Switzer Super Report

Thursday 30 April 2015

Always in style

There's a high profile banking summit going on at the moment, with lots of high profile banking people saying lots of high profile things – mostly scary things about our Aaa rating and the propensity of companies to pay dividends. But as my good friend Charlie Aitken explains today, dividends will always be in fashion, particularly when interest rates are so damn low. He expects another rate cut and I really really want another cut.

Also in the *Switzer Super Report* today, Charlie names a couple of companies he says you should buy on dips – like NAB, ANZ, Bank of Queensland and Bendigo & Adelaide Bank – and Tony Featherstone researches the gold market and whether or not it's time to get in.

In *Buy, Sell, Hold – what the brokers say*, iiNet and Insurance Australia Group get upgrades, and we take a look at the very yummy Yowie Group in *Short n' Swee*t (pardon the pun).

Sincerely,

Peter

Peter Switzer

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Dividends are never out of fashion, so buy banks on dips

by Charlie Aitken

Key points

- *People's Bank of China joins quantitative easing with 100 basis point cut in the reserves requirement ratio, which pushes up our local dollar and boosts the case for the Reserve Bank to cut.*
- *The S&P/ASX 200 Accumulation Index has returned 55% over the last five years, compared to 24% for the S&P/ASX 200 prices index.*
- *Consider buying NAB, ANZ, Bank of Queensland and Bendigo & Adelaide Bank into any slight dips, ahead of a solid reporting period for the banks.*

Last week, China was formally welcomed into the monetary easing dance party. Previously, the People's Bank of China (PBOC) had taken tentative steps, but with the 100 basis point cut in the reserves requirement ratio (RRR), China officially took to the monetary easing dance party floor. Make no mistake, this represents an aggressive policy move by the PBOC, despite comments to the contrary. Currently, the US remains the only missing participant, but with the release of further soft data over the weekend and last night, the Federal Reserve is dancing only just outside the party door.

The case for an RBA cut

Locally, there has been much speculation on the timing of the next domestic rate cut. Following the RBA's decision to leave the cash rate unchanged in April, the market is now pricing in a 56% chance of a 25 basis point cut in May, compared to 80% just two weeks ago. Just last week, a major bank became the first to officially tip 'no 25 basis point cut' in the cash rate in May. Indeed, there is some speculation that we are at the low point of the cycle. Personally, I believe the RBA remains committed to at least one more rate cut this year. I continue to forecast a 25 basis point rate cut in May before the Federal Budget.

I refer readers to the comment by the RBA governor in New York last week when he said that an interest rate cut was "still on the table." In central bank-speak, the inference is that the RBA retains an easing bias, dependent on incoming data releases. In this regard, the domestic economic outlook remains soft. Annualised headline inflation is just 1.3% per annum and the unemployment rate is 6.1%. Both are expected to contain wages growth at historic lows of 2.5%. In addition, economic growth is expected to be further downgraded in the RBA's May statement. As such, the domestic case for another rate cut remains undeniably strong.

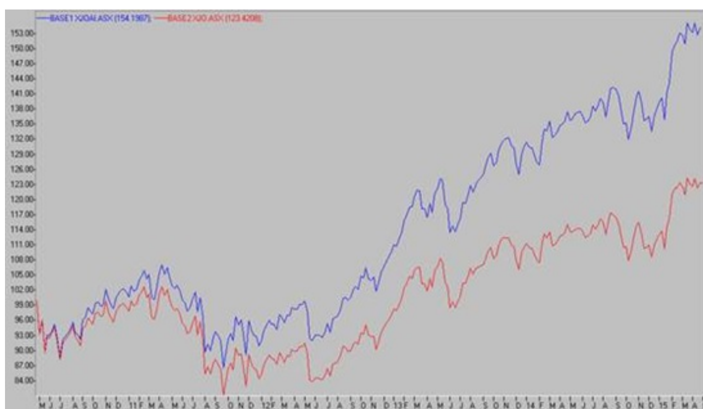
This should provide ample ammunition for at least another 25 basis point rate cut. But there is another important reason. As I have previously mentioned, the RBA has committed to a competitive currency devaluation through a lower interest rate policy. If there was any doubt about that commitment, the proof was on display again last week. After the PBOC's decision to cut the RRR by 100 basis points, the Australian dollar rose a full cent to US 78 cents. The very next day Glenn Stevens responded with a reiteration of the RBA's easing bias. The Aussie dollar was at US 80.23 cents yesterday and a rate cut rather than jawboning is now required.

