Switzer Super Report

Thursday, 21 May 2015

Time to pounce

The general consensus from the *Switzer Super Report* experts today is that stocks are cheap and you should use this opportunity to buy up big. Ron Bewley is almost jumping out of his skin with glee at the prospect of a much higher ASX/S&P 200 by this time next year, and is forecasting big increases for the major banks.

Charlie Aitken also believes that the non-negative Budget, along with positive signs such as yesterday's consumer confidence figures – the highest post-Budget level in eight years – mean it's a good time to get in and buy banks, fund managers and even some consumer stocks.

Also in the report today, *Short n Sweet* takes a look back at Geoff Wilson's January picks – they're up by an average of 26% each, and Tony Negline weighs up the pros and cons for lump sums versus pensions on retirement.

Sincerely,

Peter Switzer

Inside this Issue

Is it time to pounce?
by Ron Bewley
02

02 **Is it time to pounce?**
by Ron Bewley

05 **Non-negative Budget, consider oversold blue chips**
by Charlie Aitken

07 **Buy, Sell, Hold – what the brokers say**
by Switzer Super Report

08 **Short n' Sweet – Geoff Wilson delivers the goods**
by Penny Pryor

10 **Lump sums versus pensions in retirement**
by Tony Negline

12 **Question of the Week - should you take up the NAB ¨rights issue?**
by Questions of the Week

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Is it time to pounce?

by Ron Bewley

Key points

- *Conditions look good and a financial year forecast for 2015/16 might leave us just under 6,500 in June 2016.*
- *Property is probably the least attractive sector at this point in time but financials, with a yield back above 5% (plus franking credits) and a forecast capital gain over the next 12 months of 9% look tasty.*

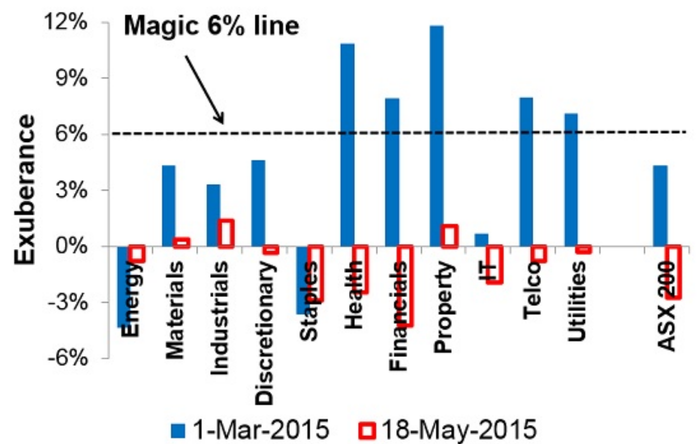
The market has undergone a major adjustment in the last little while. Some saw it as a market correction and the demise of the high-yield play. I see it as a time to get set with a little more confidence than normal. The backdrop for this posting is that it looks like our financial year forecast for 2015/16 might leave us just under 6500 in June 2016!

Regular readers will know I measure mispricing for each of the 11 major sectors of the ASX/S&P 200 and the broader index. I call this mispricing 'exuberance' and it is a measure of how far the sector prices are from my estimate of fair value. Experience has shown that when a sector or the market is more than 6% overpriced, it is so expensive that a correction or prolonged sideways movement is foreshadowed.

Exuberance measures

In Chart 1, I show my exuberance measure at two points in time: March 1 (blue bars) and May 18 (red bars). The four high-yield sectors (financials, property, telcos and utilities) were all in correction territory (above the black dotted line) on March 1 – as was the defensive (but low yield) sector, health.

Chart 1: Mispricing on the ASX 200 at two points in time



Source: *Woodhall Investment Research*

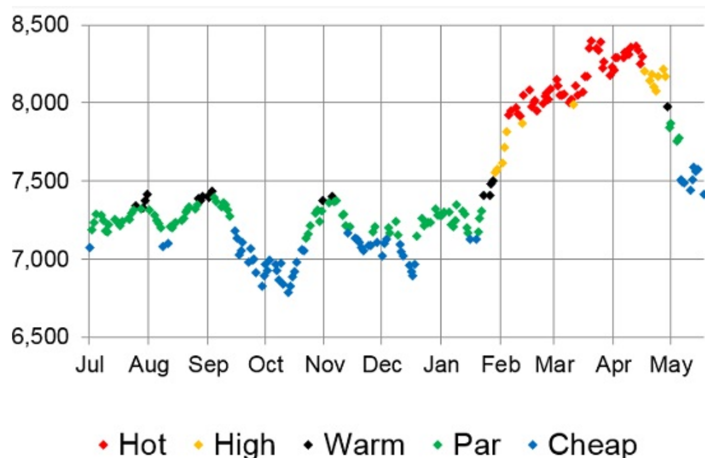
On March 1, two sectors (energy and staples) were quite cheap. Information technology was about fair price. Nearly three months later, no sector was more than a little overpriced. It is unwise to buy a stock or sector that one believes is very overpriced – even if there appears to be an attractive yield at hand. A quick snap back in price – as happened with the big banks – can erode a whole year's yield or more in a few days. Of course, investors who bought before the bubble can ignore the market gyrations. Unrealised capital gains and losses are just that – unrealised.

