Switzer Super Report

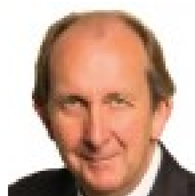
Thursday 16 July 2015

Walk this way

You know me, I don't like to skite – but I do like to point out good value for our subscribers. Yesterday there was some great value to be had for anyone who had followed Paul Rickard's advice for Westpac and BT Investment Management shareholders to buy shares in the BT share subscription plan on 22 June.

The offer closed over-subscribed yesterday and Paul says, it was "a very low risk way to make money for Westpac shareholders". Paul went all in for $10,000 and is up $1,952 (on paper), but even if you'd gone in for just $5,000 you would have made over $1,000 and you would have more than paid for your annual *Switzer Super Report* subscription!

In more money-making ideas for you today, we've got Charlie Aitken's view on US dollar movements and how to get exposure, and James Dunn reviews the retail sector to single out the flyers and the divers and those that just might be taken over to create some extra value for shareholders.



Sincerely,

Peter Switzer

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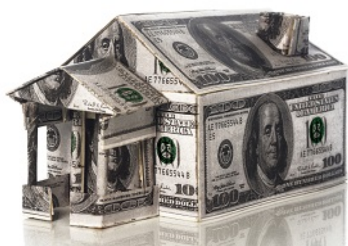

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36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

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Take advantage of dips to build US dollar exposure

by Charlie Aitken

Key points

- *If you can successfully visualise (forecast) the interest rate, currency, commodity and GDP growth points of 18 months from today, then you give yourself every chance of being a successful investor.*
- *This short-covering bounce in the A$/US$ cross, on what is unbelievable Chinese GDP data, is just another chance to get more cash into US dollars and British pounds, the only two currencies in the world that will see interest rate rises this year.*
- *ASX listed industrial US dollar earning stocks have positive consensus earnings revisions pending.*

It has been a very volatile period with global and local markets reacting to every "Twitter headline" on Greece or China. In fact, on Tuesday in America, Twitter shares themselves spiked 10% on a fake takeover rumour from, you guessed it, a tweet!

Pricing the present…

This simply reinforces my view that markets price the present. In fact I can never remember a period (outside of the GFC) where markets were reacting so violently to headlines.

With advances in telecommunications and the fact 60% of all daily turnover is high frequency trading (HFT), it should be no surprise to any of us that this is now the case.

In my opinion we all need to adjust our investing styles to accommodate for these "pricing the present" markets. I don't think it's possible to beat the "machines" and the now very level playing field in instant information.

My approach is to take advantage of the present by focusing 18 months out. I've written this before but I believe the sweet spot in investing is 18 months forward. If you can successfully visualise (forecast) the interest rate, currency, commodity and GDP growth points of 18 months from today, and also how the "herd" will react to those settings, then you give yourself every chance of being a successful investor.

It's much easier said than done as the short-term noise can easily distract you from the main game. It's almost too easy to be put off by the short-term noise and start questioning your medium-term investment strategy.

You also have to be able to tolerate markets moving against you in the short-term, which again, is easier said than done.

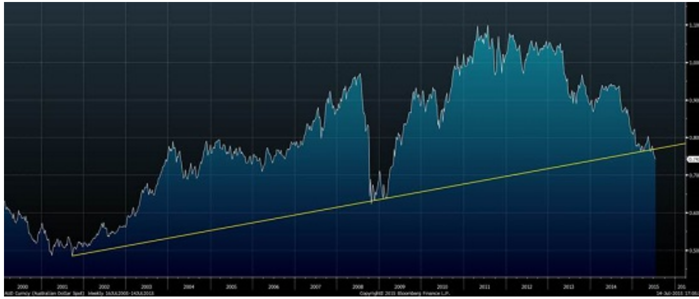
…but investing for the future

In reality most currency, commodity, interest rate and equity market trends are long cycles. Sure, they can have short-term volatility, but the trends tend to be longer and deeper than anyone ever forecasts.

The biggest change I have noticed in my move from stockbroker to fund manager is I now have far more time on my side to research and think about ideas. Broking needs action on a daily basis, that's the nature of the industry, while in funds management you need to get more right than wrong over the medium-term.