The yield bonus

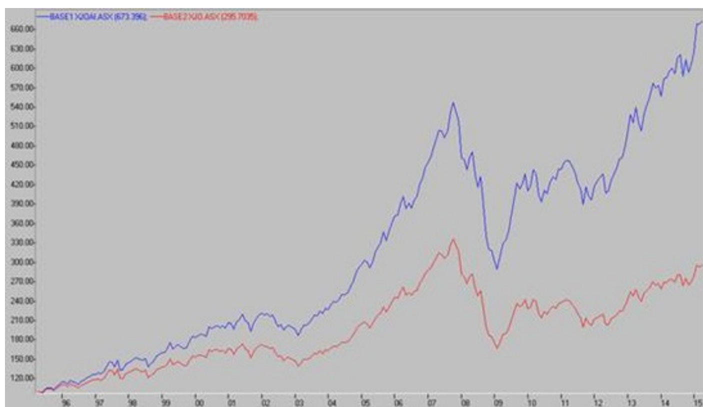
The attractiveness of grossed-up fully franked dividend yields, which remain at a 500 basis point premium over the cash rate, remains obvious to all investors. But the contribution to total returns is even more compelling. While the S&P/ASX 200 remains

roughly 15% below the all-time high, the S&P/ASX200 Accumulation index has long-passed the previous high. Currently it is 24% above the previous all-time S&P/ASX 200 high set in 2007. That is the compounding power of dividends. The S&P/ASX Accumulation Index has returned 55% over the last five years compared to 24% for the S&P/ASX 200 prices index. The 31% difference is the annualised contribution of dividends (ex franking credits) to total returns. As a result, dividends have contributed about 56% of total returns of the last five years and that is BEFORE the value of franking credits to Australian resident taxpayers.

ASX200 Accumulation Index (XJOAI) vs. ASX200 Index (XJO) last 5 years common base



ASX200 Accumulation Index (XJOAI) vs. ASX200 (XJO) last 20 years common base



S&P/ASX 200 companies are expected to return a record $90 billion ($80.5 billion in dividends and $9.3 billion in buybacks) to investors this year, a 9% increase on the $82.5 billion paid last year. It also represents a payout ratio of about 73%, compared to less than 40% in the US. In the reporting season to 31 Dec 2014, a total of 68% of companies increased dividends over the previous year. This is remarkable given earnings fell more than 20% over the same period. To put it in perspective, the $90 billion in dividends expected to be paid this year is roughly 5.5% of GDP, or nearly six months of retail spending. That is the power of dividend yield.

In addition, history shows that companies that pay higher dividends deliver higher shareholder returns than companies that have high capital expenditure budgets. The reason is they are less efficient allocators of capital. The mining sector is a prime example. They have an abysmal track record of misallocating excess capital. At the peak of the boom, mining companies were reinvesting in future growth rather than returning capital to shareholders in the form of higher dividends. Now, the reverse has happened. Go figure?

The “search for yield” and the attractiveness of fully franked dividends can only accelerate if the latest, but dated, figures from APRA are correct. In the December quarter last year, the average SMSF still had cash levels of 16.5% compared to 17% in the Sept quarter. This compares to the decade average of 10%. With nearly $80 billion in annual super inflows, cash levels are compounding rapidly. This is even more important given my expectation of another fall in the cash rate.

