Switzer Super Report

Thursday 27 August 2015

Fortune favours the brave

Today, Charlie Aitken points out, correctly, that the recent volatility has tested my "buy the dip" approach to markets. Like Charlie, I've been getting up early, or staying up late, to watch the Dow Jones' movements closely. But I haven't shifted from my strategy, and nor has Charlie. Now is the time to be brave and buy good quality stocks when they're cheap.

This is also a strategy of Tony Featherstone. Today he has five great ideas for what to do in this market mayhem. He's forecasting a pretty bullish three-years after this six-months of volatility.

Also in the *Switzer Super Report*, Tony Negline examines the cost of retail and industry super funds regulated by APRA, and in *Short n' Sweet* we take a look back at our *Super Stock Selectors'* likes of five-months ago.

Sincerely,

Peter Switzer

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Don’t be like a deer in the headlights – buy quality

by Charlie Aitken

Key points

- *Charlie believed US equities would be the last domino to fall and for weeks his fund had been short Dow Jones Index Futures and NASDAQ Index futures.*
- *Volatility will remain elevated, but another 1100-point intraday trading range in the Dow is unlikely.*
- *Australian-based investors in Australian equities have already taken the hit, and now’s the time to add high-quality companies.*

I’ve worked in markets for 22 years and I’ve seen things this week I’ve never seen before.

As a new fund manager, it has certainly been a baptism of fire in terms of what the world has thrown my investment team and me, but I’m pleased to report that we have broadly protected our unit holders’ capital with the fund down less than -1% for the month. Our MSCI World Index benchmark is -10.5%.

Down is up

It’s very rare that I would write I am pleased with the fund being down at all, but under the extreme market duress and volatility of the last week, I am calling it a good result.

In these notes I had warned about a Wall St correction. I had believed US equities would be the last domino to fall and for weeks my fund had been short Dow Jones Index Futures and NASDAQ Index futures. These short US futures position were held as protection against investments in Australian and New Zealand yield stocks, most notably, Telstra, the banks and Goodman Group.

On Monday night I was expecting a weak opening on Wall St due to Chinese led Asian weakness. Mondays tend to be bad on Wall St after a weak Friday because investors have time over the weekend to assess what happened on Friday and look at their portfolios. People with margin loans also get a call from their friendly broker.

As a global fund manager, I have all the portfolio management and execution systems set up at home, to make sure we can trade if we need to trade during the northern hemisphere session.

When I logged into the Bloomberg system, I thought I was misreading the screens. I genuinely had to do a double take. The NASDAQ 100 futures I was short were limit down -5% and curbs had been enforced to stop them trading. The Dow Jones futures were down 850pts and even traded down 1100 points for a fleeting moment. JP Morgan shares and GE shares opened down -20%. It was stunning.

I truly couldn’t believe what I was witnessing. It was a genuine crash or “flash crash”, as we tend to call them nowadays. The “machines” had gone crazy and I even saw the VIX index spike to an incredible 58.

Sense prevails?

However, the US markets started quickly recovering from their opening lows and Apple’s Tim Cook spoke, reassured Apple investors about Apple’s Chinese sales, and the greatest rally I have EVER seen in my career then started, led by Apple. The Dow Jones Industrial Average rallied 1000pts to be down just 110pts, but then succumbed to close down 550pts. It was the all-time record intraday points range in Dow history.

It was the most remarkable session I had ever seen.

Remarkable or ridiculous? Probably a bit of both.

After Monday night's antics on Wall St I obviously had to stay up for Tuesday night. The Dow opened up 400pts, traded very steadily around that level for a few hours and tired old Charlie decided that it all seemed a bit more stable tonight and went to bed.

I then got up at 5am to watch the last hour of Wall St trading, because in the last hour there always tends to be action, to watch the Dow drop 600pts in an hour. It closed down 200pts, the Dow futures then fell another 200pts in early Asian trading, then bounced 450pts in Asian trading to be up 250pts.

Last night the Dow was hovering around +200pts, Europe was down, then in the last hour the Dow added +400pts to close up 600pts!

It's been like watching some crazy poker machine but this is the world's largest and most important equity market.

