Switzer Super Report

Thursday 17 September 2015

Sell the rumour and buy the fact

It's day two of our Magic Malcolm rally but of course, it's not all because we have a new PM, although I do think that's got a lot to do with it. This market movement is all about the Fed. As Charlie Aitken says today, and I said on Monday, this looks like a real case of sell the rumour and buy the fact.

All will be made clear tomorrow morning at 4am, so stay tuned!

Also today Charlie explains why this is a great environment for low frequency investing – taking some time and setting yourself up for long-term profits. Tony Featherstone updates our takeover target portfolio and adds Qube, and in *Buy, Sell, Hold – what the brokers say*, Rio and Woodside get upgrades.

Sincerely,

Peter Switzer

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How to make money with low frequency investing

by Charlie Aitken

Key points

- *If we get a period of stability of leadership and policy the S&P/ASX 200 could be significantly higher by Christmas particularly if that stability coincides with certainty from the Fed on US interest rates and Chinese data improving.*
- *Most leading Australian industrial stocks are paying investors 6.00% fully franked to hold them. Shareholders are getting paid to take the equity risk in Australia.*
- *A historical review of previous US rate rising cycles reveals that after an initial period of volatility, which has seen the US equities down by 5% on average, the market has risen for the next 12 months following the increase on 75% of occasions.*

Over many years I have consistently written that "confidence is a derivative of leadership".

This week has seen Australia's fifth Prime Minister installed in as many years and I have had many questions from my fund investors about what I thought the ramifications were.

Firstly, I must say the view from overseas commentators I speak to is negative. Negative in the context of a "revolving door" of leadership breeds policy uncertainty and policy uncertainty leads to a higher sovereign risk rating being applied to a given country's asset base.

On the other hand, the view from domestic business leaders and other investors I speak to is positive, feeling we at least now have a "businessman" leading the economy in a time of structural change.

I'm not going to enter a political debate but I think you can see these two views played out on Tuesday and Wednesday on the S&P/ASX 200. Big foreign selling on Tuesday, flowed by big local buying on Wednesday.

Finding the value

As I have written for many weeks in these notes I think there is clear and present value in Australian financials and resources at the S&P/ASX 200 index level of 5000. Quite frankly I think a good technical support base is forming on the benchmark S&P/ASX 200 Index around 5000 and my view is the new trading range, for say the rest of the year, will be 5000 to 5400. I do expect better prices as we head towards year end.

I actually used Tuesday's heavy offshore selling to add to investments in Australia because I tend to feel there's a good chance, not a certainty, of business and consumer confidence lifting into the end of the year.

In reality, business and consumer sentiment doesn't have to improve, it just has to get "less worse". I think that's a chance under the new Prime Minister and his team. The fact the leadership change has happened at what I think is most likely the bottom of the near-term S&P/ASX 200 trading range adds to my view that sentiment only needs to get "less worse".

Again, do not misinterpret this as a political view. Yes I know the Prime Minister and the Foreign Minister personally, but that doesn't change the fact they have a big task in front of them to steady and turn the Australian economic ship.

As an investor and an Australian, all I really hope for is a period of stability – stability of leadership and stability of policy. If we can get that combination I would almost guarantee you that the S&P/ASX 200 will be higher by Christmas, and perhaps significantly higher if it also coincides with certainty from the Fed on US interest rates and Chinese data improving.

Negative nellies

The S&P/ASX 200 has had the "kitchen sink" of negativity thrown at it and the result has been a deep and painful correction. But if I look out a few months I can see a positive combination of events. As I wrote last week, bank capital raisings have finished, commodity prices appear to have bottomed in Australian dollar terms, employment is actually okay, house prices are hanging in, bank dividends will be paid in Oct/Nov and the offshore tone may also improve. It also coincides with the seasonally strong period in global equities.

So I am in the "what could go right camp?" from here and I think that is the question ALL investors should ask themselves after a correction. Perhaps we will look back and the change of PM was one step in the "right" direction. I will laugh if the market did bottom the day he was sworn in.

More fundamentally there is deep value in Australian equities and I believe there are catalysts for that value to be released in the weeks and months ahead. I like that most leading Australian industrial stocks are paying me 6.00% fully franked to hold them. We are getting paid to take the equity risk in Australia and I for one am taking it.

Headlines fade in this world of Twitter. "Grexit" and "iron ore" have all but disappeared, now the headlines are "China" and the "Fed" which too will disappear in time. Quite frankly if you bought equities every time "crisis" was trending on Twitter you'd be very, very rich.

