Switzer Super Report

Thursday 4/6/15

Money in the bank

So the market is looking a bit topsy-turvy again. Yesterday's GDP numbers were great but the market was underwhelmed. But don't fret, today Charlie Aitken explains why you can still bank on the banks. He answers the three key questions that have probably been bothering you: Why have banks fallen so far? Is the search for yield over? If so, do I sell banks now?

Also in the *Switzer Super Report* today, we've got a *Fundie's Favourite* on Lend Lease from Paul Kasian at Equity Trustees and Roger Montgomery answers some key questions on value management.

In *Buy, Sell, Hold – what the brokers say*, Harvey Norman and REA Group get upgrades and *Short n' Sweet* takes a look at what's going on at Medibank. Meanwhile, Tony Negline explains the importance of splitting superannuation with your spouse.

Sincerely,

Peter Switzer

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Still banking on it

by Charlie Aitken

Key points

- *The correction in the domestic banks has occurred due to a spike in bond yields and the imminence of new global and local regulations requiring banks to hold more capital, theoretically implying lower earnings and dividends.*
- *However, the search for yield theme hasn't been undermined by these recent events.*
- *Investors in banks are receiving a 600 basis point risk premium against a further rise in global yields.*

The sharp correction in the domestic bank sector has seen -15%+ falls for the major Australian banks (-20% plus in US dollars). With the big four banks alone representing 30% of the benchmark S&P/ASX 200 Index, this has driven an associated 370 point pullback in the S&P/ASX 200, reminding you how concentrated the Australian market is. Banks are most likely closer to 50% weightings in the average SMSF in pension mode, therefore it is understandable that my inbox gets inundated whenever there is a bank sector pullback.

In recent email responses, and in discussions at presentations, banks have now become the main topic dominating domestic investor interest. There are three questions regularly asked. Why have banks fallen so far? Is the search for yield over? If so, do I sell banks now?

Why have banks fallen so far?

The Australian banks have been harshly treated for two reasons. Firstly, government bonds had become mispriced due to QE policy and the subsequent search for yield. This mispricing finally led to a violent unwinding of a very crowded long trade in government bonds, particularly the German bund, which in turn has led to a profit taking rally and a spike in global long bond yields. That now seems to have settled down a notch, with Australian 10yr bonds back down to 2.89% from a recent high yield of 3.05%.

In Australia, the search for yield has manifested itself in the demand for fully franked bank dividends. This demand has distorted traditional valuation criteria with banks being priced on yield rather than earnings multiples. Naturally, any rise in bond yields (the expectation of future interest rate levels) will have a detrimental effect on interest rate sensitive stocks (banks). As a result, the spike in global bond yields has sparked a savage correction in yield-based asset prices, particularly Australian banks, which have the highest dividend yields in the developed world.

Secondly, the rise in bond yields has occurred against a backdrop of new global and domestic regulations requiring banks to hold higher capital ratios. The global regulations require all banks to hold higher overall Tier 1 capital under the Basel rules. To date, Australian banks have made reasonable progress in attaining the new global regulations.

The new Australian regulations proposed under the Murray Financial Services Inquiry, require banks to hold more risk-weighted capital against residential mortgages. The consensus is that between $15-$20 billion in new capital will need to be raised by the major four banks. In the recent $5.5 billion NAB rights issue, $2.2 billion was allocated to meet the new domestic regulations, while Westpac has raised $2 billion from its dividend reinvestment program. Meanwhile, both capital raisings, particularly the NAB rights issue, have only served to exacerbate the share price weakness.

The conventional wisdom dictates that less capital to lend equals a lower rate of return on equity, which

ultimately leads to lower profitability and slower dividend growth. The new capital regulations set against rising bond yields has created a perfect storm for the domestic banks sector. In the ensuing hysteria, some are viewing the correction as proof that the recent era of bank outperformance is over, while many brokers have adopted underweight positions on the sector.

In summary, the answer to the first question is: the savage correction in the domestic banks has occurred due to a spike in bond yields and the imminence of new global and local regulations requiring banks to hold more capital, theoretically implying lower earnings and dividends.

Is the search for yield over?

Now let's look at the second question. Is the search for yield over? As I have mentioned many times previously, the search for yield is a global theme driven by financial repression. In simple terms, central bank policy has artificially compressed both short and long-term interest rates, which has lowered the returns for cash and cash equivalents, such as bonds and term deposits. As a result, investors are forced into more risky asset classes such as equities and property in search of higher yield.