Obviously, as a fund manager and commentator, I take no pleasure in these market events. While I forecast a Wall St correction, I never expected it to be as violent and quick as this. The only solace I take is my fund lost significantly less money than most, but it's still a bad event for people like me even though I can limit the portfolio damage by shorting index futures. Nobody likes seeing stuff like this.

The worst should be over

My view from here is you have seen the worst of this crazy volatility. Volatility will remain elevated, but I'd be very surprised if you saw another 1100-point intraday trading range in the Dow.

On that basis I have covered my shorts in US index futures and am now slowly deploying some cash in the US, Europe, Asia and Australia. I am not looking for a V-shaped recovery in markets, probably more like a W, where there will be further swoons and tests of confidence.

However, you have to think and position six to 12 months out and I think after the global correction we've seen, investors are being paid to take risk in the right equities. That statement will prove true when volatility eases a notch or two over the coming months.

For Australian-based investors in Australian equities, I think you've already taken the hit. Now is not the time to sell in my opinion, it's the time to add to high quality companies.

I personally think the S&P/ASX 200 bottomed on Monday under 5000 and I actually put on a "bull collar" in S&P/ASX 200 Index Options, where I sold a November put and bought a November call on the view the market will recover to around 5300 by later in the year.

As I keep writing, in volatility there is opportunity. My investment team and I are researching numerous potential new investments in this period of extremely volatility.

Buy the dips

The question obviously is: is this just a correction, or the end of the 5-year bull market? I believe, and am positioning my fund for, it to be nothing more than a traditional 10-15% correction. Yes, in this world of high frequency trading, these corrections play out in days rather than months, but it would be a major mistake to confuse a correction for the end of the bull market.

After telling you last month to "keep your powder dry" I am now encouraging you to be a little braver. Don't be like a deer in the headlights: make sure you buy something of quality in this correction. Keep it large cap, keep it liquid, keep to high quality.

This has been a major test of my friend Peter Switzer's "buy the dip" approach to markets. I just wanted to end today by agreeing with Peter's view. It's been one big dip, but I believe buying this dip in high-quality global and local equities will prove the right medium-term strategy.

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5 strategies for market mayhem

by Tony Featherstone

Key points

- *Long-term investors need to be more tactical in this market to lift returns. One technique for active investors is to buy the market using exchange-traded funds.*
- *Buying high-quality Australian blue-chip stocks with a large proportion of offshore earnings also makes sense.*
- *And the market's best trade in the past three years – buying high-quality blue-chip stocks with above-average yield – still has legs.*

First, the good news, heavy falls in global equities are an opportunity to buy Australian equities and position portfolios for a double-digit total return this financial year.

Now, the bad, after a 17% peak to trough decline, the S&P/ASX 200 index is fairly valued rather than outright cheap. Also, it is too soon to conclude the worst of the selling is over as fears about China's growth linger.

The Australian market's trailing average Price Earnings (PE) multiple (excluding resources) has fallen from 17.6 times at its recent peak valuation to 15.2 times, or in line with its long-term average, using Macquarie Group numbers.

That implies the correction has removed the market's overvaluation. But the market will be exceptionally uncertain over the next six months as the extent of China's slowdown become more apparent and the first US interest-rate rise occurs.

Bullish medium-term outlook

I'm more bullish over three years and expect the bull market in equities to resume by year's end or into the New Year. But the risk of capital destruction in the next few months is high.

My sense is the market has over-reacted to China. BHP Billiton believes China's economy has bottomed and Apple Inc says Chinese demand has remained firm. China has plenty of levers left to stimulate the economy, as evidenced by its interest-rate cut this week.

Also, China-related volatility increases the odds of the US Federal Reserve moving the first interest-rate increase from September to December. The likelihood of another interest-rate cut in Australia by year's end has also strengthened recently, and there is scope for further cuts or, in a worst-case scenario, to add fiscal stimulus.

Add in a lower Australian dollar, falling energy prices, and tepid wages growth, and there are plenty of tailwinds for corporate earnings in the next few years. And enough reason to add to portfolios as value emerges in the next six months.

