Switzer Super Report

Thursday, 7 May 2015

A foreign affair

The markets have been having a bit of a rough time this week and I have to agree with Charlie Aitken when he says that the trader reaction has been premature and incorrect, but that doesn't mean you can't take advantage of it. He says it's a great time to pick up local stocks for income and the rest of the world for earnings growth.

And on earnings growth, today Roger Montgomery examines an international fund manager – Henderson Group – that is well positioned to take advantage of European quantitative easing. You can also buy it on the ASX via Chess Depository Interests.

Bruce Tustin has been involved in SMSF administration for many years but only recently started his own SMSF. He explains his strategy today. *Buy, Sell, Hold – what the brokers* say has upgrades for ANZ and Woolworths and a downgrade for Westpac.

Sincerely,

Peter

Peter Switzer

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ASX for income, ROW for growth

by Charlie Aitken

Key points

- *From here, Australian interest rates will stay low for an extended period or go lower, while US interest rates are going only one direction, up.*
- *Earnings growth in international equities is significantly stronger than Australian equities.*
- *The average weightings of international equities in Australian portfolios are going up. You can see this in the performance of Platinum (PTM), Magellan (MFG), Henderson's (HGG) and BT Financial (BTT).*

On Tuesday, the Reserve Bank of Australia cut the cash rate by 25 basis points to a record low of 2.00%. This is another important development that supports my core asset allocation thesis of buying equity income on the ASX and buying equity growth (unhedged) in the rest of the world (ROW).

Don't follow the market

However, the kneejerk market reaction from traders and hedge funds was to short-cover the Australian dollar and take profits in Australian yield equities, led by the cum dividend banks (37% of ASX200 Index), due to the fact the RBA seemed to abandon the "easing bias" in its release.

I think that's a very, very premature and incorrect trading response and I want to take advantage of it in two ways. I want to get more money offshore into global growth stocks and, simultaneously, buy the dip in cum dividend major Australian banks.

What will happen next, when the trading dust settles and the reality of record low cash rates sets in, is the next leg down will start in the Australian dollar/ US dollar cross rate and the next leg up in domestic equity dividend yield compression starts, as holders of cash and cash equivalents get further punished.

The first place to start is the cum dividend banks. ANZ, NAB and WBC offer 13-month prospective dividends (i.e. current plus next two dividends) of 275c, 324c and 286c, which on last night's closing prices translate to 13-month prospective fully franked dividend yields of 8.2%, 9.2% and 8.4%. Grossed up 13 month yields are 11.71%, 13.1% and 12% respectively versus a cash rate of 2.00%. That is more than adequate pre-tax yield compensation for taking the risk of owning bank equity.

Even if bank shares go sideways for the next 13 months, as an Australian resident taxpayer, I should collect 11.7% to 13.1% in pre-tax dividend yield, simply for holding these three banks. That is up to six times the alternative pre-tax return from cash on deposits in the very same banks. And that is only assuming bank shares go sideways. I actually think a 10% capital gain is likely from these levels too over the next 13 months.

A last opportunity?

The fact we have seen recent aggressive short-covering the Australian dollar/US dollar cross rate, and profit taking in key fully franked dividend yield equities, further increases the trading and investment opportunity. **I actually think this is Australian investors' last chance to lower Australian dollar exposure anywhere near 80 US cents.**

From here, Australian interest rates will stay low for an extended period or go lower, while US interest rates are going only one direction, up. It's just a

matter of when. I see currency spreads as nothing more than interest rate differentials and GDP growth differentials. They are like an equity, where the GDP growth differential is the share price and the interest rate differential the yield. In terms of the Aussie/US dollar spread, the US will have the GDP growth advantage and the yield spread in favour of Australia is narrowing sharply.

The Australian dollar's yield advantage to the US dollar peaked at 4.50% in 2011 and is 2.00% today. There are clearly scenarios over the next few years where that yield advantage drops to 1.00% or even parity. That would ensure the Aussie/US dollar trades in the mid 60 US cents range. That is why it is so important all Australian investors, who are interested in maintaining their wealth in global dollars, increase their US dollar exposure either directly or indirectly as I have said for three years. Currency cycles are the longest cycles of all and this one for the Australian dollar is far from played out on the downside.