I'm really enjoying the change as you realise you don't need to do anything to portfolios on a daily basis. In fact, when you do act, it is adding to a position you have for the medium term when the market is giving you another short-term risk adjusted chance.

A classic example of this earlier this week was the kneejerk bounce in the Australian dollar. As you know I think the Australian dollar/US dollar is in structural decline and my medium-term price target is 65 US cents. The long-term chart below confirms the decade long uptrend is clearly broken and there is clear technical air below.



Of course that doesn't mean the A$/US$ can't have short-term trading bounces. That happened yesterday due to the combination of weaker than expected US retail sales and stronger than expected Chinese GDP data for the second quarter. The A$/US$ cross gained about 1.00% on that combination on trader short-covering.

Clearly Beijing wasn't going to print a bad GDP number after the massive correction in Chinese equities, and unsurprisingly the number came in at "7%" versus the consensus view of "6.8%". It remains beyond belief that Beijing can collate GDP data from 1.2 billion people just 15 days after the end of the quarter!

Honestly, all Chinese data is utterly incredible. They wouldn't be cutting rates up there if the economy truly was growing at "7%", neither would steel prices be at 20-year lows and commodity prices collapsing.

Take advantage of volatility

The way I see it, this short-covering bounce in the A$/US$ cross, on what is unbelievable Chinese GDP data, is just another chance to get more cash into US dollars and British pounds, the only two currencies in the world that will see interest rate rises this year.

Currencies are broadly about interest rate differentials. When the A$/US$ was 106 US cents, the interest rate differential was 4.50%. Today the interest rate differential is 2.00% and the A$/US$ is 75 US cents.

When I look out 18 months, I see that USA/Australia or Fed/Reserve Bank (RBA) cash rate differential being 1.00%. That could either be our cash rates holding at 2.00% and US cash rates rising to 1.00%, or our cash rate falling to 1.50% and the US cash rate rising to 0.50%. Either way, I can see no scenario where Australian cash rates rise, and under both scenarios the A$/US$ will have a 6 in front of it. To me it's just a matter of when.

It may well be faster than anyone currently expects. I remain of the view that the Federal Reserve will start raising cash rates this year. That was again reaffirmed by Fed Chair Janet Yellen last night.

While current consensus is for December "lift off", I wouldn't rule out September. I note that Fed "insider" Jon Hilsenrath of the *Wall St Journal* also seems to feel September is still the Fed's target.

I also wouldn't rule out the RBA cutting cash rates in August. It could actually be the "double-whammy" which nobody currently forecasts. Note well the Bank of Canada cut rates by 25 basis points to 0.50% last night. The Canadian economy is quite similar to Australia and they have cash rates 1.5% below ours.

Betting on the currency

Unfortunately for Australia and the Australian dollar, the outlook for our key commodities looks over-supplied for the next few years minimum. It's hard to see what changes that scenario unless the commodity producers themselves curtail production. At this moment in time that seems unlikely.

As a nation we simply need the currency to adjust to drive growth. It will adjust further and I am betting that we will all be surprised how quickly it happens in the second half of this year. Just look at the New Zealand Dollar, Canadian Dollar and Brazilian Real for guidance on what comes next for the Australian dollar.

On that basis I continue to use days of strength in the A$/US$ to sell Australian dollars and switch to US dollars and GB pounds. I also believe that ASX listed

industrial US dollar earning stocks have positive consensus earnings revisions pending. In a market broadly lacking EPS growth for FY16, any upgrade, even a currency driven one, is an upgrade.

The list of US dollar earners includes Westfield (WFD), Brambles (BXB), Macquarie (MQG), CSL, Amcor (AMC) in the ASX20 Leaders Index.

Australia for income, rest of world (ROW) for growth. That remains my strategy.

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The retail sector – flyers and divers, and potential takeovers

by James Dunn

Key points

- *On the most recent retail trade figures for May, overall retail trade showed a 4.7% annual growth rate, well above the five-year average growth rate of 3.6%.*
- *The annual growth rate of online sales, at 9%, has slowed markedly from the peak level of 32% recorded in January 2011.*
- *Some stand-outs are Premier Investments, which is up 57% in total return in the past year; Beacon Lighting (up 91%); and Domino's Pizza (up 84%).*

The Australian retail sector definitely presents a mixed bag to investors. Australian retailers are facing headwinds, but are also gaining confidence from some positive changes.