So, does the recent spike in bond yields invalidate the search for yield? No, is the short answer. Here's why. Bond yields are a future reflection of the expectation of short-term interest rates, which in turn are driven by economic growth and inflation expectations. Currently, with the exception of the US, global growth is anaemic and inflation remains at historic lows. Even the US economy is sending mixed growth signals. More importantly, the Fed has categorically stated that any rate rises will be slow and measured.

Investors appear more concerned with the timing of the first move in US interest rates, rather than the magnitude of the subsequent rate rises. Let's look at the facts. The official forecast for the Fed Funds Rate (cash rate) at the end of next year is still just 1.75%. Rather than ultra-low, US cash rates will still remain extremely low, relative to history. The search for yield is far from finished.

Although the Fed has finished its QE policy, the other major central banks have the monetary taps turned fully ON. Incredibly, the size of the current QE programs operating by the ECB and BOJ have the capacity to buy 100% of the planned sovereign debt issuance of both regions for the next 12 months. Meanwhile, the Bank of England is still operating its own QE program. Clearly, long government bonds remain badly mispriced, but in the medium term, central bank policy is committed to ultra-low bond yields and even lower cash rates.

There's no doubt that central bank policy has created another asset class bubble. Like all the others, it too will end badly. The recent spike in bond yields is a warning. At the same time however, history shows that the catalyst for all bond bear markets and crashes (there haven't been many) all began with an aggressive tightening of US monetary policy. At the moment, the Fed remains dovish. History also dictates, " Don't fight the Fed." In short, my view is that the rise in bond yields is a correction, rather than a warning that global cash rates will rise dramatically. As such, the search for yield theme hasn't been undermined by recent events.

Do I sell banks?

That brings us to the third question. If the search for yield is over, do I sell the banks? Given my benign view on bond yields, the obvious answer is no. Here's why. As I have mentioned, the Fed expects the US cash rate to be just 1.75% by December next year. In Australia, the RBA basically admitted a policy error recently (as I predicted) by reiterating that any further rate cuts will remain policy dependent. At the same time, the RBA downgraded its forecast for 2015/16 domestic GDP growth by a 0.5 percentage point. By implication, a further rate cut is likely with any additional economic weakness and any further strength in the Australian dollar. My view is both outcomes remain highly likely to occur.

After the recent correction, the big four banks are yielding over 5% fully franked once again. This implies a tax effective yield of nearly 8% grossed up for franking credits. This compares to a NON tax-effective cash rate of 2% with a good chance of a further rate cut to 1.75%. At current levels, bank investors are receiving a 600 basis point premium for

investing in bank dividends rather than cash. Put another way, investors are receiving a 600 basis point risk premium against a further rise in global yields. I'm a simple man but the risk/ reward appears very skewed in favour of fully franked bank yield.

Add on any weakness

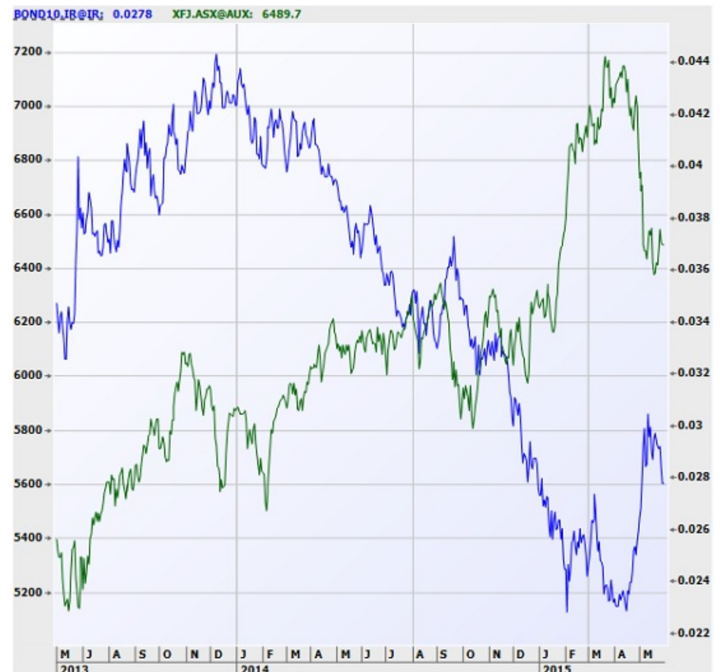
The recent hysteria over an expected decline in bank earnings and dividends due to higher capital requirements also appears misplaced. On consensus expectations of $15-$20 billion in additional funding required to meet the new regulations, both NAB and Westpac are nearly 50% complete. In particular, Westpac has raised $2 billion by merely underwriting its dividend reinvestment plan. In addition, the expected fall in bank profitability appears dependent on static earnings from the bank's other divisions. Just recently, net interest margins were supported by banks not passing on the full rate cut. The banks have many growth levers to offset changing industry conditions. I don't see the new capital requirements as draconian.