Still banking on it

Strategically I remain a buyer of sustainable Australian fully franked dividend yields at a reasonable price. I think the recent trading pullback in the major banks is a clear buying opportunity ahead of their record interim dividends in May.

While CBA, Macquarie Group and Westpac are in my “Nifty 15”, I’d also be buying NAB, ANZ, Bank of Queensland and Bendigo & Adelaide Bank into any slight dips, ahead of what will be a cracking reporting period for the banks.

Other dividend growth companies in my “Nifty 15” include Goodman Group, Telstra, Transurban Group, Sydney Airport, Wesfarmers and Westfield Corporation.

Dividends are never out of fashion. They (plus franking credits) will continue to contribute a high proportion of the total return available in Australian equities.

Australia remains the yield market of the region. Faster growth is available elsewhere in the region. So a portfolio of domestic income and regional growth is the answer.

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Is it time to add gold?

by Tony Featherstone

Key points

- *The Australian dollar gold price, which matters most for local producers, has rallied from A$1,333 an ounce in November 2014 to around A$1,500.*
- *Because gold has a different relationship to shares and bonds, it can protect wealth when other assets are going backwards.*
- *Exchange-traded products (ETPs) eliminate company and market risk inherent in investing in gold equities, and offer purer better exposure to gold bullion.*

Investment bright spots have a habit of emerging in the market's darkest places. Amid unrelenting resource-sector gloom, the iron ore price bounced in April, the Australian-dollar gold price has rallied and gold equities are outperforming the broader market this year.

Resource bears will argue this is a bear-market rally that attracts and destroys fresh capital. That may be true of iron ore, but there is more substance to the gold sector's near-term outlook, and the case for modest portfolio exposure to the precious metal is strengthening.

Although still off a peak of US$1900 reached in early 2011, the good news is the Australian gold price, which matters most for local producers, has rallied from A$1,333 an ounce in November 2014 to around A$1,500. With further Australian-dollar weakness likely this year as interest rates are cut and as the US dollar rises, a higher A$ gold price is a reasonable bet, assuming a stable US$ gold price.

That should underpin further gains in local gold stocks, which are collectively coming off several years of heavy losses. The All Ords Gold index's total return of 31% so far this year compares with an 11% gain in the S&P/ASX 200 Accumulation index, which assumes dividend reinvestment.

A rally in sector heavyweight Newcrest Mining partly explains the index gain. After being hammered in recent years, Newcrest has delivered a one-year total shareholder return of 41%. But at $14.84 a share, it remains well down on its $41.45 peak in early 2011.

Reasons to buy gold

Some prominent forecasters have become more bullish on the outlook for gold. British commodities researcher Metals Focus said in late March that 2015 was likely to mark the end of the bear cycle for gold.

Macquarie Group is also positive on gold's medium-term outlook. Its global commodities team has a long-term forecast gold price (2019+) of US$1,500, with an average of US$1,255 in 2015 and US$1,363 in 2016. Like Metals Focus, Macquarie expects further gold-price volatility in the near term, before the metal stabilises and gradually improves in the next few years.

Lower interest rates are another reason to buy gold. Unlike most other assets, gold bullion does not provide yield. But with interest rates at record lows, the return on bank term deposits is 3-4%, less in real terms after adjusting for inflation. Another one or two rate cuts this year would further reduce the gap between bank deposit rates and gold's zero yield.

Gold, it seems, is in a tug-of-war between the prospect of rising US interest rates and a rising Greenback, and the potential for another bout of global financial-market volatility, which would spur demand for safe-haven investments. Greece's

potential exit from the European Union could be a trigger.

These market machinations will provide fuel for gold speculators to get in and out of the market. However, long-term investors, such as SMSFs, should view gold for its portfolio-diversification benefits rather than as a tool for quick gains.