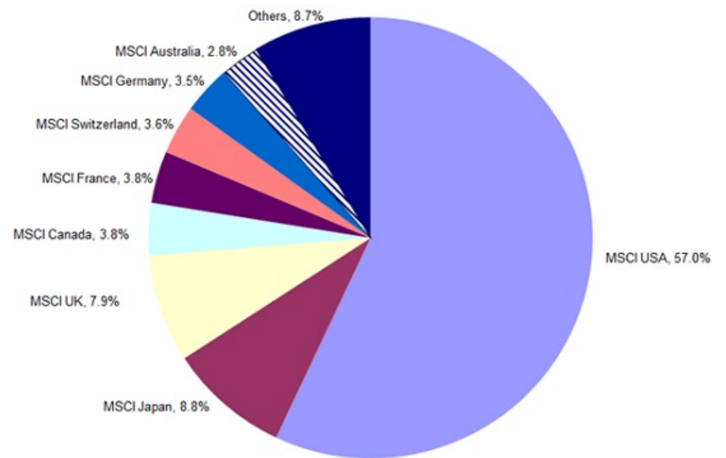
The rest of the world (ROW)

For Australians, it is important to note that the earnings growth in international (ROW) equities is significantly stronger than Australian equities and this is BEFORE you take into account any potential gains from currency translation.

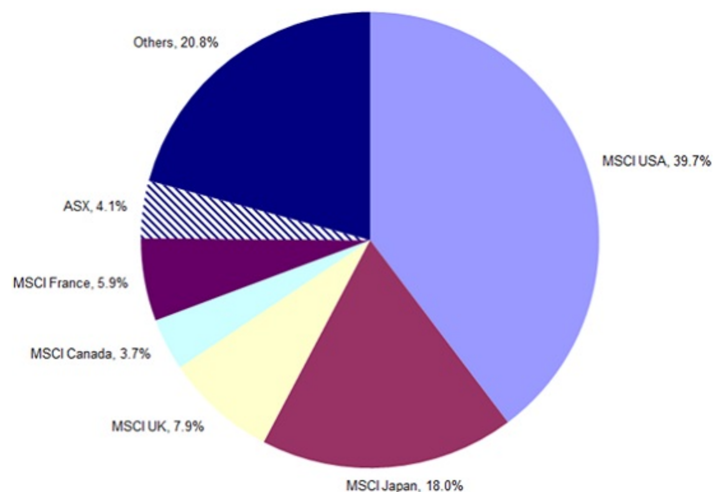
The table below confirms Australian equities have a yield advantage over the ROW, but a clear growth disadvantage over the next 12 month forecast period.

Country Index	12 month forward P/E	12 mth fwd EPS growth	12 mth fwd Dividend yield
MSCI World Index	17.0x	6.3%	2.5%
MSCI Australia	16.4x	0.5%	4.8%
MSCI France	16.7x	13.3%	3.1%
MSCI Germany	15.5x	11.1%	2.6%
MSCI Hong Kong	16.6x	3.4%	2.7%
MSCI Japan	15.3x	14.7%	1.9%
MSCI Singapore	13.9x	5.6%	3.6%
MSCI UK	15.8x	-2.1%	4.0%
MSCI US	17.5x	5.4%	2.0%

In terms of global diversification, it is also worth reminding ourselves of **Australia's weighting in the global equity universe.**



It's also worth noting from a liquidity perspective what **percentage of global average daily equity market turnover Australia is.**



Both the charts above don't include Chinese equities because at this point in time they are not part of the MSCI World Index. That will probably change in the not-too-distant future.

Volumes trading in China are staggering. In April alone, average daily turnover in Chinese mainland equities was US$229 billion. Yes, you read that right, up from a year-to-date average of US$141 billion. In Hong Kong, average daily turnover was US$25 billion up from a year-to-date average of US$14.3 billion.

This volume spike coincided with huge upside performance from Chinese equities, with the Hang Seng +14%, H shares +18% and the Shanghai Composite +19%. Year-to-date gains are now +20%, +22% and +39% respectively.

It's also worth noting that there were 30 A share IPO's in April and **the average performance since listing is +109%!**

That's a performance pie I feel very, very few Australian investors benefitted from in April and reminds you of the opportunities in the region.

Global growth

Finally, again on the diversification theme, it's worth remembering ASX200 and MSCI Australia sector weights versus the rest of the world.

Sector Weights	ASX 200	MSCI Australia	MSCI The World Index
Consumer Discretionary	4.1%	1.8%	12.9%
Consumer Staples	6.7%	7.5%	9.8%
Energy	5.1%	4.8%	7.8%
Financials	47.8%	54.2%	20.6%
Health Care	5.9%	5.6%	13.2%
Industrials	7.3%	6.0%	10.8%
Information Technology	0.7%	0.5%	13.4%
Materials	14.8%	15.4%	5.2%
Telecom Svcs	5.7%	2.4%	3.3%
Utilities	2.0%	1.9%	3.2%

Australian equities represent a huge overweight in financials and materials, while a huge underweight in consumer discretionary, healthcare and information technology.