The residential housing bubble is another perceived risk for bank earnings. With the exception of Sydney, national house prices are growing at just 4-5%. Even more importantly, the loan to value ratio across the major banks indicate that the average mortgagee has nearly 50% equity. Bank bears have been calling an end to bank profitability for years but to date it has failed to materialise.

In Australia, dividends have contributed roughly 60% of total equity market returns. In the last decade, bank dividends have been cut just once, which occurred in the GFC. In a low-growth, low-return environment, with a cash rate of just 2% (and risks it goes lower), it makes no sense to sell bank shares. Particularly within the tax effective superannuation umbrella, where a superannuant receives an ATO refund for the franking credits. <u>My advice is don't sell banks but add to existing holdings on any weakness.</u>

The final chart confirms that Australian Government (AGB) 10yr bond yields (blue) and the ASX200 Financials Index (XFJ) (green) are extremely inversely correlated. With AGB 10yr yields reverting to yield downtrend as Australian economic data remains sloppy it is fair to expect a bounce in the financials index from these oversold levels, led by the beaten up major Australian banks.

Shut your eyes and buy one of them today is my advice to Australian investors who can value franking credits.



Australia for income, rest of world (ROW) for growth.

Go Australia, Charlie

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Q&A with a value investor

by Roger Montgomery

Each month I chat with Peter on his show – and let me say that I believe he is working himself into the deck to bring to you the latest insights and ideas. As a result of these appearances, we sometimes receive questions that we gladly answer. Here are some answers to the more common questions we receive about value investing and the Montgomery investment philosophy.

Question: If you see the market as overvalued and most stocks you look at above their intrinsic value, do you just stay in cash until they become cheaper, even if you could be waiting years (like the 2003-2007 period)?

Answer: It is true that in theory, yes, we would have to wait years if value wasn't present. In practice, however, this is rarely, if ever, the case. First, we aren't investing in 'the market', we are investing in individual businesses and, while the broader market can be expensive, we can still be offered mouth-watering opportunities under various circumstances. This is even more true now that we will be investing globally as well as locally. Consider the recent sell off in the price of Sirtex. We had sold a meaningful portion of the fund holdings at above $32 and following the announcement of trial results, we managed to repurchase those shares at under $18. The shares subsequently rallied, in just a few weeks to over $28. All the while, the market was described as 'expensive'.

Question: I know you like stocks that pay no dividends, but what happens if management does something stupid and the stock price plummets? At least you have got something from your investment if you have received dividends.

Answer: You have misunderstood our stance on dividends, which is quite a common misunderstanding. Our position is that all things being equal, a company with a high ROE that can retain its profits and compound them at a high rate, is worth more than a company with the same ROE but paying some proportion of its earnings out as a dividend.

We are quite happy to buy companies that pay dividends but a lower price must be paid for a business that earns a high return on equity but pays more of those earnings out, rather than reinvests.

Question: What is your view of commodities? I understand that you like to value companies based on ROE, RR, etc, but do you ever try to reasonably predict the metal/commodity/gold price for next year?

Answer: While we presciently called the end of the iron boom some years before it occurred, we believe it is mostly impossible to predict prices of anything in the short term. Over longer periods, there are supply/demand considerations that might be easier to discern.

With regards to taking advantage of this, I have so far been biased to investing in the commodity itself rather than stocks. Companies that mine, plant or otherwise produce a commodity have risks associated with them that are unrelated to the commodity's price itself. For example, for an exploration company, there are funding risks and execution risks, not to mention agency risk and stock market risk.

I am loath to invest in commodity type businesses because they are the antithesis of a high quality business – one being able to raise prices in the face of excess supply, without a detrimental impact on unit sales volume.