Markets price the present. That is all they do. My job, and your job as an investor is to take advantage of the present and visualise the future. Once you visualise the future you should set your portfolio to match that visualisation. I need to accurately forecast the Twitter headlines of three, six, 12 and 18 months from now in this world of instant everything and markets priced by high frequency traders. I'd prefer to be a low frequency investor.

Low frequency investing

The markets right now are giving you are chance to be a *low frequency investor*. They are giving you a chance to set a high quality portfolio for the next few years. That is true domestically and globally. That is what I am trying to do with my fund: build a high class domestic and global portfolio that will perform over the next few years.

That includes in the US where I am not afraid of the first Fed rate rise in 9 years. I don't know if that rate rise will come this month, next month or December. My point is, it is a "known known" in terms of being telegraphed to markets and I believe markets are pricing it in.

A review of previous US rate rising cycles reveals that after an initial period of volatility, which has seen the US equities down by 5% on average, the market has risen for the next 12 months on 75% of occasions. There has been three such cycles since 1994. In that year the S&P had a 9% correction after the first rate rise only to rally 16% the next year.

In 1999 the SP 500 rose 6% over the next few months. In 2004, following a 7% fall, the market was up 20% over the next year. This fits well with history given that a Fed rate raise would be consistent with the strongest three-monthly period for US equity monthly outperformance. Since 1950, Citigroup reveals that the three-monthly performance from October has averaged 4% while from November it's been 4.3%. Against this positive backdrop, the American Intelligence Survey, the benchmark for investor sentiment, is at its lowest level since 2008. In addition, cash levels are high. So the risk is to be under-invested in US equities. As Peter said on Monday this could be a real sell the rumour buy the fact event. The key for me this time is the US equity market has already had a correction, unlike the previous three cycles.

Interesting also is Vanda research detailing the outperformance of cyclicals under a US rate tightening cycle. Long trade is US industrials, banks and materials and long EU banks and emerging markets. Similarly, given the extreme pessimism to everything China-facing, others are promoting the China mean reversion trade with a view to looking at commodity related plays and emerging markets. I think we basically agree with this scenario and we are positioned for a resource rally and EU performance through the DAX. In this respect, the DAX was up last night Good data from Germany recently – stronger PMI, growth and export data – supports our long DAX view.

All in all I remain of the view that it's time to be constructive and invested in global and domestic equities. Yes, there will be bouts of short-term volatility as the world trades every "Twitter" headline, but to me these are opportunities to increase exposure to high quality equity investments.

I'll be on Peter's show on Monday night and to expand on these views.

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Takeover portfolio update – Qube and Aurizon added

by Tony Featherstone

Key points

- *Cashed-up multinationals will increasingly acquire smaller country-based logistics companies and bolt them on to global transport infrastructure.*
- *Qube has excellent medium-term growth prospects through its investment in the Moorebank intermodal transport project in Sydney.*
- *The falling Australian dollar, potential for Australian wine exports into Asia, and signs of improving industry conditions for viticulture should eventually encourage another predator to knock on Treasury Wine Estate's door.*

Much has been made of the coming boom in Asian middle-class consumption and its effect on food demand. Less considered is the transportation of food across diverse Asian markets and the massive investment needed in supply-chain integration.

The OECD predicts a global middle class of 4.9 billion by 2030, from 1.8 billion in 2009. Two-thirds of the new middle class will be Asian and their diets will change dramatically as more protein is incorporated. Stronger global transport networks will be needed to facilitate trade and help feed another 3 billion middle-class consumers within 15 years.

Cashed-up multinationals will increasingly acquire smaller country-based logistics companies and bolt them on to global transport infrastructure. The goal: to better integrate supply chains across Asia, move more goods at lower cost, and get ready for middle-class consumption growth.

It's a big task. Diverse Asian markets have fragmented supply chains and transport infrastructure. Investment of $US8 trillion in South East Asia alone is needed by 2020 to bridge the region's infrastructure gap, according to estimates from the World Economic Forum.

Japan Post's $6.5 billion takeover of Toll Holdings in May reinforced the potential of logistics in Asia. Japan Post brought the capital, and Toll had the expertise in running an integrated freight and logistics business. Toll's growing Asian footprint and customer relationships in the region was another attraction for Japan Post.

Brookfield Infrastructure Group's surprise $8.85 billion bid in August for rail and ports operator Asciano makes sense: Asciano handles nearly half of all container traffic entering or leaving Australia. Brookfield can combine its North American and European assets with Asciano's Australian port operations, and bolster its global container platform.