I believe we are at the infancy of a structural change in Australian asset allocation to increase the weighting of global equities. Australians will always have some home bias, due to the nuances of the Australian taxation and superannuation system, but in my view the average weightings of international equities can only go in one direction – up.

You can see this with your own eyes in the performance of Platinum (PTM), Magellan (MFG), Henderson's (HGG) (see Roger Montgomery's story today) and BT Financial (BTT).

As the Australian dollar falls and Australian earnings growth underperforms the world, you will see more and more money flow into global products.

ASX for income, ROW for growth. That's how the Future Fund and family offices asset allocate and so should you.

Go Australia, Charlie

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Buy, Sell, Hold – what the brokers say

by Switzer Super Report

In should come as no surprise that banks feature heavily in this week's broker actions, given a few of the majors disappointed. What might be a surprise is that there were no movements on CBA with the eight brokers on FN Arena retaining their existing ratings – **Buy/Hold/Sell 1/5/2.**

In the good books

Citi and JP Morgan upgraded ANZ to Neutral from Underweight. Buy/Hold/Sell 2/4/2 First half results were slightly better than Citi expected. The Dividend Reinvestment Plan (DRP) discount and asset divestment, as an alternative approach to raising capital, allayed some concerns. Citi considers the diversification away from Australia is setting ANZ apart from its peers. Not only was the weaker Australian dollar an earnings driver but the underlying performance of the offshore business was stronger. JP Morgan analysts observed how ANZ Bank shows a good understanding of the challenges and the actions that need to be taken, but bottom line, the analysts emphasise, is the future holds a relatively uninspiring low-to-mid single digit EPS growth trajectory through FY15.

Credit Suisse upgraded Tower (TWR) to Neutral from Underperform. Buy/Hold/Sell 1/1/0 The company expects to increase the claim provisions for the Canterbury earthquake to $NZ22.4 million. Credit Suisse lowers FY15 profit estimates by 65% and increases the outer years by 9.0%. The FY15 distribution is lowered by 10%, assuming Tower will utilise excess capital to fund the first half dividend. Rating is upgraded as a result of the recent pull back in the share price and now the negative news is out of the way.

JP Morgan upgraded Woolworths (WOW) to Neutral from Underweight. Buy/Hold/Sell 0/4/4 Quarterly sales update missed and the Investor Day included a frank admission the company had dropped the ball in terms of looking after its customers. JP Morgan has decided to upgrade citing increased confidence in a turnaround. While confidence has grown, the analysts say execution will be key. Woolworths is a strong business with lots of potential, say the analysts. Their confidence stems from early signals of a cultural change.

In the not-so-good books

Citi downgraded ASX to Sell from Neutral. Buy/Hold/Sell 0/4/4/ Following the March quarter update, Citi is lowering earnings expectations for FY15-17 by 1.0%. The broker acknowledges the strong, debt-free balance sheet and yield appeal but considers the prospect for a near-term step change in earnings is limited.

Morgan Stanley downgraded Westpac (WBC) to Underweight from Equal-Weight. Buy/Hold/Sell 1/4/3 First half results missed the broker's forecasts. Morgan Stanley considers the trading multiples are stretched and margin pressure will continue to weigh on the outlook for institutional banking. Moreover, there is the risk of even more onerous requirements for investment property loans, which account for over 46% of the Australian mortgage book.

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 – easier than I thought

by Bruce Tustin

Name: Bruce Tustin
Age: 65
Other members of the SMSF: 1
Where do you live? Sydney

How long have you had your SMSF?

I've had it for five years now

Why did you start it up?

It was really to hold some unlisted shares in two or three companies that I had.

How big is it?

$1 million

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

I use an SMSF administration service and so in terms of managing it I don't have any difficulties. It doesn't take much work and it just provides the right services.

What's your asset allocation?

Currently it's around 50% unlisted shares, 30% ETFs, 20% international ETFs and 10% cash.

I wanted to not have all of the equity exposure to Australian shares because I haven't really needed franking credits, it's more about having an even spread between assets.

The asset allocation will change over time as I exit some of the unlisted shares. Ultimately, it will be 100% equities/listed and some cash, but it was also 80% unlisted at one point too. Over the next year, it will move to significantly more listed.

Are you pleased with its performance?

I have been pretty happy with its performance. With unlisted vehicles, you really don't know until you exit them what you're going to end up with but I'd say it's around 20% per annum on an annualised basis.