The financial sector

In Chart 2, I focus just on the financial sector's price index and exuberance over the current financial year. Instead of using a simple line chart to show how the price index evolved over the financial year, I have colour-coded it to show exuberance and price in the same chart – a sort of 3-D effect. The red dots signify correction territory above the 'magic 6%' line in Chart 1. The blue dots represent a bargain – or significant negative mispricing (other conditions being satisfied as I write about on my website). The other

colours fill the spectrum of mispricing. I would not buy in red or yellow territory. I am sorely tempted in green and blue. I might buy in the black if I have other good reasons.

Chart 2: Price index and exuberance in the Financials sector over time



Source: *Woodhall Investment Research*

What I see in Chart 2 is the sector was trading sideways with many buying opportunities. At the start of February, the price index grew aggressively (in yellow) and stayed in the red zone for over two months. This was a period when investors were chasing yield too aggressively after the February cut in the RBA rate. Eventually, the bubble had to pop and it did so quickly. Interestingly, the index turned blue just after the second rate cut – possibly because the RBA did not give an outlook statement making future rate cuts seemingly less likely. As it happens, the index is now just about where it was before the February rate cut.

It is important – at least in my opinion – to appreciate that we are at a reasonably unusual point in the market cycle. In Chart 3, I have calculated the average exuberance across the 11 sectors without reference to the sign. That is, the average absolute value of +2% and 2% is +2% (rather than the 'usual' average of 0%). This absolute measure gives a good idea of how balanced the market is.

Chart 3: Average absolute exuberance across sector

Source: *Woodhall Investment Research*

While the current level of the index in Chart 3 is not at the lowest – it is pretty close to it. In my opinion, this supports getting back into the market in general – or the high-yield sectors, if that is what an investor wishes.

Sector forecasts

In Table 1, I show my current forecasts for each sector and the index. Property is probably the weakest sector at this point in time but financials, with a yield back above 5% (plus franking credits) and a forecast capital gain over the next 12 months of 9% looks tasty. Of course, the diversification principles I discussed in my posting last month are just as relevant now. This table just makes me feel content about being in the market – or getting in if I wasn't already set.

Table 1: 12-month-ahead sector forecasts of yield and capital gains

ASX 200 -	Sectors	Yield	Cap gain
Resource-related	Energy	3.4%	37%
	Materials	3.6%	8%
	Industrials	3.6%	13%
High yield	Financials	5.4%	9%
	Property	4.8%	2%
	Telco	4.9%	8%
	Utilities	5.0%	7%
Other	Discretionary	3.9%	12%
	Staples	4.8%	8%
	Health	2.0%	14%
	IT	2.8%	11%
ASX 200		4.5%	11%

Source: *Woodhall Investment Research*

By the way, some readers might remember I got bullish on Cochlear when it was in the low $50’s a couple of years or so ago. Not many agreed with me at the time but I sold most of what I bought then in the low $50s at an average of above $80 with some as high as $91! I still have a small holding in Cochlear and I am prepared to get in deeper again when I think the time is right. I took profits and risk off the table for a breather.

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Non-negative Budget, consider oversold blue chips

by Charlie Aitken

Key points

- *The economic importance of providing support for both consumer and business confidence in the Budget should not be underestimated.*
- *With the cash rate at record lows, bond yields coming back down and a non-negative Budget out of the way, along with the big jump in consumer confidence yesterday, the stage is set for a return to outperformance from anything Australian with a reliable fully franked dividend yield.*
- *It's a good time to pick up the oversold major banks and fund managers like AMP, Platinum and Magellan.*

This time last year we were dealing with a Federal Budget "emergency" that arguably, due to political over-spinning, led to a genuine confidence loss in households and corporates. However, the good news is the Federal Government appears to have learnt from that tactical mistake and this year's Budget has been positive for the domestic equity market, led by consumer facing equities and high fully franked yield exposures.

