not be willing to keep the business afloat, and the company could then pass the hat around and ask existing owners to refund some of their dividends through a bonus or rights issue or to ask new shareholders to inject capital through a capital raising of some description. But if the hat comes back empty, game over.

It is proof positive of a challenging business to discover that airlines are monotonous in their efforts to raise fresh capital or in their suspension of dividends. They are tough businesses: capital-intensive, labour-intensive, fiercely competitive and ultimately selling something that people want to pay the lowest price for. These are not the ingredients of a sound long-term investment.

When I first wrote about this subject in 2003, Qantas shares were trading between $3.20 and $3.40. In 1999, they traded as high as $5.00. Today, they are $3.36. Virgin Blue’s shares had only just listed in 2003, with great fanfare, and were trading between

$1.91 and $2.15. Today, they trade at 50 cents.

The recent tripling of the share price of Qantas does not give me cause for comfort nor does it suggest the economics of the airline has permanently improved. Indeed the rally is potentially a signal that the market is becoming increasingly irrational.

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Buy, Sell, Hold – what the brokers say

by Switzer Super Report

Oil and commodity forecast cuts continue to dominate broker downgrades with ratings adjustments for Oil Search, Woodside and Worley Parsons.

In the good books

JP Morgan upgraded Fairfax Media (FXJ) to Neutral from Underweight. Buy/Hold/Sell 2/5/0
After the recent investor briefing, JP Morgan analyses Domain's competitive position and earnings evolution and adopts a more positive outlook on future pricing. The broker considers 2015 market revenue share a key indicator for determining whether Domain will be an improved number two in a strong market or able to take share from REA.

Morgan Stanley upgraded Fortescue (FMG) to Equal Weight from Underweight. Buy/Sell/Hold 0/6/2 Provided iron ore prices do not collapse, Morgan Stanley expects Fortescue will have a few years to work on a solution to its debts. While less than a month ago the broker envisaged the prospect of negative free cash flow, the rating is moved back to Equal-weight from Underweight. While the debt issue is not removed, the broker considers it is now more a longer-dated event.

In the not-so-good books

Citi downgraded Oil Search (OSH) to Sell from Neutral. Buy/Hold/Sell 7/0/1 No discussion, Oil Search has been blessed with a large contingent resource, providing it with the opportunity for high margin production growth, but further share price appreciation would signal investors are blatantly ignoring the risks that remain attached to developing LNG projects.

Deustche Bank downgraded Perpetual (PPT) to Hold from Buy. Buy/Hold/Sell 2/6/0 At 9%, Perpetual's March quarter assets under management growth was slightly ahead of the broker's forecast but it was all about appreciation of the market and little to do with new funds inflows. Flows are waning as the market reaches towards historical PE levels. Perpetual's valuation is also getting rich and after a 26% total shareholder return yearto-date, the broker sees limited further upside.

Morgan Stanley downgraded Woodside (WPL) to Underweight from Equal Weight. Buy/Hold/Sell 1/4/3 Morgan Stanley revises its rating to Underweight from Equal-weight as Woodside is considered to offer the least leverage to a rising oil price scenario. The broker expects a cyclical recovery in oil prices but from a lower base and over a longer period.

Macquarie downgraded Worley Parsons (WOR) to Neutral from Outperform. Buy/Hold/Sell 2/4/1
Macquarie has cut its WTI oil price forecasts (US$/bbl) to US$52 in 2015, down from US$68, and to US$62 in 2016, down from US$79. The service industry is seeing solid front-end work in looking for cost-effective solutions for customers but little in the way of sanctioned projects.

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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My SMSF – a big bet on global

by Ashley Pittard

Name: Ashley Pittard
Age: Around 40

How long have you had your SMSF?

10-years plus

Why did you start it up?

It was just far simpler to have the money in something that I could manage because that's my job. My job is to invest people's superannuation.

How is it invested?