On the plus side

Let's look at the positives. On the most recent retail trade figures for May, overall retail trade showed a 4.7% annual growth rate, well above the five-year average growth rate of 3.6%, according to CommSec. The rise was driven by non-food retail spending, which was up 5.1% on a year ago (compared to a five-year average of 3.2%); and sales by chain-store retailers and other large retailers, which showed a 5.3% increase over the year, versus a five-year average of 4.4%.

While department stores continue to struggle, most specialty-store categories saw sales grow in the year to March 2015, according to retail landlord Novion (which became part of Federation Centres last month).

Interest rates remain at record lows. And retailers would have been buoyed by the June employment report, which showed a 7,300 rise in jobs after increasing by 39,000 (revised) in May. More importantly, full-time jobs rose by 24,500 in June and CommSec says 214,900 jobs have been created in the past year.

The lower A$ is helping retailers fight off the challenge from online retail sales. National Australia Bank estimates that Australians spent $17.1 billion on online retail in the 12 months to May 2015 – equivalent to 7% of spending at traditional bricks and mortar retailers – the annual growth rate of online sales, at 9%, has slowed markedly from the peak level of 32% recorded in January 2011.

Also, in just five years, the number of cashed-up Chinese and Hong Kong tourists coming to Australia has more than doubled.

Possible minuses

Against that, Australian consumer confidence is proving an erratic number. Last year, it was hit hard by the perceived harsh Federal Budget. Just when it seemed to be recovering, concerns about China's stock market downturn and Greece's debt turmoil combined this week to push the confidence figure to a seven-month low on the monthly Westpac/Melbourne Institute Index and a 12-month low on the weekly ANZ/Roy Morgan Index.

Not all of these positive trends are uniformly good for the nation's retailers, and vice versa for the negatives. But it makes the sector one for stock-pickers.

While there are stand-out performers such as Premier Investments (owner of Smiggles, Peter Alexander, Just Jeans, Jay Jays, Portmans, Jacqui E and Dotti), which is up 57% in total return in the past year, Beacon Lighting (up 91%), and Domino's Pizza (up 84%), there are also some major laggards, such as

department store heavyweight Myer (down 41%), upmarket goods retailer OrotonGroup (down 55%) and even the sector giant Woolworths (down 19%).

On analysts' consensus target price, there is a clear division in how the market sees the retailers:

Upside Flyers

Super Retail (SUL): 7.6% upside to target price
OrotonGroup (ORL): 31.1% upside to target price
Kathmandu (KMD): 10.3% upside to target price
Flight Centre (FLT): 14.6% upside to target price
Dick Smith (DSH): 13.5% upside to target price
Myer (MYR): 6.8% upside to target price
Billabong (BBG): 23.7% upside to target price
Metcash (MTS): 13.6% upside to target price

Downside Divers

Beacon Lighting (BLX): 5.5% downside to target price
Premier Investments (PMV): 12.9% downside to target price
Woolworths (WOW): 7.2% downside to target price
JB Hi-Fi (JBH): 8.6% downside to target price
The Reject Shop (TRS): 8.9% downside to target price
Domino's Pizza (DMP): 12.1% downside to target price

Fair value

Harvey Norman (HVN): 3.4% downside to target price
Wesfarmers (WES): 0.1% upside to target price

Takeover potential

But there is one factor that could suddenly change these views – a takeover bid.

On the last day of June, New Zealand retailer Briscoe Group – a homewares retailer and the operator of the Rebel Sport franchise in New Zealand – lobbed an unexpected takeover bid for adventure gear retailer Kathmandu.

Kathmandu shares surged 26% on the bid to $1.53, just short of the value at the time of the part-scrip, part-cash bid, which equated to $1.55. But when the market looked closer at the offer, the shares fell back to $1.43, and have since recovered to $1.53. Analysts at New Zealand broking firm Forsyth Barr reckon that Briscoe would have to offer about $1.93 a share to induce KMD shareholders to sell out. That would be great news for Kathmandu shareholders, who have watched their stock tumble from $3.68 a year ago to as low as $1.15 last month.