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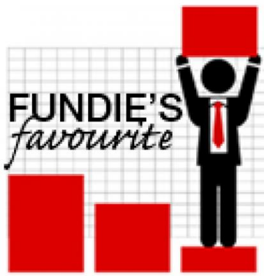


The perfect leverage to the property market - Lend Lease Group

by Fundie's Favourite

How long have you held Lend Lease Group (market cap $9.5 billion)?

We've had an overweight position versus the benchmark in Lend Lease Group (LLC) since July 2014.

What do you like about it?

Lend Lease Group is leveraged to the Australian property market cycle through its residential development division. The low interest rate environment, combined with strong overseas demand, is driving its strong pre-sales of residential apartments across its portfolio (in Australia and the UK), under-pinning its development profit for the next three years (given two to three years lag for settlement). In addition, Lend Lease has continued to grow its residential projects pipeline with a number of new offshore projects announced recently in Asia and the USA.

How is it better than its competitors?

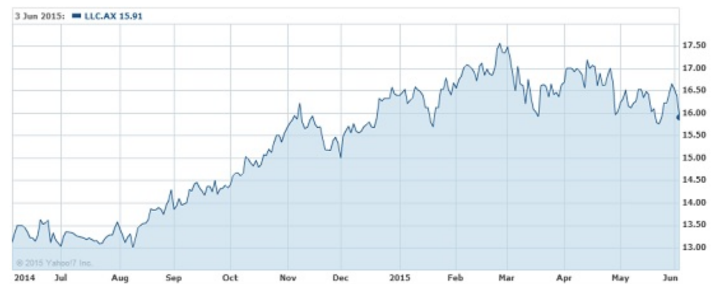
The company has extensive residential development experience in Australia, with the largest urban regeneration projects pipeline in multiple geographic locations. Lend Lease Group has a global footprint, enabling the company to diversify its portfolio risk and leverage its core competencies in offshore markets.

What do you like about its management?

Experienced senior management and a supportive board have a clear long-term strategy and vision. Management has improved its internal risk-management and has been focusing on creating a projects portfolio effect to diversify its risk and market exposure.

What is your target price on Lend Lease Group?

Around $18.50 in the next 12 months.



Source: *Yahoo!7 Finance*

At what point would you sell it?

We will look to review our position if the domestic property cycle shows signs of deteriorating.

How much has it added to your overall portfolio over the last 12 months?

Lend Lease Group is up around 28% over the past year, outperforming the S&P/ASX 200 Accumulation Index, which is up around 8% on a total return basis over the same time period.

Is it a liquid stock?

Yes. There would be no liquidity issues for most global and domestic investors.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Macquarie upgraded Harvey Norman (HVN) to Neutral from Underperform. Buy/Hold/Sell 4/2/2
Harvey Norman no longer reports quarterly sales data but feedback suggests a strong second half for the retailer, with the tailwinds of rising house prices, the May rate cut, improving consumer confidence and the Budget's small business incentives. Ireland is also rapidly improving. The broker believes the good news is largely reflected in the share price but that the risk is to the upside over the next 3-6 months.

UBS upgraded REA (REA) Group to Buy from Neutral. Buy/Hold/Sell 5/2/3 UBS considers REA Group is cheap relative to its online peers. The market attributes almost no value to the international assets and the leads-based opportunity. The stock underperformed since the March quarter as slower revenue growth was affected by a number of factors the broker believes are transient but the long-term growth profile is intact. UBS upgraded on valuation grounds.

In the not-so-good books

Deutsche Bank downgraded BHP to Hold from Buy. Buy/Hold/Sell3/4/1 Now the de-merger of South32 (S32) is complete the focus for BHP turns to oil and copper and Deutsche Bank envisages difficulties with growth. Oil production will peak in FY15 because of a drop in US onshore volumes, conventional field decline and a lack of growth options. Moreover, for the first time in over a decade the company's copper equivalent production growth is flat.

JP Morgan downgraded Southern Cross Media (SXL) to Underweight from Neutral. Buy/Hold/Sell 2/3/3 JP Morgan envisages challenges ahead for Southern Cross Media with continued ratings issues in metro radio and regional TV as well as the company's high gearing relative to other Australian media operations. Advertising conditions are weak and there appears to be no quick fix. JP Morgan also notes a likely increase in the affiliation fee with Ten Network (TEN) from FY17 onwards.