It can also drive better integration of Asciano's domestic operations. There is scope for Asciano's well-performing rail business and its improving ports business to work closer together and for the company to be "transport agnostic" – that is, provide a more seamless logistics service to clients rather than focus on a particular transport mode.

Takeover tailwinds

Conditions are ripe for takeovers of transport companies as the lower Australian dollar makes them more attractive to foreign predators in US-dollar terms. Multinationals struggling to lift or maintain organic growth rates in a sluggish global economy will be forced to flex their balance sheets, buy smaller players, and grow by acquisition.

The takeover of Toll Holdings and the bid for Asciano will surely have other global transport companies running their rulers over similar Australian assets.

Qube Holdings and Aurizon Holdings (which we will cover in a later column) are worthy takeover candidates. Both are well run, have quality assets, operate in duopolistic industry structures, and are sound long-term investments in their own right, regardless of takeover. Buying companies on the basis of takeover alone is fraught with dangers because the timing is impossible to predict.

Qube stacks up

Shares in the ports and logistics operator for containerised and bulk products have fallen from a 52-week high of $3.05 to $2.02. A slowing Australian economy is bad news for port volumes and Qube's 2014-15 full-year result was slightly below market expectation.

Qube has a stellar annualised five-year total shareholder return (including dividend reinvestment) of 22%. But the one-year return is minus 17%. Australian transport companies have a challenging short-term outlook amid slowing domestic demand, and the sharemarket correction in July and September crunched share prices.

Chart 1: Qube Holdings

***Source**: Yahoo!7 Finance, 17 September 2015*

Qube reported 18% revenue growth to $1.4 billion, and 13.5% growth in underlying earnings (EBIT) to $163.9 million for FY15. Guidance was unchanged: earnings from the ports and bulks operations will be lower in FY16 than FY15.

The Sydney-based company has significant strategic value, given its position in the duopolistic container stevedoring and automotive stevedoring industries. Only it and Asciano offer a range of logistics services in all five capital cities. Qube has shown it can grow faster than the economy through astute acquisitions.

The company has excellent medium-term growth prospects through its investment in the Moorebank intermodal transport project in Sydney. Moorebank will become Australia's largest inland intermodal terminal when fully developed. The project, due for completion in FY17, is a game changer for Qube, a catalyst for a share-price re-rating as tenancy signings are made, and another reason for a foreign predator to make a bid before the value at Moorebank is unlocked.

Macquarie Equities said in August: "While the near-term outlook remains challenging, Qube management's track record of delivering accretive growth opportunities will continue to drive the stock. The key catalyst for Qube remains tenancy signings at Moorebank to underpin value, and while long-dated, the project remains highly accretive, in our view."

Seven of 12 broking firms that research Qube have a buy or strong buy recommendation, four have a hold, and one has an underperform, consensus estimates show. The mean price target of $2.69 suggests Qube is about 30% undervalued from the current price.

At $2.02 a share, Qube trades on a forecast Price Earnings multiple of 20 times FY16 earnings. Asciano, at $8.17, trades on 19 times forward earnings and looks fully valued.

Asciano and Qube both have significant strategic appeal. Their assets are hard to replicate because of their industry structures, and easier for foreign players to buy rather than build. They would be worth more in the hands of a global logistics company that can integrate them into Asia Pacific supply chains –a reason Japan Post and Brookfield arguably paid "overs" for their bids for Toll Holdings and Asciano respectively.

A handful of substantial shareholders in Qube could wrangle a higher price from a predator, should a bid eventuate. But there's enough value in Qube at the current price to reward investors over the next three years, regardless of corporate activity.

Takeover update

Woodside Petroleum's bid for Oil Search this month unleashed a flurry of media reports that predicted the mergers and acquisitions (M&A) boom had finally arrived in Australia, and speculated on potential takeover candidates.

There are several M&A positives: cheap debt, low equity prices, an Australian sharemarket trading in line with its long-run average PE multiple, and balance sheets collectively in good shape. But low business confidence is weighing on M&A volumes.

That could change if Australia's new Prime Minister, Malcom Turnbull, can boost consumer and business confidence over the next 12 months, and create more regulatory and political certainty for corporate Australia to invest.

This month's takeover targets list adds Qube Holdings and Aurizon. I considered adding Woolworths and Treasury Wine Estates, and may do so in coming issues.

Underperforming Woolworths needs a shake-up and will come under the gaze of private equity if its share price keeps falling and its Masters hardware chain continues to disappoint.