There is a good argument that long-term investors should consistently allocate a small portfolio weighting, arguably no more than 3-5%, to gold. The allocation could be higher in periods of extreme volatility, such as the 2008 Global Financial Crisis, and lower when global equity markets are booming, as is the case in the US now.

Because gold has a different relationship to shares and bonds, it can protect wealth when other assets are going backwards. Gold was the best-performing asset during the 20 worst days for the US S&P 500 index since 2000, according to Macquarie Equities Research last year.

How to gain exposure

The question, then, is how to rebuild gold exposure in portfolios, knowing the precious metal should only ever have a small allocation in a balanced portfolio, and does not suit investors, who need income-producing assets to live off. There are three main options.

The first is buying Australian gold equities. They provide more leverage to rises and falls in the gold price, and a rising Australian share market is a much-needed tailwind for the gold sector. Analyst opinions on gold stocks, however, are mixed. For Newcrest, for example, there are four buy recommendations, five holds and six underperforms.

Macquarie Group's preferred gold picks are Evolution Group, Regis Resources, Saracen Minerals Holdings, Doray Minerals and Gold Road Resources.

Option two is using exchange-traded products (ETPs) for gold exposure. They eliminate company and market risk inherent in investing in gold equities, and offer purer better exposure to gold bullion. The ASX-listed ETFS Physical Gold ETP, from ETF Securities, has rallied from $130 in late 2014 to $145.

The ETFS Physical Gold ETP (ASX Code: GOLD), one of the market's largest, is unhedged for currency movements. Investors seeking hedged currency exposure could use the Betashares Gold Bullion ETF – Currency Hedged.

Option three is owning gold bullion directly, a strategy more SMSFs are adopting, according to anecdotal reports from the Australian Bullion Company and other gold-bullion providers.

Owning gold bullion means being able to take physical delivery of the metal – something ETPs cannot offer. Also, transaction and storage costs for gold bullion compare favourably with annual management fees for gold ETPs over time, argue gold-bullion providers.

Gold ETPs are best bet at this stage

Of the three options, I favour using unhedged gold ETPs for portfolio exposure. It is too early to get bullish about gold equities in this market given poor sentiment towards resource stocks and the likelihood of the commodity-price rout having further to run.

The best time to buy resource stocks is when the sector has stopped investing, or when small mining-service companies and explorers are going bust by the day – conditions not yet seen in this market, but getting closer.

The ETFS Physical Gold ETP (ASX Code: GOLD) should benefit from medium-term gains in the gold price and be cushioned by further modest weakness in the Australian dollar in the next 18 months. It is also a simpler way to add gold to a portfolio compared with gold equities or owning gold bullion.

I understand the appeal of owning gold bullion for self-directed investors. But investing via regulated listed, liquid share markets usually makes more sense than over-the-counter markets in commodities, when retirement income is at stake.

Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis

at April 28, 2015.

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Buy, Sell, Hold – what the brokers say

by Switzer Super Report

Merger and acquisition activity has driven broker actions this week with a ratings upgrade for iiNet and a downgrade for TPG. Recall Holdings has also been upgraded.

In the good books

Morgans upgraded iiNet (IIN) to Add from Hold. Buy/Hold/Sell 3/5/0 M2 Telecom has made a scrip-based bid as a counter offer to TPG Telecom's $8.60 cash bid. Morgans believes the M2 bid is superior to the TPG offer. Should a higher bid not materialise, the broker believes iiNet shareholders should be comfortable with equity in the combined group and this is a better outcome than the TPG offer.

Macquarie upgraded Insurance Australia Group (IAG) to Outperform from Neutral. Buy/Hold/Sell 1/7/0 If the NSW storms were not bad enough, IAG has also seen a jump in claims for the earlier Cyclone Marcia to levels well above expectations. The combination sees the insurer downgrading FY15 margin guidance and reporting reinsurance protection for 2015 is now all but used up. However, aggregate reinsurance will kick in if further events occurred, thus the broker suggests earnings certainty remains through to end-2015. On that basis the broker has cut its FY15 earnings forecast but increased FY16, and on the strength of the IAG sell-off has upgraded to Outperform.

