Switzer Super Report

Thursday 24 September 2015

A crisis of confidence

It wasn't just the decision to leave rates on hold, but the commentary after from Fed Chair Janet Yellen that has many wondering whether the Fed has a communication problem. Charlie Aitken was very upset and in his article today explains what damage it has done to the markets.

Also in the *Switzer Super Report*, there are some great opportunities in the A-REIT sector and today Tony Featherstone lists five awesome specialist trusts to consider. Our *Fundie's Favourite* is Simon Conn of Investors Mutual, who explains why Steadfast Insurance can continue to deliver.

In *Buy, Sell, Hold – what the brokers say*, Goodman Group and Premier Investments get upgraded and in *Questions of the Week* I explain how to use my buy-on-the-dips strategy.

Sincerely,

Peter Switzer

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Yelling at Yellen

by Charlie Aitken

Key points

- *Unfortunately, the lack of "lift off" via a rate rise was made worse by Yellen's commentary. US equity futures fell for the entire duration of the press conference.*
- *The press always reports market loses in "billions" but gains in "points" and there have been plenty of headline grabbing scare stories, most of which will not prove to be correct.*
- *In the meantime, keep buying dips in high quality companies and wait patiently for the gloom to lift.*

I was sitting up at my trading screens at home very early last Friday morning (4am) waiting for the FOMC rates decision and associated commentary from Federal Reserve Board Chairman, Janet Yellen. What a disappointment it turned out to be.

As a global absolute return fund manager, events like FOMC interest rate decisions are important. This is particularly so after nine years of zero interest rate policy (ZIRP).

While the markets had decided that a rate hike, or aka "lift off", wasn't coming this month, what they, or I, didn't anticipate was the dovish (bearish) tone from Yellen in her press conference.

When doves cry

Traders had expected no rate rise yet "hawkish" (bullish) commentary. However, they got no rate rise and 'dovish' commentary, which simply made markets ask the question *"what does the Fed know that we don't?"*

You can see this via how US equity markets moved ahead and after the rate hold decision. Wall St had rallied from recent lows, after New York Federal Reserve Board President William Dudley made comments that the rate rise wasn't a given. That triggered a short-covering relief rally into the decision. The confirmation of the rate hold saw the Dow instantly rally another 200 points, only to fade sharply in the next two hours, as Yellen held a press conference. The next day global markets melted down again as investors and traders reacted to the Fed's dovish tone.

That is an understandable reaction because the Fed has created confusion. This is the most important Central Bank in the world and they have confused/misled markets and markets are reacting to that confusion with volatility.

As I always say "confidence is a derivative of leadership". That is true in politics, corporate life, funds management, sport and even central banking. It would appear clear to me that markets are losing confidence in Janet Yellen's leadership of the Federal Reserve.

Central banking is about delivering a clear and consistent message. Ben Bernanke did that extremely well. Mark Carney at Bank of England and Mario Draghi at the ECB also do that very well. It's fair to say Glenn Stevens at the RBA is also in that clear and consistent message camp. **Unfortunately for all of us, Janet Yellen is an absolutely TERRIBLE COMMUNICATOR and she is the most important central banker of them all.**

She is clearly a highly intelligent person. Yet history is lettered with great intellects who were woeful communicators.

Mixed messages

The Yellen led Fed is sending inconsistent and mixed messages. Believe it or not, markets would have RALLIED if the Fed had raised rates, as it would have been seen as a sign of confidence in the US and global economies.

Unfortunately, the lack of "lift off" was made worse by Yellen's commentary, which, in my view, was the single worst press conference I have ever seen from a central banker. It was absolutely terrible and US equity futures fell for the entire duration of the press conference.

The other problem with the Fed is too many voices speak. On Saturday, three other Fed members came out with their own views to try and offset the damage Yellen had done. Again, all this did was increase confusion and in turn volatility.

It would appear the Fed has become "beta" dependent, not "data" dependent. US economic data has justified a Fed rate rise for at least the last six months. However, negative movements in global markets (beta), emerging markets and commodity prices seem to have swayed the Fed into a hold when they should have raised. The strong US dollar may also have played a role in their decision.