Of the other major retail stocks, Myer, OrotonGroup and Woolworths are also seen as possible takeover candidates.

Two parties have been named as potential bidders for Myer: retail magnate, chairman of Premier Investments and former chairman of Coles Myer, Solomon Lew, and Australian private equity firm Archer Capital, which would probably need co-investors to make a serious bid for Myer.

Myer shareholders would love to see some of the Kathmandu effect put into their share price. The department store icon famously has never traded above the $4.10 at which it was floated in November 2009, and is now, at $1.26, almost 70% down on that float price, and just off a record low.

Upmarket retailer OrotonGroup is another stock that has fallen badly from grace on the stock market, and could use some takeover action. From $9.25 in 2011, Oroton has slid dramatically to $1.935. Broker UBS says OrotonGroup is a potentially attractive target for overseas luxury companies.

Reports have also emerged in the media that US private equity giant Kohlberg Kravis Roberts (KKR) has a bid prepared for Woolworths. At $34.1 billion, Woolworths would be a big bite for any potential acquirer – but Woolies is a lot cheaper than it used to be. WOW has been hammered on the stock market over the past year, and is down 28% since April 2014. Woolies has been consistently beaten on sales growth by its Wesfarmers-owned arch-rival Coles, and under growing pressure from foreign competitors, such as Aldi and Costco, that have moved into Australia. The company's hardware joint venture, Masters, has been soundly beaten by Wesfarmers' Bunnings operation, and there has been a series of write-downs and weak sales results.

Although such an approach would be one of the

biggest deals in Australian corporate history, the falling US$/A$ exchange rate and cost of capital are favourable for a US-based acquirer. KKR is a very big private equity player, but even it would probably need to bring in other partners.

None of the other retailers has been mentioned in recent speculation as a potential takeover candidate – but remember that in theory, any company trading on the stock exchange is a potential takeover target, at any time.

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Buy, Sell, Hold – what the brokers say 16/7

by Staff Reporter

In the good books

Citi upgraded BHP (BHP) to Buy from Neutral. Buy/Hold/Sell 4/4/0 Following recent share price weakness, Citi analysts have decided it's time to upgrade. At the same time, they highlight "significant risks" remain. Earnings estimates decline further as commodity prices forecasts have been updated.

JP Morgan double upgraded Cochlear (COH) to Overweight from Underweight. Buy/Hold/Sell 2/0/6 The second "Ear to the Ground" survey, which is based on US audiologists, suggests overall market growth for cochlear implants is about 10%. Moreover, the company appears to be regaining lost market share. The broker expects a robust FY15 result and this should underpin attractive growth over several years despite large hedge book losses. JP Morgan believes any improvement on the productivity of R&D spending has potential to create meaningful earnings leverage.

Morgan Stanley upgraded Flight Centre (FLT) to Equal-weight from Underweight. Buy/Hold/Sell 2/4/0 Shares have fallen 24% since the June 23 warning and Morgan Stanley envisages considerable longer-term pressure on the business model. Valuation, yield and excess franking credits provide support. All up, the broker argues the stock should trade at a discount to the wider market but considers the current price/earnings ratio a fair valuation.

Credit Suisse upgraded Seek (SEK) to Neutral from Underperform. Buy/Hold/Sell 4/3/1 CS has upgraded in response to recent share price weakness. The analysts have also reduced estimates in response to the company's recent market update, which showed Seek Learning is not performing in line with expectations.

In the not-so-good books

Macquarie downgraded Resmed (RMD) to Underperform from Neutral. Buy/Hold/Sell 3/3/2 The broker has read all the literature and spoken with cardiologists in order to assess what impact SERVE-HF (a trial of a sleep apnea treatment which failed to meet its primary endpoint) will have on broader industry sales, and decided that the impact will be broader than just the SERVE-HF population and that it is difficult to be confident other patients are not at risk. Nor does the broker believe the upcoming CPAP (Continuous Positive Airway Pressure) studies will deliver the positive results the market has baked into the ResMed price.