But for now, the global economy is grinding towards a higher gear, the Australian share market is grinding towards the next phase of the bull market, and valuations are grinding towards their historic average. Gains are hard won as the market moves sideways, in a longer-term context, and the global economy works off its excesses from the previous cycle.

In that context, long-term investors must eke out every percentage of return they can, and use corrections to top up on high-quality companies when they offer better value. Here are five strategies to consider.

1. Capitalise on a short-term over-reaction in domestic equities

Long-term investors need to be more tactical in this market to lift returns. One technique for active investors is to buy the market using exchange-traded funds, such as the SPDR S&P/ASX 200, at the bottom of corrections, in anticipation of relief rallies.

Granted, the Australian share market is not cheap and the risk of further volatility is high. But as we get through the seasonally weak third quarter, and into the stronger fourth quarter and beyond, a double-digit gain from the SPDR ASX 200 ETF (more after dividends) by June 2015 is a reasonable bet, from the current level.

Chart 1: S&P/ASX 200 index over five years

2. Capitalise on Chinese contagion

As mentioned, the market has over-reacted to China's slowdown and it still has strong medium-term growth prospects as it morphs from investment- to consumption-led demand. However, buying mainland Chinese equities is too risky.

I prefer Hong Kong, which is a natural beneficiary of rising wealth in China, is considerably cheaper than other developed markets, and better regulated than emerging market exchanges.

The ASX-listed iShares MSCI Hong Kong ETF was on a trailing PE of about 8 times (at August 25) after China's sell-off. In contrast, the iShares S&P 500 Core ETF, which provides exposure to US equities, has a trailing PE of about 18 times.

Chart 2: Hang Seng Index over one year

3. Focus on winners from a lower Australian dollar

Fears about China's economy reinforce that the Australian dollar needs to fall further as commodity prices decline and domestic interest rates are cut again.

Buying high-quality Australian blue-chip stocks with a large proportion of offshore earnings makes sense because they benefit as profits earned overseas are translated into Australian dollars. (And is a strategy long-promoted by the Switzer Super Report)

Key beneficiaries of this trend, Macquarie Group, James Hardie Industries, CSL, and Westfield Corporation have further to run as the Australian dollar eases and the US economy expands. None are cheap, but the correction has improved value.

Chart 3: Australia dollar versus US dollar over five years

4. Don't give up on the yield trade

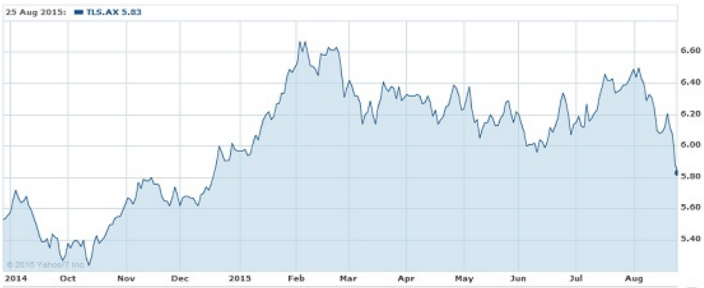
The market's best trade in the past three years – buying high-quality blue-chip stocks with above-average yield – still has legs.

Yes, the latest profit-reporting seasons had mixed news on yield: more companies signalled a cautious outlook for dividend growth, and a handful paid a special dividend in a good sign of confidence. As banks hold more capital, which weighs on their return on equity, and as utilities look overvalued, yield stocks are less attractive.

But yield is always relative. A 7% grossed-up yield from the Commonwealth Bank or Telstra Corporation (after franking) and a modest double-digit total return (assuming dividends) is an acceptable risk-adjusted return in this market.

Stick to the household names for yield in this market: they will be among the first bought by income investors if the market drops below 5,000 points.

Chart 4: Telstra sold off this month



5. Special situations

Market corrections provide opportunities to buy outstanding growth stocks that always look overvalued in rising markets. One of my favoured strategies over the past five years has been buying the internet advertising stocks – Seek, REA Group and Carsales.com.