Now we have the situation where markets have now moved back Fed "lift off" expectations to 2016, which could well mean markets remain volatile and uncertain for the remainder of this year. I think we are all confused by the Fed and that's a bad thing. It's a bad thing when confusion combines with weak technical and momentum indicators in markets.

While I still recommend buying dips in high quality global and Australian equities, the enduring confusion caused by the Yellen-led Fed will mean that volatility continues. By volatility I mean genuine up and down volatility inside these new lower trading ranges we find ourselves in. Unfortunately we will NOT get a major rally UNTIL the FED gives us clarity on "lift off". Markets need leadership and they need it from the Fed more than ever.

Clarity needed

While I think there's plenty of value, growth and yield to be found globally and locally in the right equities, for that value to be released we will need the Fed to deliver some clarity, which would lead to equity risk premium being added back to equities (ie P/E's go up).

The other thing we need to consider is sentiment. As a fund manager, I see all the research and strategy views from leading analysts and strategists. I also see all the technical analysis from leading technicians. I have to tell you since the Fed increased confusion, the flow of research into my inbox has been universally bearish. There is even a growing chorus who say the 5-year equity bull market is over. Everyone is concerned and I can see that in my inbox.

While the contrarian in me sees that as a bullish development because universal bearishness never happens at the top, in this world of instant information you will see more and more of these negative views find their way into the mainstream press and affect retail investor sentiment.

Australia, in particular, seems an easy whipping boy. This week alone I have read "Australia is toast", "Australian banks to cut dividends in 2018", "Australian housing market had peaked", "Australia heading into recession", and "Australia dollar headed to 50 US cents". Of course, the standard S&P/ASX 200 falls by "$35 billion" was also wheeled out a few times. The market goes down in "billions" but up in "points".

Either way, the negative analysts and strategists are giving the press plenty of ammunition for headline grabbing scare stories, most of which will not prove to be correct, but do have a sentiment and pricing effect as they hit the mainstream press. It's basically a negative feedback loop.

This is all as frustrating for me as a fund manager, as it is for you as an individual investor. While I can protect capital by shorting index futures etc, and have done that effectively over the last two months (AIM fund up marginally versus S&P/ASX200 -11.5%), for individual investors this is a difficult period because you don't have the currency and index hedging tools that professional investors have available.

Hope for tomorrow

But even for professional investors, this feels like being in the spin cycle of a washing machine. My team and I have had to move quickly to protect our unit holders' capital. I suspect we are going to continue to have to be nimble for the remainder of the year, until Janet Yellen gives us come clarity and confidence.

Yellen speaks at 7am tomorrow morning Australian time. Let's all hope she doesn't create further confusion.

I wouldn't be betting my house on her ability to do that or the markets potential to trust her. I think markets have lost faith in her leadership of the Fed and it will take some time for that trust to be rebuilt.

In the meantime, keep buying dips in high quality companies and wait patiently for the gloom to lift.

5 awesome A-REITs for your portfolio

by Tony Featherstone

Key points

- *A-REITs collectively met market expectations during the latest profit-reporting season, unlike industrial stocks, which disappointed, particularly on their earnings guidance for 2015-16.*
- *The Asia Pacific Data Centre Group (AJD) A-REIT owns data centres and is a lower-risk play on the cloud-computing boom, while National Storage REIT is benefiting from opportunities in the highly fragmented self-storage industry.*
- *The Arena A-REIT invests in the growth sectors of healthcare, childcare and education and has exposure to government-tenanted facilities, while the US Masters Residential Property Fund A-REIT invests in undervalued neighbourhoods in growth markets that are within an hour's commute of downtown Manhattan.*

A 9% correction in the Australian Real Estate Investment Trusts (A-REIT) sector since March has put it back on the radar for long-term income investors. Smaller, specialist A-REITs, in particular, look interesting after heavy price falls.

A pullback was needed. The search for yield sparked a stunning rally in A-REITs last year and early this year, and drove many above their asset backing. The sector was overvalued but the weight of money and expectations of rising property prices fuelled gains. Let's have a closer examination of the sector before considering five smaller A-REITs that could add value.

The sector overview

The S&P/ASX 200 A-REIT index soared 33% between January 2014 and February 2015, underpinned by gains in sector heavyweights Westfield Corporation and Goodman Group. The sector easily outperformed the broader Australian share market, even after accounting for the A-REIT index's falls this year.