Effectively the assets have either been in the company (the majority of PM Capital's funds under management is in global equities) or our enhanced yield fund. The reason I'm able to do that is I'm not a majority shareholder of the firm. When we originally started as with a lot of firms we got opportunities to buy stakes in our business. Over a longer-term period, considering where I was going to get the best returns, I've always though the global fund is going to get the better returns

Does it bother you that it might be over exposed to international assets?

I have my house in Australia and I work in Australia. I like to have my assets globally if I can, only because I see a better risk reward payoff. I can get global financial stocks like Lloyds of London (UK) and Wells Fargo (US) for half the price of a CBA share.

Is it more or less difficult to manage than you thought it would be?

I effectively outsource it to my accountant. I think that's the best way to. Of course you pay a fee for it but mine is very, very simple.

I look at it this way. I could have taken my superannuation and put it into a fund, whereas now the only fee I'm paying is to my accountant. It's cost effective because I'm not paying a management fee to a third party.

How has it performed?

It's difficult to measure performance as it's invested in the unlisted shares of PM CAPITAL, which I'm able to do as I'm a minority shareholder, but as a guide, The Global Companies Fund (which I manage) has annualised after fees performances of 30.4%, 31.8% and 15.6% for the one, three and five-year periods to the end of March. The Enhanced Yield Fund has annualised returns of 3.6%, 4.9% and 5.4% over those same one, three and five-year periods. Its benchmark is the RBA cash rate, which it has outperformed over all those periods

What are your favourite investments/stocks and why?

At PM Capital we invest at the epicentre of a crisis, so I like US property, US banking and near-term European property and European financials – anything with regards to a rebound in Europe.

Companies I like at the moment include Lloyd's of London, Wells Fargo, Banco Popular (Spain) and Bank of Ireland. We've owned the brewer names like Heineken and the reason we like them is because they're global business and they are duopoly earners.

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What happens to your SMSF if you get sick and die?

by Tony Negline

Key points

- *If you want to receive any money from your super fund because of a temporary incapacity, your fund needs income protection insurance.*
- *For permanent incapacity benefits, you have to be suffering from mental or physical ill heath that will prevent you from ever working again in a job which involves your level of education, training and experience.*
- *Death insurance policy claim proceeds are paid into the super fund as capital and are not taxed.*

One of our readers asked some good practical issues about insurances inside your SMSF which I think you'll find interesting. Here is there question

I have a SMSF and my husband and I are beneficiaries. We are both 56 years old. We currently have group life cover in the fund but not TPD. We were wondering:

1. *If, God forbid, one of us becomes disabled or gets sick (such as cancer), before age 60, could our SMSF pay out the members fund balance? What, if anything would be the tax consequences of this be? Obviously the fund would need to sell the shares if the money could be accessed, but would they still be subject to capital gains tax if the money were being paid out for this purpose?*
2. *If one of us were to pass away (again God forbid), it is my understanding that the life policy would be paid out to the surviving spouse tax free. However, could the fund balance in shares of the deceased beneficiary be just moved over to the surviving beneficiary so that the shares don't have to be sold?*

Illness and injury

Let's deal with Part 1 first. At a super law level you're asking about two different types of disability – temporary and permanent.

Under the super laws temporary disability arises when you can't work due to illness or injury, which isn't permanent. Definitions in your trust deed might be more restrictive so make sure you check it too.

Your question relates to the possibility of getting sick. The early diagnosis of most illnesses doesn't immediately involve discussions about permanent stopping work or imminent death. In fact, most people who become ill stop work for up to 36 months so they can receive intensive medical treatment and recuperate. Once cured they often return to work full-time.

For reasons that I explain in this article you can't take any of your savings out of your super fund were you to suffer from temporary incapacity.

So if you want to receive any money from your super fund because of a temporary incapacity, your fund will have to own what's called salary continuance insurance or income protection insurance. You should also read this article as it contains important information about the type of policy your fund's trustee can buy.