What are your favourite investments/stocks and why?

Australian ETFs because I'm not really a stock picker and I prefer to invest in the index.

I look at the market and it's quite volatile and, typically, the market moves beyond where it eventually lands. When I see a correction in the market, I'll buy because typically it will bounce back.

When do you plan on taking a pension?

That's probably about three years away. I'll just convert the fund into a pension at that stage.

What investments do you have outside of superannuation?

My family home.

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A stock that benefits from European QE

by Roger Montgomery

Key points

- *Fund managers can generate for their shareholders a high and an increasing rate of return on virtually no capital.*
- *Favourable conditions for fund managers might persist as the Eurozone joins the bond-buying party.*
- *Henderson Group, listed on the London Stock Exchange and available in Australia via CHESS Depositary Interests, is one such fund manager.*

As global central banks continue their quantitative race to the bottom, investors may be viewing the elevated share market as a difficult place to find attractive prospects.

I consider a high quality company to be one that can deploy large amounts of capital at high rates of return. Another type of high quality company is one that produces high, and increasing, rates of return on virtually no capital. Fund managers fit this latter category.

The fund manager fix

Fund managers are generally remunerated two ways; a fixed margin charged on the total value of assets they manage, and a performance fee charged on returns that exceed an agreed benchmark.

Assets under management (AUM) will grow when capital flows into the fund or prices of the underlying assets increase. Because a fund manager's revenues are linked to the value of the assets managed, the fund manager can enjoy strong revenue growth without requiring a great deal of additional resources.

For instance, if equity markets increase by 10% while flows remains static, then the manager only needs to track the benchmark for revenue to increase by 10%.

Fund management businesses also enjoy a high degree of operational leverage. Once a portfolio is established, it requires very little incremental cost to manage the capital flows. This means that a manager, able to grow revenues by 10% by tracking a benchmark, will experience considerably higher growth at the profit level. What's more, if the manager can outperform the market, then the share of excess returns is directly recognised as gross profit.

But beware; these forces are just as powerful in reverse and when fund flows move in the opposite direction (an issue that PIMCO has been dealing with since the departure of Bill Gross).

The global goal

That aside, it does seem as though favourable conditions for fund managers might persist as the Eurozone joins the bond-buying party. The European Central Bank has announced a bond-buying program that's equivalent to 7% of the Eurozone GDP. The credit market, however, is not large enough to absorb this investment, so capital must be forced into alternative asset classes. Indeed, this is precisely what has transpired – a sharp increase in European equity markets of 15% this calendar year has been experienced amid the flood of cash.

A company that appears to currently be well positioned to take advantage of these forces is Henderson Group (ASX: HGG). This company may not be on many investors' radars because it is listed on the London Stock Exchange, but it trades on the ASX via listed securities called CHESS Depositary Interests.

Henderson manages £81.2 billion of assets across Europe, North America and Asia. It's bigger than BT and similar in size to Colonial. The portfolio is well diversified, with 19% in European equities, 32% in global equities, 24% in global fixed income and 25% in multi-asset and alternative asset classes.

In 2013, Henderson management said they planned to double AUM within five years. Thus far, the plan appears to be on track, if it is not exceeded. The company grew AUM by 11% in the first quarter of 2015 alone. Despite this strong growth, we currently believe the share price implies that AUM will only grow with the market, seemingly underestimating the potential for major capital inflows.

Retail realisation

Another positive realisation following the recent quarterly announcement was the profile of Henderson's inflows and particularly the rising proportion of retail inflows. The retail market refers to investments by individual investors. For reasons unbeknown to us, institutions aren't willing to pay good fund managers appropriately, so Henderson's penetration into the retail market is a positive development. And those strong retail flows may be a reflection of solid performance. Henderson is outperforming the broader market, with 75% of its funds outperforming over one year and 86% outperforming over three years.

The operational leverage from the sizeable capital inflows should start flowing through the company's next financial statements. The majority of Henderson' earnings are denominated in British pounds, and the pound has remained relatively stable against the Australian dollar.

Notwithstanding a stock market correction, Henderson is a company that provides the potential for material upside. Indeed, it is one of those rare companies with fundamentals that actually benefit from an elevated share market. Should robust stock market sentiment in Europe be maintained, fund managers like Henderson are positioned well. And in a stock market where value is rare, a company that isn't being priced as euphorically as some poorer quality business is rarer still.

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Beware of tax incentives and corporate trustee structures

by Tony Negline

Tax planning is an important consideration as we head towards June 30.