Australian Budget – non-negative

According to the media, the Budget was an exercise in re-shuffling savings and expenditures programs for little result. I also read that the Budget was more about saving the Coalition than saving the Nation. While the first comment has some merit, the second is naive in the extreme. I can't ever remember a government introducing policies to intentionally lose an election. Clearly, the Government adopted a populist approach by postponing any major policy reforms and cost cutting measures in an effort to regain support. In short, the Budget was framed to appease an obstructive Senate and to pass the fairness test with the voters. The reality was the Government had no choice.

The final judgement on the success or rejection of the Budget is invariably the reaction of financial markets. In recent conversations with investors, the overwhelming response has been: "It appears the share market liked the Budget." That's true. The equity market did respond positively, led by consumer stocks and high fully franked yield exposures. I believe the main reason for the investor vote of confidence was the policy omissions rather than any major new policies. Rather than adopting an aggressive reform agenda, this was always going to be a "steady, as she goes" Coalition budget with a primary focus aimed at restoring both consumer and business confidence.

As such, the lack of any changes to negative gearing and any reference to the possibility of diluting the tax effectiveness of dividend imputation was a welcome relief for investors. Similarly, the omission of any proposal to impose any tax changes on superannuation balances or an intention to raise the GST rate was also received well by the electorate. This was important as the consumer confidence figures prior to the budget revealed genuine uncertainty in the economic and political outlook. The Budget's success was not what the Government said, but what it didn't say. I think the omission of any negative policy is a genuine positive for both Australian property and equity investors.

The importance of support

While the Budget didn't provide any major reform initiatives, the economic importance of providing support for both consumer and business confidence

should not be underestimated. It's clear that European austerity measures proved to be ill conceived and even more poorly-timed. At a time when the Eurozone was staring down a genuine deflationary threat, the harsh cost-cutting strategies aimed at reducing high sovereign government indebtedness proved a disaster. The EU chose sovereign debt reduction over economic growth, which only exacerbated and, ultimately, prolonged the EU recession.

The other positive is that an accommodative budget has taken the pressure off the RBA as the sole driver of economic growth within the domestic economy. At a recent NY conference, the RBA governor commented that monetary policy alone was unable to stimulate global economic growth. This is even more important domestically, considering the Budget papers contained yet another downgrade to economic growth forecasts following the RBA's similar move last week.

It's important to note that the Budget was complementary to RBA policy. In no way has the Budget weakened the RBA's easing bias. On the contrary, the RBA's downgrade to economic growth last week, a confirmation that inflation will remain within the target over the next two years and the recent Aussie dollar strength, has provided the RBA with the perfect opportunity to cut the cash rate again later this year. In my view, the "search for yield" is far from finished.

Although the ASX/S&P 200 has fallen below the low end of my forecast trading range 5700 – 6200, I think with the cash rate at record lows, bond yields coming back down, and a non-negative budget out of the way, along with the big jump in consumer confidence yesterday, the stage is set for a return to outperformance from anything Australian with a reliable fully franked dividend yield. The fact that franking credits weren't touched in the Budget is another positive for this theme, particularly with our benchmark ASX200 index being 56% financials.

Time to buy oversold blue chips

It may well seem boring, but I think the major and regional banks are oversold and offer solid contrarian prospective total return value:

- Commonwealth Bank (CBA)
- ANZ (ANZ)
- NAB (NAB)
- Westpac (WBC)
- Bank of Queensland (BOQ)
- Bendigo and Adelaide Bank (BEN)
- Suncorp (SUN)

Fund managers now have clear air after no changes to superannuation taxation:

- AMP (AMP)
- Magellan (MFG)
- Platinum (PTM)
- IOOF Holdings (IFL)
- BT Investment Management (BTT)

While on the consumer facing side, I continue to like:

- Wesfarmers (WES)
- Sydney Airport (SYD)
- Transurban (TCL)
- Westfield (WFD)
- Crown Resorts (CWN)
- Telstra (TLS)

This pullback in Australian industrial equities is an opportunity to selectively deploy cash. I also think the short-covering/quasi index fund covering in resource stocks is coming to an end and trading profits should be taken.

Hunker down for a long period of low cash rates in Australia. They could even go lower (1.50%) if US data continues to disappoint and the Aussie dollar remains 10 to 15 cents above fair value.