S&P/ASX 200 A-REIT index

On a total-return basis, the S&P/ASX 200 A-REIT index has a one-year return (including distributions) of 16%. The S&P/ASX 200 index has 3% negative return, after heavy falls in the past few months. Over five years, the A-REIT index has returned 13% annually, versus 6% for the S&P/ASX 200.

Several factors underpinned the rally. Record-low interest rates and measly cash rates forced more investors to buy bank, utility and property stocks for yield. Also, underlying property prices kept rising, despite sluggish economic activity. And the A-REIT sector was in better financial health after its debt and management excesses in the lead-up to the 2008 GFC.

A-REITs collectively met market expectations during the latest profit-reporting season, unlike industrial stocks, which disappointed, particularly on their earnings guidance for 2015-16. Earnings and dividends forecasts for the A-REIT sector have been downgraded, but not by as much as industrial companies, consensus analyst forecasts show.

Much depends on interest rates. An expected rise in US interest rates over the next 18 months is a headwind for interest-rate-sensitive stocks, such as A-REITs. The sector historically outperforms the share market when bond yields fall and underperforms when they rise.

But the US Federal Reserve seems in no hurry to raise rates, after keeping them on hold this month because of the unstable global economic outlook.

Moreover, A-REITs typically outperform in periods of high share market volatility because income from long-term leases is, in theory, more certain than corporate profits. Expected distribution yields of 5-6% in FY16 for many of the largest A-REITs are another positive.

There is enough to suggest long-term investors should take advantage of lower prices to get set in the A-REIT sector again. But caution is needed: the prospect of US interest-rate rises, slowing earnings growth and an overvalued direct property market are threats.

Conservative investors should stick to the largest A-REITs that have a mix of assets. Westfield, GPT Group and Goodman Group appeal. Those with greater risk appetite should consider smaller, specialist A-REITs, some of which have listed in the past few years.

Australia is following US trends with specialist REITs emerging through the Initial Public Offering (IPO) market. The US market has REITs over prisons, student accommodation, residential property, public storage, mortgage providers, and many others.

Specialist A-REITs often grow by buying and consolidating smaller properties. They invest in a narrower property segment than large A-REITs, issue more equity to raise capital to acquire assets, and have higher tenant risks. Gains and losses can be larger.

Here are five specialist A-REITs to consider:

1. National Storage REIT (NSR)

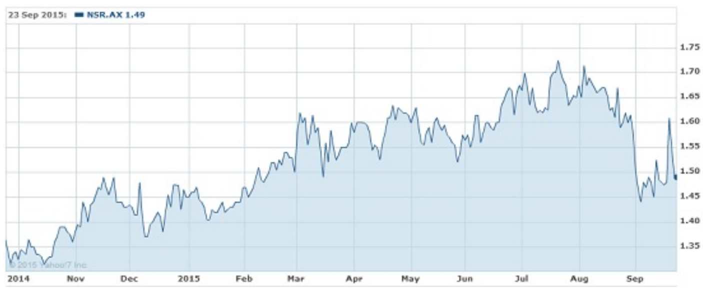
After listing at 98 cents a unit in December 2013, the self-storage A-REIT peaked at $1.75, before easing to $1.49 yesterday. It is benefiting from opportunities in the highly fragmented self-storage industry. Longer term, it is a play on capital-city densification, smaller apartments and demand for extra storage space.

National Storage is not cheap. The $1.49 unit price compares with the latest stated net tangible asset (NTA) of $1.11 a unit – its premium to NTA is among the sector's highest.

But it has a more attractive earnings growth profile than many A-REITs that is not fully captured in the NTA. It can grow faster than the sector by buying small self-storage operators, or operating their assets. It also has reasonable scope for occupancy growth.

National Storage's FY16 guidance was slightly below market expectation. Still, it deserves a spot on portfolio watch lists in anticipation of improving value. It would look more interesting closer to $1.30.

National Storage REIT



2. Asia Pacific Data Centre Group (AJD)

The NEXTDC spin-off owns data centres and is a lower-risk play on the cloud-computing boom. It will benefit as NEXTDC attracts more companies to its state-of-the-art data centres, in turn reducing tenancy risk for Asia Pacific Data Centre Group (AJD).