Seek has a one-year total shareholder return of minus 29% and trades on a forecast PE of about 21 times, according to consensus estimates. REA is off 11% and trades on 24 times 2015-16 earnings. Carsales.com's total return is down 9% and it is on a forecast PE of 21 times. By their standards, the valuation metrics appeal.

These are three genuine industry "disruptors". Seek disappointed with weaker-than-expected earnings guidance in its latest result. REA Group's result was below market expectation and Carsales' was just in line. Trading conditions for these companies have softened, but it's way too soon to suggest they cannot continue to deliver hyper growth as they expand overseas.

Chart 5. Portals under pressure (Seek compared to REA and Carsales.com over one year)

** All charts sources at Yahoo!7 Finance, 27 August 2015*

Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at August 25 2015.

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Fundie's favourite – Amcor outperforms

by Paul Kasian

Paul Kasian is head of asset management at Equity Trustees.

How long have you held the stock?

We have held an overweight position for a number of years.

What do you like about it?

Amcor Limited (AMC) is a global packaging company with operations across Australasia, North America, Latin America, Europe and Asia. Based in Melbourne, it is the twentieth largest company on the ASX with a market capitalization of $15.574 billion.

Amcor holds the number one or two position in each of the markets it participates in, with the majority of its earning coming from very defensive industries such as food and beverage, and healthcare. It has achieved a nice balance between dividend growth and earnings growth. It continues to successfully deploy capital from low growth geographies into higher growth emerging markets, thus increasing returns.

How is it better than its competitors?

Amcor's scale advantage provides a competitive advantage in wining and maintaining its customers. It has a focused portfolio of businesses, and has developed a unique and differentiated set of capabilities in managing the business.

What do you like about its management?

Amcor has developed a track record of disciplined cash and capital deployment, and adheres to a very resilient shareholder value creation model. Management is realistic about where the business and the external environment now sit, and are adapting to thrive in a lower growth environment.

How do you think Amcor will perform in the year ahead?

We think Amcor will outperform in a more challenging environment. Ongoing A$ weakness is likely to continue to generate outperformance versus the rest of the market.

At what point would you sell it?

We regard it as a core holding in our portfolios, and would probably only sell it if the investment proposition was to alter radically, or if it became excessively expensive versus other opportunities, which it is not at the moment.

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

Amcor is up 17.25% in the last year, well outperforming the overall market.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Citi upgraded Caltex (CTX) to Buy from Neutral, and UBS to Neutral from Sell. Caltex delivered a half-year result broadly in line with July guidance. Citi reports the company is set for a capital return towards the end of calendar 2015 – most likely through an off-market buy-back. While the competitive landscape looks challenging, UBS believes Caltex is well placed to defend its position and upgrades to Neutral.

UBS upgraded CBA to Buy from Neutral following significant share price weakness. The analysts acknowledge the shares are trading at a premium vis-a-vis peers but given global turmoil and uncertainties, they prefer exposure to the higher quality in the local banking sector. Asset quality on the back of rising bad and doubtful debt charges remains their key concern regarding the sector.

Credit Suisse upgraded Coca-Cola Amatil (CCL) to Outperform from Neutral. Credit Suisse observes a turnaround in the first half with reduced downside earnings risk from further margin erosion. This supports earnings, dividend and valuation.

Deutsche Bank upgraded Medibank Private (MPL) to Buy from Hold and Morgan Stanley to Equal-Weight from Underweight. FY15 results were ahead of Deutsche Bank's forecasts. Underlying gross margin expansion surprised the broker with a further 30 basis points expected in FY16. The broker upgrades FY16 and FY17 forecasts by 10% and 14% respectively. FY15 margins also surprised Morgan Stanley and with more assured FY16 guidance the broker upgrades to Equal-weight from Underweight.

Citi upgraded Oil Search to Neutral from Sell. First half profit was higher than Citi expected. Production costs were lower. The broker believes the company is doing well in controlling what it can in a low oil price environment. Given market weakness Citi now considers the stock fair value at a US$70/bbl long-term oil price. Relative to peers the broker considers the market is currently paying near full value for the LNG expansion.