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Buy, Sell, Hold – what the brokers say

by Switzer Super Report

In the good books

UBS upgraded Bendigo Bank (BEN) to Neutral from Sell. Buy/Hold/Sell 1/5/2 The share price has pulled back since the result in February. UBS maintains its concerns over the impact of mortgage competition on margins and the reliance on the Homesafe house price gains to support the dividend. Still, potential sector net interest margin re-pricing after the bank capital raisings should support the regional banks.

Citi upgraded Oil Search (OSH) to Neutral from Sell. Buy/Hold/Sell 7/1/0 Citi has upgraded oil and foreign exchange forecasts. The broker expects the low point in oil will come in the second half of 2015, with supply and demand responses improving thereafter. The sector remains attractive for the broker although the near-term oil price is a risk. Oil Search is now closer to the broker's target as a result of the recent weakness and is upgraded to Neutral from Sell.

Citi upgraded Seek (SEK) to Neutral from Sell. Buy/Hold/Sell 3/3/2 Citi reviews the stock in the light of the recent pull back in the share price. Earnings forecasts are lowered by 4.0% for FY15. While near-term momentum is mixed, the medium-term growth story regarding domestic placements and international is intact. The broker still envisages downside risk to earnings but the shares are trading broadly in line with valuation so the rating is upgraded.

UBS upgraded Westpac (WBC) to Buy from Neutral. Buy/Hold/Sell 2/3/3 The recent result was softer than expected but the broker observes a significant pull back in the shares, with the stock underperforming peers by 5.0% and the market by 10.0%. The franchise is considered strong, with leading asset quality and strong capital generation.

In the not-so-good books

UBS downgraded NAB (NAB) to Neutral from Buy. Buy/Hold/Sell 2/3/1 The decision to spin off the UK business and strengthen the balance sheet was difficult, UBS maintains. The market may have rewarded the bank by enabling it to be the best performing major in the year-to-date but to UBS, the stock is no longer cheap. While there is medium term upside potential in business banking, the broker considers it involves significant risk.

JP Morgan downgraded Newcrest Mining (NCM) to Underweight from Neutral. Buy/Hold/Sell 0/3/5 JP Morgan observes the Australian gold sector has put in a positive performance for the year-to-date but with valuations now full and expectations of a lower gold price for the remainder of the year, the decision has been made to downgrade Newcrest.

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 – Geoff Wilson delivers the goods

by Penny Pryor

In January, we asked chairman of fund management group Wilson Asset Management, Geoff Wilson, to write about three great stocks you'd never head of.

We gave him leeway to mention a company he's involved in because it had a philanthropic bent but either way, just five months on, these companies have certainly delivered the goods.

IPH Limited (IPH)

This is a patent and trademark attorney group, better known as Spruson & Ferguson, and is one of the leading intellectual property services firms in the Asia-Pacific region.

In January, Geoff said; "The industry fundamentals are strong. IPH is one of the first patent attorneys to list, providing the potential to act as a consolidator of the sector going forward. The industry is characterised by good cash flow, recurring revenues and high quality clients, particularly so at IPH."

It was trading at around $3.65 when he first mentioned it and is now at $4.70, an increase of 29%.

Source: *Yahoo!7 Finance, 21 May 2015*

Mantra (MTR)

Geoff's second company was hotel group Mantra, which listed in June last year. Geoff explained that in the last decade, Australia has experienced an undersupply of new hotel rooms being built to meet the increasing demand from overseas and domestic travellers.

"As a consequence, hotels are experiencing very high occupancy rates and seeing increases in RevPAR, or revenue per available room (a common performance metric in the hotel industry) across Australia," he said.

And what about its share price? Well it was about $2.75 when Geoff mentioned it and is $3.90 now. That's a rise of 42%!

Source: *Yahoo!7 Finance, 21 May 2015*

Future Generation Company (FGX)

Geoff's third pick was the listed investment company, the Future Generation Company, of which he is a director. Wilson Asset Management is one of the 14 participating fund managers investing FGX's capital, which have offered their management services to the LIC for free. That pro bono support will enable it to donate 1% of its assets to children's charities each year.

It hasn't had as big a jump up as our other two dynamos but it has still risen around 8% since January.

Source: *Yahoo!7 Finance, 21 May 2015*

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Lump sums versus pensions in retirement

by Tony Negline

Key points

- *The two main attractions of super pensions in SMSFs for those aged at least 65 are their tax-free nature – both the investments themselves and the income paid – and the fact that there is no maximum on the income drawn.*
- *The main advantage with lump sums is their flexibility.*
- *The good news is that if you feel you have made the wrong decision, then with good paper work you can easily change your mind.*

Australia's retirement policy has always had one feature shared by few other countries – we allow retirees to take all their money out of super and do whatever they want with it.