AJD rallied from $1.06 to a 52-week high of $1.32 and has since eased to $1.27. It arguably should trade at a higher premium to the latest stated NTA of $1.24 per unit, given AJD has excellent exposure to the fast-growing cloud-computing industry as more companies store and manage data offsite.

An expected yield of 7.5%, based on consensus forecasts, appeals. PM Capital, Bennelong Funds Management and a few other good judges are substantial shareholders.

Asia Pacific Data Centre Group

3. Arena REIT

Investors could not get enough of Arena when it listed in June 2013 after raising $75 million at $1.01 a unit through an IPO. It peaked at $1.90 and now trades at $1.61.

Arena invests in the growth sectors of healthcare, childcare and education and has exposure to government-tenanted facilities. It delivered 19% growth in operating profit for FY15 and its net asset value increased 18% over the year.

Arena has relatively long leases, good geographic diversity, exposure to sectors with attractive fundamentals, and a healthy balance sheet. The $1.61 unit price compares with a NAV of $1.33, but Arena deserves a premium given its healthcare and childcare exposure.

Arena REIT

4. Galileo Japan Trust

A smaller A-REIT, the Galileo Japan Trust, is also worth watching. Unlike many small-cap A-REITs, it trades at a significant discount to net asset value and offers exposure to the improving Japanese property market.

Its underlying FY15 earnings and FY16 guidance beat market expectation and it could yield as much as 10% given the expected increase in its distribution payout ratio.

At $1.77, Galileo trades at a 29% discount to its latest stated net asset value of $2.29 a unit. It is subject to currency risk from the Australian dollar/Japanese Yen, and as a micro-cap A-REIT it has higher debt and risk than others on this list. It does not suit conservative investors.

But I like the medium-term outlook for Japanese property and Galileo's discount to NTA is excessive. Macquarie Equities has a 12-month price target of $1.96.

Galileo Japan Trust

5. US Masters Residential Property Fund (URF)

URF was the first Australia-listed property trust established to invest directly in US residential property. It invests in undervalued neighbourhoods in growth markets that are within an hour's commute of downtown Manhattan. The fund owned 543 properties at June 2015.

URF has rallied from $1.85 to $2.12 over 12 months, and performed strongly over three years. It trades at a modest premium to its latest stated net asset value (NAV) of $2.01 per unit (after accounting for estimated withholding tax if the portfolio was sold). The NAV is $2.20 a unit before withholding tax on unpaid distributions.

I like the outlook for US residential property as the country's economy strengthens, and rate URF's strategy to buy and renovate properties around New York. It completed 34 large-scale renovations and 62 small-scale renovations in the first half of FY15.

The fund is well run. It delivered 47% revenue growth in first-half FY15 over the prior corresponding period. URF said: “The fund anticipates rental revenue to continue to grow during the remainder of 2015 and in 2016 as more completed properties are delivered from the renovation pipeline.”

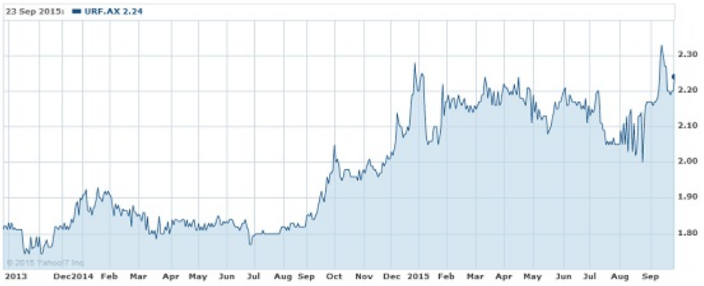
URF also expects further increases in the value of its property holdings, underpinned by its renovation work, rental income growth, and property sales in comparable markets.

The market is underestimating URF’s long-term potential, and it is easy to overlook. A fund that buys and renovates US residential properties is an unusual proposition compared with Australian REITs, which mostly invest in industrial, retail and commercial properties.

But US residential property is still recovering from losses after the 2008-09 GFC and the country’s housing cycle has further to run as interest rates remain low.

Moreover, URF’s strategy to buy and renovate US residential properties around New York provides a unique exposure for Australian investors via ASX. Investors who are “overweight” Australian residential property could consider the US variety for diversification.

US Masters Residential Property Fund



Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at September 23, 2015.