Credit Suisse downgraded Sydney Airports (SYD) to Neutral from Outperform. Buy/Hold/Sell 3/4/0
Credit Suisse does not expect an uplift in distribution guidance at the first half results because of sensitivity around international aeronautical fee negotiations. Revenue estimates are trimmed on lower passenger growth and weaker retail revenue expectations although this is partly offset by lower financing costs. The risk/reward is considered balanced and the stock fairly valued so Credit Suisse downgrades to Neutral from Outperform.

JP Morgan downgraded UGL(UGL) to Underweight from Neutral and Macquarie to Underperform from Neutral. Buy/Hold/Sell 0/1/6
The operational update guided to FY15 earnings of around $47 million, lower than the broker's forecasts of $60.1 million. The second half will be affected by further impairments and restructuring costs. The company has provided a guide to recovery but success is now dependent on execution and the broker notes risks include failure to win LNG maintenance contracts, delays in the ramp up of infrastructure building and delivery of Ichthys. Macquarie warns stability needs to be sustained and the Ichthys project is only 30% complete.

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 – Medibank private

by Penny Pryor

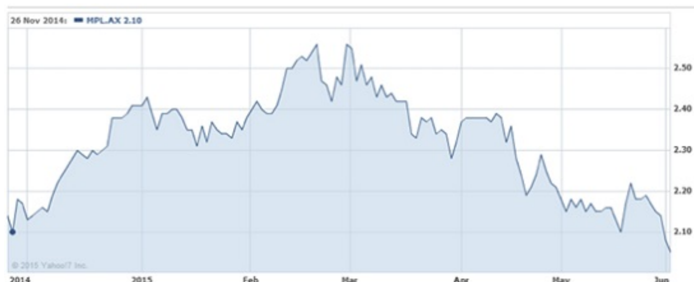
When *Switzer Super Report* co-founder Paul Rickard analysed the Medibank IPO last October, he said that it was priced at the top end of the range and forecast dividends were "dressed up".

The main story for Medibank was always going to be the cost out story and its success would depend on its ability to reduce its management expense ratio.

While the company delivered on its forecast, with an expected MER slightly better than the prospectus forecast at its recent first half results announcement, the market was not impressed. Perhaps some were hoping the prospectus forecasts were conservative and were expecting much better.

"If some analysts and investors thought this, then I would put this in the naive category. Unlike some earlier privatisations, Medibank has retained largely the same board and management team post privatisation – so it has always been unclear why privatisation would be that material an enabler to taking cost out," Paul says on *Switzer Daily* today.

The company certainly did very well for a little while at the beginning of this year, getting as high as $2.59 before its first half profit results. However it is now around $2.05 and below the listing price of $2.11.



Source: *Yahoo!7 Finance*

The moral to this story could well be that not all government IPOs are great. At current prices, Medibank is trading on a multiple of 20.7 times FY15 earnings and 19.1 times FY16 earnings.

That might still be too high for Medibank and Paul says he'd only see value if it got down to $1.75, or a multiple of 16.3 times FY16 earnings and a dividend yield of 4.5%, instead of the 3.9% fully-ranked yield it is now expected to pay.

The five brokers that rate the stock on FN Arena are, in aggregate, relatively downbeat with only one Outperform (from Macquarie), three sells or underweights (UBS, Morgan Stanley and Credit Suisse) and one Hold (Deutsche Bank). The consensus target price is $2.21 with a range between $1.85 and $2.65.

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Split contributions while you can

by Tony Negline

Key points

- *As Australia's population ages over the next three decades, future governments may be tempted to impose new taxes on superannuation balances.*
- *The process for splitting contributions is very simple, all you have to do is complete a Tax Office form.*
- *You can split contributions if your spouse is aged under 55 and if they're aged between 55 and 65 and not retired. You can be of any age.*

The financial year-end is fast approaching and there are quite a few issues all superannuants need to think about before 1 July.

Today, I'm going to look at "contribution splitting".

This strategy has been around for 10 years. It involves taking some or all of your contributions and transferring them to your spouse.

Who cares about splitting super – it's tax-free after 60?!

This is a good and fair point. However it is still very relevant.

Contribution splitting was originally introduced to provide some relief from punitive taxation when someone exceeded their Reasonable Benefit Limit or RBL.