Now what about permanent incapacity? Well under these rules, you have to be suffering from mental or physical ill heath that, in your trustee's view, will prevent you from ever working again in a job that involves your levels of education, training and experience that you would have at the time you're disabled. Again this is the super law definition.

Your trust deed may be more restrictive this than this – for example, it might say that permanent incapacity benefits are only available if you are unlikely to perform any work in the future.

If your trustee decides you satisfy this definition, then all the money you have in your super fund can be paid out to you. If two medical practitioners make a similar declaration, then specific and often substantial tax concessions will be attached to your permanent disability benefit.

These permanent incapacity benefits can be paid as a lump sum or pension.

How it is paid will depend on your trust deed, what you want and what your trustee is prepared to do. Many older SMSF deeds only allow these benefits to be paid as a lump sum.

If a pension is permitted, then when the pension commences, the tax rate on the assets paying the pension falls from 15% to 0%. If a pension is being paid, any assets sold that fully support that pension will typically not be subject to capital gains tax.

If a lump sum is paid then the assets will be sold when your fund's tax rate is 15% which means CGT, if relevant, will be payable.

Death

Now to deal with the second question. Yes the death insurance policy claim proceeds will be paid into the super fund as capital and are not taxed. When these proceeds are paid out to a dependant beneficiary, then lump sums are typically paid out tax-free.

As an aside, please note that only two death benefit lump sums are permitted.

Pension benefits come with tax concessions – please see the table below – dependent on the age of the deceased and the beneficiary who receives it. Any assets sold when paying a pension will typically not incur CGT for the same reasons outlined above.

All of a deceased's benefits have to be paid out as either a lump sum or pension including their account balance. That is, their account balance can't be transferred to the surviving beneficiary's account in the super fund.

If, at the time of death, the deceased wasn't receiving a pension, then any assets that have to be sold to pay a lump sum will be subject to CGT.

Finally please note there is a different tax table for non-dependants. Spouses are always considered to be dependants of each other.

Dependants			
	Deceased at time of death	**Dependant's age**	**Taxation**
Lump sum	All ages	All ages	Tax-free
Income stream	Under 60	Below 60	Taxable component – marginal rates less 15% rebate Tax-free component – tax-free
		At least 60	All tax-free
	At least 60	All ages	All tax-free

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A cautionary tale on the hype

by Questions of the Week

Question: I got quite excited about all the hype about Slater & Gordon and bought it at $7.90. I am now concerned at its dramatic drop in three weeks. How long do you think it will take before I see it in positive territory and what is your long-term view of this stock? Do I reluctantly now cut my losses and run?

Answer (By Paul Rickard): There is a good lesson here – don't get excited about the media acquisition hype.
Unfortunately, the track record of Australian companies buying companies offshore is pretty appalling – so the odds are against Slater & Gordon making this acquisition work.

Of course, there has been a two for three accelerated rights issue – so the fall in the share price is not quite as bad as it looks.

Question 2: I am interested in buying some shares in Wealth Defender Equities. However, I was wondering whether I would be better off buying the shares when the fund (WDE) listed on the 21 May 2015?

Answer 2 (By Paul Rickard): Possibly – will depend on the enthusiasm or not of sellers. The downside is you will pay brokerage and also miss out on the loyalty option. On the upside, you may pay less than $1.00 per unit if it trades around NAV, which will be worth around $0.975

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Don't miss this!

Are we heading for a recession or are the economic signs out there more positive? My colleague Paul Rickard and I tell you whether the negative nellies out there are just plain wrong!

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Peter Switzer

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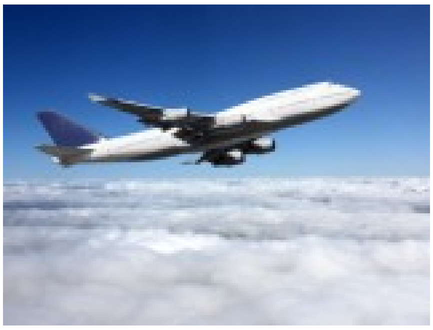

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