All charts sourced at: *Yahoo!7 Finance, 24 September 2015*

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Fundie's Favourite – get some insurance for your portfolio with Steadfast

by Simon Conn

Simon Conn is senior portfolio manager at Investors Mutual.

How long have you held Steadfast Group (SDF)?

We have held the stock for over a year.

What do you like about it?

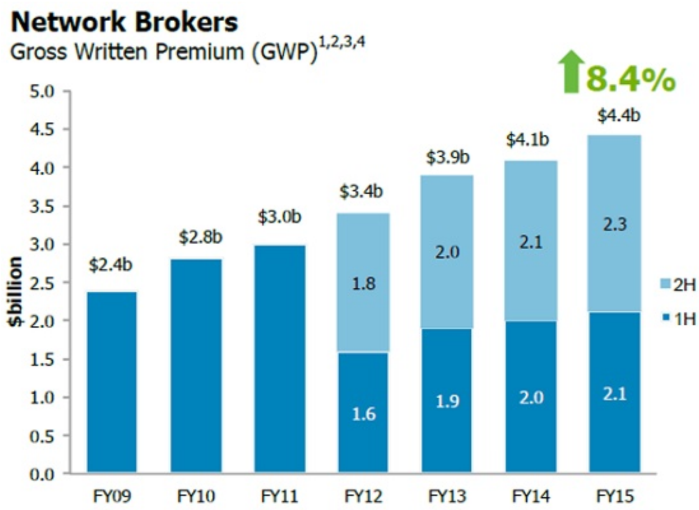
Steadfast is an industry leader in insurance broking and underwriting agencies, representing over 300 broker businesses and 22 underwriting agencies, with combined billings of over $5 billion in premium.

The strength of the franchise lies in the scale of distribution and close relationships with insurers. Steadfast brokers generate recurring earnings. Brokers have low customer churn; they sell an essential product, help clients tailor insurance coverage and assist in lodging claims. Unlike insurance companies themselves, Steadfast's broking and underwriting businesses take no insurance risk on their balance sheet.

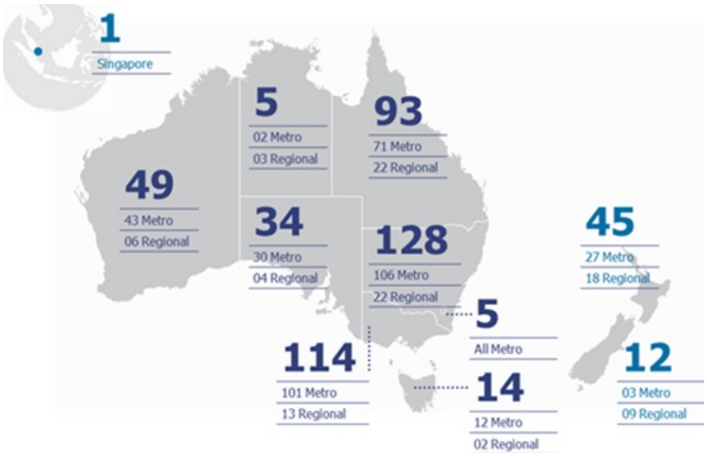
Underwriting agencies represent a complementary part of the business, sitting between brokers and insurers and underwriting specialised or niche lines of business on behalf of insurers.

How is it better than its competitors?

Steadfast has opportunities for organic and inorganic growth. Network premiums have grown at approximately 10% per annum for the last five years. Steadfast has outperformed peers and grown earnings through increased market share, cost savings and acquisitions.



Acquired businesses remain independently managed and require minimal integration, so they can be viewed as low risk.



What do you like about its management?

CEO Robert Kelly established the company in 1996. He has over 45 years experience in the industry and his relationships within the network provide the company with potential bolt-on acquisition opportunities. Having spoken to the company at length, we have confidence in their acquisition discipline and due diligence processes.

What is your target price?

All things being equal, we would expect the share price to reach $1.90 within the next year or two.

Is it a liquid stock?

Steadfast is reasonably liquid as it is a top 200 stock.