Thankfully, RBLs are no longer with us. But the desire to tax higher account balances in super never seems to be far from the headlines.

Indeed, it seems that the ALP will definitely head to the next federal election, with a policy of taxing pension account balances if the income generated exceeds $75,000 in any financial year. It is unclear if this new announcement includes realised capital gains but under a similar policy the ALP announced whilst in government, these were added into the definition of income.

Notice that the focus is on account balances, not on the earnings of the super fund.

As Australia's population ages over the next three decades, future governments may be tempted to impose similar taxes.

So one way to potentially avoid these higher taxes problem is to split your super contributions with your spouse – assuming you're lucky enough to have one.

Effectively, you take contributions made either by you or for you and transfer them to your spouse's super account. In this way, the value of your account balance increases at the slower rate than it otherwise might have.

It may also mean you're eligible for a part age pension.

Your fund's trust deed

Contribution splitting is definitely allowed in the super laws.

But is it in your fund's trust deed? You need to check this first before doing anything else.

Administration fees

The process to split contributions is very simple.

All you have to do is complete a Tax Office form,

which is available at this link.

It shouldn't take more than about 10 minutes to fill this form out.

Once it's done, you simply hand it to your fund's administrator. They will then look after the rest. They'll need to keep the document on file because it's a tax document and your fund's auditor might want to see it when checking the accuracy of your fund's financial transactions and compliance with the super laws.

Your fund's administrator might want to charge you a fee to help you complete the form, file it and to implement it in your fund's financial accounts. You should check with them how much they charge.

Age restrictions

You can split contributions if your spouse is aged under 55 and if they're aged between 55 and 65 and not retired. You can be of any age.

You can't split contributions with your spouse if they're aged between 55 and under 65 and are retired.

If your spouse hasn't been in paid employment for many years, then there may be an argument that they're retired. If this applies to you and your spouse, then I encourage you to take advice before proceeding with contribution splitting.

Time limit for fund to receive splitting document

For your 2013/14 financial year contributions, your splitting document must be received by your fund before 30 June 2015.

A super law allows you to submit the contribution splitting notice in the year the contributions are made if your whole super benefit in a fund is about to be paid out. However, this is very rarely used.

What contributions can you split?

For SMSFs, you can split all personal contributions that you've claimed as a tax deduction and all employer contributions, including salary sacrifice.

All after-tax or non-concessional super contributions and small business CGT contributions can't be split.

A simple and easy transaction

This is one of the simpler transactions to implement within super.

For what it's worth, I have done this for the last several years and will continue to do so unless the law is changed.

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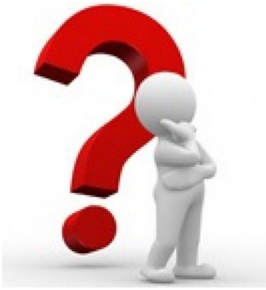

What to do with Macquarie and the India Fund

by Questions of the Week

Question: Is there any chance you could provide some informed commentary on the upcoming India Fund float.

Answer (By Paul Rickard): Two pieces of advice re the India Fund:

a) Read the prospectus very carefully; and
b) On listing, the NTA will be $0.96 per share (you are paying $1.00 for something worth $0.96.) Of course, there is a free option as well.

My guess is that if you want to invest, you may be better off waiting until it lists on the ASX.

The Indian market has had a fantastic run up over the last two years. While it is a growth economy, it is not without its challenges – so invest in moderation.

Question 2: Where is the Macquarie Group headed or is it already overpriced and over rated? Should I consider it as a potential growth opportunity?

Answer 2 (By Paul Rickard): I much preferred Macquarie Bank when it was around $20 a few years back – so I am a little wary about it at around $80. In fact, it is up almost 40% this calendar year – starting at $58.29 and now $79.70. That said, the company is driving forward and it is a company that will benefit from a lower Australian dollar.

Macquarie's FY15 result beat most of the brokers' forecasts. While positive on the stock, the brokers in the main remain wary given the share price appreciation. According to FN Arena, sentiment is +0.4 (scale -1.0 is most negative to +1.0 most positive). The consensus target price is $81.56 (a small premium to the current price), with the stock trading at a FY16 multiple of 15.5.

You will note that Macquarie is a member stock of our growth portfolio. I don't see any reason to sell – just not sure I want to buy more at this price. So bottom line, look to buy on a market dip.

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