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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Why company CEOs should have skin in the game

by Roger Montgomery

Regulatory change in recent years has given additional focus to the topic of executive remuneration. Investors can now find detailed reports on management compensation set out in companies' annual reports, and have the opportunity to lodge a protest vote at the AGM should they feel that the board has – on their behalf – been unduly generous.

This ability for shareholders to vote down a remuneration report has been criticised by some directors, who feel that shareholders have been given undue power, and may use it to 'punish' the board for weak share price performance, or for other outcomes that may be outside the board's control.

A difficult choice

Notwithstanding these developments, being CEO at a large listed company remains a very lucrative career choice. Boards of directors typically rationalise this on the apparently sensible grounds that the company wishes to attract candidates of the highest calibre. No board, it seems, is satisfied with a manager who is merely competent. Indeed, the universal prescription for attracting and retaining talent seems to be to direct large amounts of shareholder money into management's collective pocket to ensure a better-than-average outcome.

It may well be that paying higher salaries in pursuit of better talent is sensible on a case-by-case basis, but clearly this can't work in aggregate. If all companies do it, the pool of management experience and talent isn't going to suddenly become deeper. In aggregate, the only thing that will increase is salaries, and companies will effectively pay more, in aggregate, for the same talent.

Longer term, it is possible that higher remuneration attracts people who might have done other things in managerial roles. However, attracting the sort of manager whose life choices are dictated by financial gain also has the potential to work out badly.

The problems

There are a couple of vexing problems at work here. The first is an agency problem. Remuneration decisions involve the board spending shareholders' money, and if life is made easier for the board by spending more of it, then we should expect that that will happen. Just as IT executives in years gone by reduced career risk by buying IBM products regardless of price, boards reduce career risk by spending up on "premium" management. This is not to say that boards are malicious, just human.

A second problem is that it is fiendishly difficult to judge the quality of a manager. As investors, we try to do this as part of our assessment of investee companies, and we find it really, really hard. Success in corporate life owes an awful lot to luck – being in the right place, in the right industry at the right time. It can be near impossible to gauge the individual contribution of a manager until many years into their tenure (and in some cases not until after their tenure). In this, we feel for the board, which needs to make an assessment in limited time on the strength of an "executive search process".

These problems combine to create an unfortunate dynamic: a spending decision being made by directors who can't be certain what they're getting for the money, and won't feel the pain of spending too much of it, but face personal risk if things don't work out so well.

It's a bit like your health insurer letting you choose which doctor they will pay to perform your open-heart surgery. If Dr Rolex charges $100,000 and Dr Swatch charges $50,000, Dr Rolex has probably scored himself a new patient.

Why skin in the game is necessary

None of this should be seen as a criticism of company directors. While some will no doubt do a better job than others at discharging their duties, the problems outlined above are problems with the system, not the individuals involved.

One obvious way of addressing the issue might be to require better alignment of board and shareholder interests, for example by directors having a large part of their personal wealth invested in the companies they oversee.

In some cases, this would be an onerous requirement to place on directors, and it is probably unrealistic to expect that it could be broadly implemented in practice. However, directors who do not have a large part of their own wealth invested alongside shareholders should not complain when shareholders deliver a 'strike' against the remuneration report.

As the owners of the business, this is entirely their prerogative.

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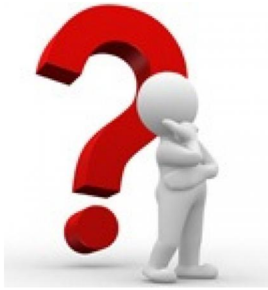

The Costa IPO and ETFs

by Questions of the Week

Question: Do you think it is worth taking up shares in the Costa float?

Answer (By Paul Rickard): I haven't studied the Costa float in detail, so my comments are only cursory.

I don't really like private equity sell downs, the multiple looks on the high side, and can't see Costa as a must have stock.

Question 2: In your article you suggest buying an ETF over the S&P/ASX 200 index. Can you please suggest a few for me to have a look at, or which ones are in your portfolio.

Answer 2 (By Peter Switzer): The ETF over the S&P/ASX 200 has the code STW. You can find it here.

Here are some other useful resources on ETFs, which you could consider.

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