Macquarie upgraded Recall Holdings (REC) to Outperform from Neutral. Buy/Hold/Sell 2/3/1 Macquarie reviews assumptions around a merger with Iron Mountain. The suggested synergies of US$250 million are considered a stretch but the deal would still work without synergies, given the tax benefits. The broker considers the current share price does not hold any material takeover premium yet the value creation from the merger would be significant and materially accretive.

Macquarie upgraded Wesfarmers to Neutral from Underperform. Buy/Hold/Sell 0/6/2 Coles' March quarter sales growth of 4.1% remains a standout, the broker suggests, and implies the supermarket is stealing share from Woolworths. There is nevertheless downside risk assuming Woolies responds with a price war. But Bunnings continues to thrive, K-Mart and Officeworks are now delivering on investment and Liquor, and Target is quietly turning around. The broker believes the Coles risk is built into the current Wesfarmers price and a 10% premium to market is justifiable on a 5.3% yield.

In the not-so-good books

Morgans downgraded TPG Telecom (TPG) to Reduce from Hold following the counter bid for iiNet from M2 Telecom. Buy/Hold/Sell 1/1/3 Morgans believes the M2 bid is superior to the TPG offer. Regardless of the outcome, the broker considers M2's bid means TPG shareholders are worse off. Either TPG walks and earnings are lower than expected without iiNet, or it pays more and the value created for TPG is therefore lower.

Deutsche Bank downgraded Seven West Media (SWM) to Hold from Buy. Buy/Hold/Sell 4/3/1 The company intends to undertake an equity raising with maximum proceeds of $612 million which, in the broker's view, will remove a significant overhang on the balance sheet. But the undertaking is highly dilutive to Deutsche Bank's earnings forecasts and the rating is downgraded to Hold from Buy.

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 – Yowie Group

by Penny Pryor

Just over a month ago, James Dunn singled out Yowie Group (YOW) in his article 7 stocks under 70 cents, and a week after that, Julie Lee from Bell Direct named the same company as one of her 'likes' in our very first Super Stock Selectors.

She said: "Who doesn't love chocolate with little animals inside."

We hope you've been following our *Super Stock Selectors* because if you haven't, you really should. Each week we've been asking market experts to name a company they like, and one they don't and if they have time they often share the reasons behind their thinking as well.

Julie Lee liked Yowie, not just because of its sweetness, but also because the chocolates are about to be distributed in the US where they have massive potential.

Yowie's chief competitor – Ferrero Group which sells Kinder Surprise – cannot be sold in the US because of the choking hazard involved in small toys in confectionary.

Yowie has been able to get around that ban, largely because it has created a special capsule for its toy, which has been granted the only patent for a chocolate-encased toy by the US Food and Drug Association.

Why am I talking about Yowie again? Well, it is up almost 20% since we mentioned it on 23 March when it was trading at 60 cents. It's now at 72 cents and wouldn't make our 7 stocks under 70 cents list today!

Yowie Group (YOW)

Source: *Yahoo!7 Finance, 30 April 2015*

Yowie doesn't pay a dividend but good things are expected from the distribution arrangement in the US so it is definitely one to watch.

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Binding nominations not everything they're cracked up to be

by Tony Negline

Key points

- *Recent court cases have highlighted the importance of the correct wording of binding death benefit nominations.*
- *You need to execute your binding death benefit nomination strictly in accordance with your trust deed's requirements.*
- *You might want to consider recording your decisions as trustee but not explaining them in writing in case you are ever questioned in court.*

Beware – binding death benefit nominations are not necessarily the cheap and easy solution you may have been led to believe they are.

This unfortunate lesson has been borne out by two recent court cases.