It's common to see people borrow this year's investment and pre-pay next year's interest cost. They want a tax deduction for the investment (for example for agricultural investment schemes) and for the total interest cost for as little impact on their personal cash flow.

Sadly I have often seen people grab at various tax incentivised investments only to see the investment itself fail.

If the investment falls over, any loans you have taken out still have to be repaid, unless there was some inbuilt protection mechanism.

The investments cost real money and if they do fail the only advantage you will have retained are the tax concessions.

Beware of tax incentives

This was the sad state of affairs for Mark and Lorrell Jamieson, who successfully sued Westpac Bank in the Queensland Supreme Court for dodgy financial planning advice.

There is no denying this case certainly involved poor advice. But their case had another important aspect as well – the desire to reduce income by investing in tax schemes.

Over a number of years, the Jamiesons had invested in Great Southern agricultural investment schemes. They did this via an adviser, formerly licensed through a large non-bank financial advice firm.

In 2007, they acted upon advice provided by a Westpac planner to put money into a whizz-bang Macquarie Bank product. To gain any tax advantage, the Jamiesons had to borrow a multi-million dollar amount from Macquarie and pre-pay the 2008 financial year interest.

The product failed – the precise reasons aren't discussed in the case's written judgement – but the Court accepted that the GFC was the primary cause.

The Jamiesons had sought damages to restore them to the position as if no borrowing had taken place, however, they were required to revise their damages, as the Court said they would have used the amount to make an alternative investment instead.

Both parties appealed this decision to the Queensland Court of Appeal and both failed.

My simple advice – tax concessions are good and there's nothing wrong with chasing them. But they shouldn't be the main reason you invest in anything.

SMSF individual trustees show their value

I'm a big advocate for SMSFs having corporate trustees. But sometimes having this type of trustee structure might not be your best option.

In February 2015, I mentioned a 2013 Victorian Supreme Court case that enabled an SMSF to avoid having to refund contributions made with borrowed money. You can read that article here.

The SMSF initially had individual trustees but changed to corporate trustees not long before the business involved in the case failed.

The bank involved – Macquarie Bank – wasn't happy with the initial judgement and appealed to the Victorian Court of Appeal. Earlier this year, The Chief Justice of the Victorian Supreme Court agreed with

the original decision.

However, the other two judges hearing the appeal, overturned that decision in March and said the SMSF trustee must repay the money.

Interestingly, one of those judges said that if the SMSF's trustees had remained as individual trustees then it was likely that the money wouldn't have had to be repaid. The key reason here was the ignorance of the transactions and their structure by the super fund's other trustees.

Some businesses borrow to make super contributions for their employees. Not many people borrow money to make personal super contributions (as had partly occurred in this case).

However, if you are thinking about doing this, then perhaps you might want to have individual trustees for your fund and make sure that any other trustees your SMSF has don't know much, if anything, about the borrowing and the super contributions.

Then if you have financial trouble, you might not have to hand the money contributed to super back!

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Tricky transition to retirement and healthcare

by Questions of the Week

Question: If I began a transition to retirement pension this month (May), how is my maximum pension worked out? Can I then draw 10% out again in July?

Answer (By Paul Rickard): The maximum pension is calculated as 10% of your account balance on 1 July or when you start the pension. So if you commence a pension on (say) 15 May, it will be 10% of your account balance on that date. Unlike the minimum account balance, it is not pro-rated – you can take out the full 10%.

And yes, you could potentially take out another 10% on July 1 (based on the then current account balance).

Question 2: When I compare the stocks that the *Switzer Super Report* seems to follow i.e. Resmed, Ramsay Health Care, CSL, etc. to the exchange-traded fund iShares Global Healthcare IXJ, the ETF seems to outperform a portfolio of these stocks over most timeframes. I appreciate that IXJ is global but would be interested in your view.

Answer 2 (By Paul Rickard): I would be really surprised to see that IXJ has outperformed CSL or Ramsay over “most time frames”.

For example, IXJ’s five-year return (including dividends) is quoted at 22.2% per annum to 31 March 2015. Ramsay has gone from around $14.00 in March 2010 to close March 2015 at $67.24. Excluding dividends, I calculate this return to be 36.8% per annum.

Also, it looks like IXJ lost about 4.5% in April.

That said, investment in global healthcare stocks has proved to be enormously successful and as such, IXJ is one of the best (if not the best performing) ETF on the market (over most timeframes). As you say – it is global, and you are taking on a currency risk.

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Don't miss this!

In this *Super Sessions* update we review the month of April and tell you what sectors performed the best.