Steadfast (SDF)

***Source**: Yahoo!7 Finance, 24 September 2015*

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Credit Suisse has upgraded Goodman Group (GMG) to Neutral from Underperform. Buy/Hold/Sell 3/4/0 Credit Suisse has used a sector update on A-REITs to upgrade its rating for Goodman Group. Rolling forward its valuation modelling has led to a higher price target; $6.11 versus $5.91 previously. Given the share price has tumbled some 13% in recent weeks, the stockbroker thinks it's time for an upgrade.

Citi upgraded Premier Investment (PMV) to Neutral from Sell. Buy/Hold/Sell 1/5/0 Citi saw a "solid" result. More importantly, the rollout of success story Smiggle is to accelerate this financial year. Plus management is handling the foreign exchange headwinds well. Earnings forecasts have been pared back, but only slightly so on higher cost assumptions (from the roll-out of Smiggle).

In the not-so-good books

Credit Suisse has downgraded Evolution Mining (EVN) to Neutral from Outperform. Buy/Hold/Sell 4/2/0 The latest quarterly update on commodities prices has simply delivered yet more negative revisions, with the analysts exclaiming "There is little to like about most commodities over the medium-term, just relative degrees of unloveliness". The subsequent update on the copper and gold sector has triggered a few changes in rating. Credit Suisse retains a relatively flat outlook for gold prices, but has now incorporated even lower prices for copper.

Macquarie downgraded The PAS Group (PGR) to Equal-Weight from Over-Weight. Buy/Hold/Sell 0/1/0 Australian Brands Investment, a US incorporated company, has made a bid for PAS Group at 63c a share. The company has begun to buy shares and will maintain the bid until the close on November 9. It owns 19.23% of the issued stock. With the potential reduction in liquidity should the acquirer fail to privatise the company and end up with a majority stake, Morgan Stanley downgrades. The broker considers the turnaround just starting in the business, leaving a longer-term opportunity. Still, there are risks from a weak consumer environment, sharp currency depreciation and underperformance in Metallicus – along with a 19.23% blocking stake.

Credit Suisse has downgraded OceanaGold (OCG) to Neutral from Outperform for the same reasons it downgraded Evolution Mining. Buy/Hold/Sell 1/3/1.

Macquarie downgraded TPG Telecom to Neutral from Outperform. Buy/Hold/Sell 2/3/1 A 33% increase in profit for TPG in FY15 came in just ahead of guidance. It was a strong second half, Macquarie notes, featuring solid cash conversion, although capex was higher than expected. The key for TPG now is the successful integration of iiNet. While Macquarie is confident in TPG's longer-term growth prospects, valuation has become a bit rich. Hence a downgrade to Neutral.

The above was compiled from reports on FNArena 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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How to buy on dips

by Questions of the Week

Question: It seems to me that instead of building a portfolio and staying long, you have to be buying and selling all the time – otherwise there is ultimately no cash to buy these dips you keep referring to.

If you keep buying dips, eventually there is nothing left unless you are selling things from time to time to create cash. What is your response to this, remembering I am trying to build a portfolio and stay long? It seems to me your theory requires one to be a trader or have a money tree at the bottom of the garden.

Answer (By Peter Switzer): I am certainly not trying to suggest that you have to be a trader, or for that matter, have a money tree. That said, I can see where you are coming from.

When I talk about buying the dips, the funds could come in the following situations:

- Most SMSFs in accumulation phase have continual income to invest – new contributions, interest and dividends from existing investments etc;
- Australian shares make up (for most funds) just a part of their super fund – so the money could come from another asset class if you are underweight Australian shares;
- Or if you are not fully invested, then this would be a good time to move money out of cash into shares.

Obviously, if you are already fully invested and have no cash, you can't buy the dips. However, if the situations above apply, then what I am saying is that this is a good opportunity to buy Australian shares.

Question 2: I have been very happy with the stellar performance of Vita Group (VTG) over the last 18 months. However, since paying a handsome dividend, it has taken a dive. I have scrutinised the results balance sheet etc., and cannot see any problems.

It is clearly beyond me and I seek your expert advice.

Answer 2 (By Paul Rickard): The fall in price for Vita Group (VTG) coincided with the release of its profit result on 24 August. While this was very strong, the company cast doubts about its ability to pay any further special dividends (ATO has withdrawn the class ruling for dividends paid after 30 June).

I can't see anything else – so I sense this fall is just profit taking (after a huge run up in price).