Ioppolo v Conti

This case was an appeal from *Ioppolo & Anor v Conti* that I wrote about first here.

The appeal was heard by the WA Court of Appeal and like the initial case was commenced by the executors of Francesa Conti's estate. They lost both cases.

In reality, these cases didn't revolve around actual binding death benefit nominations but, in part, a misunderstanding about how these documents work. Also involved was a trust deed, which you could argue had questionable drafting.

In this case, the three-year time limit on binding death benefit nominations that typically apply to APRA regulated funds was in place because of how the trust deed was written.

Francesca Conti died in August 2010. She'd been married to Augusto for 28 years and had four children from a previous marriage. Two of these children were executors of her estate. The couple had started an SMSF in 2002 and before death, she had completed two binding death benefit nominations in favour of her husband. At the time of death, both binding death benefit nominations had lapsed.

The problem was Francesca's will said her children should get her super monies.

As sole surviving trustee of the SMSF, Augusto then paid Francesca's benefit to himself and nothing could be identified that was wrong with his decision to do this or how he managed the super fund.

The practical lessons learned from this case are:

1. Have you completed a binding death benefit nomination on the assumption that your fund's trust deed allows for it?
2. Have you executed your binding death benefit nomination strictly in accordance with your deed's requirements?
3. Augusto always recorded his decisions as trustee but never explained them. As an SMSF trustee, you should think about doing the same in case you are questioned in court.

Munro & Anor v Munro & Anor

This is a Queensland Supreme Court case that was handed down in late March. It also involved the validity of a binding death benefit nomination. In this case the binding death benefit nomination had been executed by Barrie Munro who had been a practising solicitor before his death in August 2011.

The case involved Munro's second wife, Suzie, and his two daughters from a previous marriage.

The binding death benefit nomination would have paid Munro's super benefits to his estate, which would have seen this money paid directly to Suzie and, via testamentary trusts, to his two daughters. The will said that any money paid directly from a super fund to Suzie would offset what she was entitled to under his Will.

After Mr Munro had died, he was replaced as a trustee of the fund by his wife's daughter, Angela Pooley, who it appears wasn't related to Bruce.

Suzie and Angela decided that Bruce's binding death benefit nomination was invalid and said they intended to exercise their discretion as to how his benefit should be paid from the fund.

The court decided the binding death benefit nomination was invalid because it nominated the "trustee of his deceased estate". These words had been written by someone in the office of Munro's accountant.

Ordinarily, most people might know what the intention of these words was. However, referring to a 1960s Full Bench of the Australian High Court case, this form of words was not helpful in anyway. The only way the benefit could have been paid to his estate is if the binding death benefit nomination had made reference to his legal personal representative.

In any event, the three-year time limit for large fund binding death benefit nominations, which had been important in the Ioppolo case above, didn't apply in this case.

The key take out from this case is that, **if a practising solicitor can get a binding death benefit nomination wrong, then what makes anyone else think they don't need good legal advice when they complete one of these documents?**

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International ETFs and short selling

by Questions of the Week

Question: Your article comparing ETF/LIC for the Aussie market was very informative. I would like to gain exposure to European and US markets through an ETF as opposed to direct share holding.

Answer (By Paul Rickard): We do have a few articles on overseas exposure which you can access here, here, and here!

Please let me know if you have any further questions at all.

Question 2: Where do I find a list of the companies being short sold and the extent of short selling in them?

Answer 2 (By Paul Rickard): ASIC publishes short positions on their site, and you can download an excel file with all the information – updated daily – at the following link.

We also provide a table of stocks shorted in our *Switzer on Saturday* newsletter. This table also shows how their positions have changed compared to the week before.

You can view an example of this table on the latest *Switzer on Saturday* at this link.

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Don't miss this!

In this *Super Sessions* update we talk about Europe's biggest economy – Germany – and how you can gain exposure to it.