JP Morgan upgraded Scentre to Neutral from Underweight following what proved a financial (interim) performance largely in line with expectations. The stockbroker found it was a solid performance, pointing at continued improvement in operating metrics. Scentre is selling four lower quality assets but has nevertheless reiterated distribution guidance. Estimates have been lifted.

UBS upgraded Westfield to Buy from Neutral. First half cash flow was ahead of UBS estimates. Portfolio metrics continue to be attractive. Net property income was below expectations because of the timing of asset sales and FX. In the broker's view the valuation cannot be ignored and the rating is upgraded to Buy from Neutral.

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 – Super Stock Selectors deliver the goods

by Penny Pryor

Today in *Short n' Sweet*, I wanted to examine some of our *Super Stock Selectors'* likes. We've been running this for five months now and it's worth taking a look to see how some of our Selectors' picks have staked up.

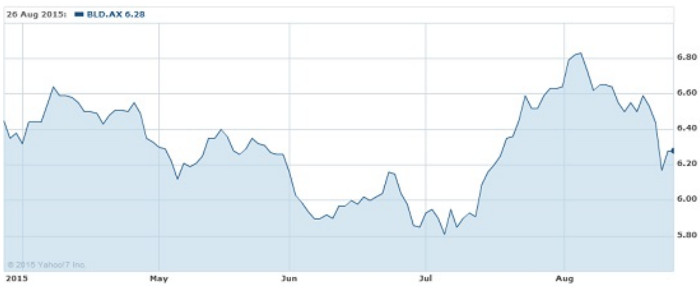
But before I do, let me stress (again) that these aren't long-term recommendations, merely short-term 'likes' that have caught the attention of our analysts, brokers and market watchers that week. They don't always align with our own choices here at the *Switzer Super Report* either, but we do think it's important to share a wide range of views with our readers, which is why we do this weekly survey.

With that disclaimer out of the way, how have the 'likes' of five months ago performed? And also remember the recent volatility will mean all shares will have a rough ride in recent weeks.

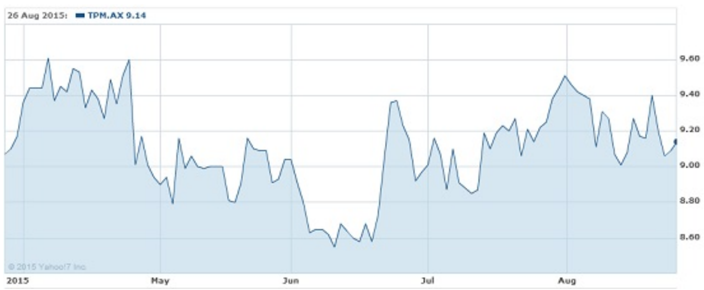
First up we've got equities analyst at Bell Direct, Julie Lee. She liked Yowie Group (YOW) and it has done extremely well.

Fortescue Metals Group, the like of Michael McCarthy, chief market strategist at CMC Markets, is a bit all over the place but has done better than the market.

Chartist Gary Stone's inaugural like was Boral, which reported today. The market didn't like its outlook statement – so it is now down.

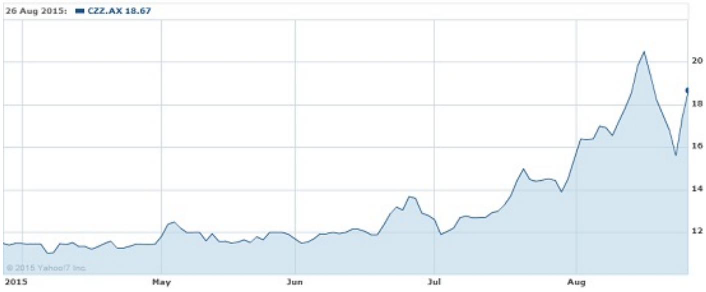


And Elio D'Amato, CEO Lincoln Indicators, liked TPG's result and its offer for iiNet, which has since been approved. It's stayed steady over the past five months, which is not an easy feat in the current market.



Macquarie Group (MQG) was IG Markets analyst Evan Lucas's like. It's down but don't forget the index is down by over 11%.

Finally we’ve got Capilano Honey from Raymond Chan, managing partner Morgans and this has certainly been a keeper.