This flexibility constantly allows critics to claim that many retirees face some sort of moral hazard in that they will waste their retirement money on consumables or luxuries, such as holidays, and then go on the Government's aged pension.

It's true that new retirees are keen to enjoy their newfound freedom and travel around Australia and abroad. They might also use some of their super to pay off their mortgage and other debts, renovate their home or update their motor vehicle and home furnishings.

But use all their super savings? Yes, this definitely happens in some cases but it's rare. For some people, ready access to a large amount of money burns a hole in their pocket.

However, most retirees recognise that aged pensioners aren't particularly well off, retirement might last many years and retirement homes later in life probably have to be funded.

The family home is a powerful asset

According to the Centre for Independent Studies, over 90% of retirees own their family home and don't have a mortgage.

There are three main advantages with this approach:

1. It is often cheaper to own a house than rent, as well as the ongoing emotional attachment to the building and locality.
2. Bequeathing the family home to surviving children receives various tax concessions, especially Capital Gains Tax and State or Territory duties exemptions or reductions.
3. The home is exempt under the Age Pension Assets Test – in reality, homeowners are treated very favourably under this test.

By the time retirees have reached their early to mid eighties, the majority of their super and other savings have been used, however most still own their home.

Lump sums versus pensions

The two main attractions of ***super pensions*** in SMSFs for those aged at least 65 are their tax-free nature – both the investments themselves and the income paid – and the fact that there is no maximum on the income drawn.

However, super pensions come with various restrictions and costs including the following:

1. You must take income each year and that income must satisfy a specific minimum – for example, if you are at least 65 years in age

but less than 75 years, then 5% of the market value of your pension's assets has to be paid as income each financial year.

2. These minimum income factors increase as you get older. And you have to take this minimum income even if you don't want or need it.
3. The income in most cases must be paid with cash.
4. Your fund might need an actuarial certificate each year if you have pension and non-pension money in your fund.

What about **lump sums?** The main advantage with lump sums is their flexibility. Once aged at least 65, lump sums can be taken at any time for any amount. In other words, you only take out what you need and you're not restricted by the minimum pension income rules.

There are two disadvantages with lump sums:

1. Although you might be retired, the income and realised capital gains from your super assets (if not used to support a pension) will be taxed at 15%.
2. Your fund needs to complete paper work every time a lump sum is paid and your SMSF administrator may charge a fee to organise and record each payment; this includes the need to recalculate your taxable and tax-free components on the day each lump sum is paid.

Centrelink assessments

From 1 January 2015, lump sums and pensions are treated in the same way for Centrelink age pension purposes. Under the income test, the pension is deemed and the market value of your super assets is counted for the assets test.

What's the better option?

For most people, the full tax exemption from pensions will prove the better option – as well as the ability to take lump sums whenever necessary.

However, some will prefer the complete flexibility of the lump sum approach.

The good news is that if you feel you have made the wrong decision, then with good paper work, you can easily change your mind.

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Question of the Week - should you take up the NAB rights issue?

by Questions of the Week

Question: Would you kindly help me with the NAB renounceable entitlement shares please. I hold just under 500 shares. Should I participate in this offer?

Answer (By Paul Rickard): NAB is conducting a two for 25 rights issue at a price of $28.50 per new share. So, for your 500 NAB shares, you will get 40 rights that allow you to buy new NAB shares at $28.50.

You have three choices:

1. Take up the rights – you will pay $28.50 for the new shares or a total of $1,140. You must do this (and pay for the shares) by Monday 1 June;
2. Sell the rights on the market – ASX code NABR. Currently, around $4.90 (the price will be very close to the current NAB share price minus $28.50). Rights trading ceases next Monday 25 May;
3. Do nothing – in which case, your rights will effectively be auctioned to the institutions – and you should receive a cheque back.

The options you should probably consider are one or three. While you could consider option two, brokerage costs may eat into the proceeds (gross proceeds before brokerage will be around $196). The downside with option three is that you have no control over the timing or any expenses charged.

So, if you have the cash and want to invest more in NAB, take option one.

If you don't have the cash, or don't want to increase your exposure to NAB and banks in general, do nothing and wait till NAB sends you a cheque. If you want certainty around the price and brokerage costs are small, then sell your rights on the ASX.

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