All of our ‘likes’ are ahead of the market and three are in positive territory – again no mean task given the roller-coaster ride we’ve all been enjoying lately.

**All charts sourced at Yahoo!7 Finance on 27 August 2015.*

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Switzer Super Report
Investment advice for the smart SMSF

How much does it cost to run a super fund?

by Tony Negline

It's always interesting to see how much a sector costs to run.

Large super funds are a good case in point. Recently APRA published data that showed that administration and operating costs for the 2014 financial year increased by 8% to $5.9 billion.

By comparison, consumer prices increased by 3% over the same 12-month period.

Interestingly, APRA notes that the operating expense ratio (that is expenses divided by assets under management expressed as a percentage) fell to 0.53%, which doesn't sound like a lot and this clearly shows the danger of any investment expenses being expressed as a percentage.

We can easily get conned into thinking the number is low when reality might be very different.

But what if you looked at these increased expenses in dollars for each super fund account? There are 31 million accounts in these funds, which means each account is being charged an average of $190.

What have funds been spending their operating income on? APRA says: "Compliance and system costs associated with the implementation of superannuation reforms have contributed to the increase in the industry's cost base over the recent years. RSE licencees have also been allocating larger budgets to support brand recognition and member education, to establish internal investment management teams and to deploy complex membership data analytics."

(RSE licencees hold a licence issued by APRA that permits them to run large super funds.)

I would expect that many trustees who authorised these additional costs would have received legal advice arguing that most of these expenses are justified, even for long-standing members.

But ask yourself how happy you would feel to know that you had accepted lower returns because your fund wanted to improve its marketplace image and other expenses that might not in any way help you save for your retirement.

The following graph tells a fascinating story when you consider that the market value of APRA regulated super assets has not had such a steady increase as the money extracted from member accounts:

Figure 14 - RSE administration and operating expenses

Source: APRA Statistics[12]

Once again, check the variability when these expenses are expressed as a percentage of the market value of assets.

Note the $5.9 billion costs don't include investment management expenses.

To this number we can add another $2.6 billion, or an average of $84 per account.

So on average, APRA funds have cost an average of $274 in the 2014 financial year to run.

So key questions for anyone in an SMSF are: how do your SMSF expenses compare? Have your total fund expenses (administration, actuarial, audit, tax) work been increasing much faster than inflation? What about your costs of investing money?

Clearly it would be worth your while doing some quick comparative research!

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LICs versus ETFs and health care stocks

by Questions of the Week

Question: I'm thinking of buying some Milton Corp shares for our super fund. What do you think of them or would you suggest something else?

Answer (By Paul Rickard): Milton Corporation (MLT) is a broad based investment company with an outstanding track record.

The question you need to ask is whether you want to pay a premium to invest.

As at 31 July (their last reporting), Milton was trading on the ASX at $4.81 – a 4.8% premium to their net tangible asset (NTA) value of $4.59.

Yesterday, Milton closed at $4.31 – which I estimate to be a premium of approximately 5.0% to their current NTA.

Personally, I wouldn't pay a 5% premium to invest in this company. Other broad-based listed investment companies include AFIC (ASX Code AFI), which was trading at a 4.6% premium on 31 July and Argo (ARG), which was trading at a 5.6% premium on 31 July.

Given these premiums, an option you may wish to consider is a broad-based ETF, such as S&P/ASX 200 fund (ASX Code STW), which tracks the S&P/ASX 200 index.

Question 2: I would like to take advantage of the lower share prices to buy some more health stocks. What would you suggest? I have a small holding in Medibank Private. Should I sell it?

Answer 2 (By Paul Rickard): The companies I would consider are CSL, Ramsay and Resmed. They are all trading on pretty high multiples – so you really need to take advantage of dips to buy.

In regard to Medibank Private, the market liked the result – which beat market expectations in regard to earnings and margin. The margin was up due to claims management and cost control. At around $2.40, Medibank is trading on a PE of 21.3 for FY16.

I am not a huge fan of Medibank. It is a cost story – not a growth story – so at a PE of 21 times, I think it is pretty fully priced.

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