Private equity could strip Masters out of Woolworths, buy Mitre 10 from the struggling Metcash, combine the groups and provide a stronger competitor for Bunnings. Separating the hardware business could help Woolworths regain its operational mojo.

That deal has been speculated before, but the slide in Woolworths – its shares have fallen by about a third from the 52-week high of $36 – adds to the urgency for change.

Wine group Treasury Estates has been a takeover target for some time and last year rejected two private equity bids that valued it at $3.1 billion. Treasury's performance this year vindicates the board's decision: the one-year total shareholder return is 47%.

However, the falling Australian dollar, potential for Australian wine exports into Asia, and signs of improving industry conditions for viticulture should eventually encourage another predator to knock on Treasury's door.

No takeover targets have been removed from the current list, shown below:

Takeover targets
Gold Road Resources
Aurizon Holdings
OzForexGroup
NIB Holdings
Automotive Holdings Group
iSelect
Reckon
Australian Agricultural Company
Qube
South32
Monash IVF Group
Ten Network Holdings
Ensogo
OrotonGroup
Mincor Resources
Myer Holdings
Santos
AWE

Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at September 15, 2015.

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Sydney Airport Holdings is flying high

by George Boubouras

George Boubouras is chief investment officer at Contango Asset Management

How long have you held the stock?

We have had an overweight position to Sydney Airport Holdings (SYD) for nearly a year.

What do you like about it?

We were targeting cyclical infrastructure exposure with the core view of lower long bond rates maintained for longer. Airport assets generally perform well in a lower rate environment. Further, it is a well run asset from the retail/property management through to the key stakeholder partners (airlines).

How is it better than its competitors?

Many of the competitors are not listed. Those with access to quality airports are effectively just Sydney and Auckland Airport.

What do you like about its management?

We like its sound management that continues to deliver a clear strategy that is executed well.

What is your target price on Sydney Airports?

Our internal price target is at various ranges above $6.25 that reflect different scenario analysis.

At what point would you sell it?

The stock is up 24% year to date so it has already performed above initial expectations. Above our price target would be a potential signal to rebalance.

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

It has added significant alpha to our large cap portfolio.

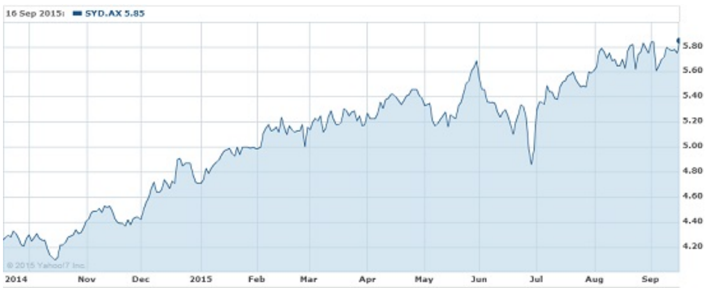
Is it a liquid stock?

Yes, very liquid.

Where do you see the value?

In the global and domestic rate cycle, asset mix from retail through to airline partner agreements and, importantly, the strategic vision to optimise asset even further. Plus the quality management.

Sydney Airport



***Source**: Yahoo!7 Finance, 17 September 2015*

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Macquarie upgraded Drillsearch (DLS) to Outperform from Neutral. Buy/Hold/Sell 4/2/0 Macquarie has cut its Aussie forecasts by 8-9% to US63c in 2016, US67c in 2017 and US75c long term. Domestic oil and gas producers reporting in Aussie see a net 37% earnings forecast upgrade as a result, albeit for some this is offset by US dollar costs. The broker's sector multiple has risen as a result, as has the broker's rating for Drillsearch, to Outperform.

UBS upgraded Rio Tinto (RIO) to Buy from Neutral. Buy/Hold/Sell 6/2/0 With iron ore appearing the better commodity into 2016 through supply side discipline, as opposed to oil, UBS upgrades Rio Tinto to Buy from Neutral. Looking at production guidance for 2015, the broker observes the majority of commodities are expected to reveal negative or near-flat production growth.

Only Pilbara iron ore is expected to add meaningful production growth this year.

Citi upgraded Transurban (TCL) to Buy from Neutral. Buy/Hold/Sell 5/2/0 Transurban has not escaped the broad market sell-off and Citi's expected total return has risen to 15.7% on the weaker share price. This triggers an upgrade to Buy. Transurban is exposed to defensive assets in a tough macro environment and offers an attractive yield and distribution growth, along with a pipeline of growth options.

Macquarie upgraded Woodside Petroleum (WPL) to Neutral from Underperform. Buy/Hold/Sell 1/5/2 Due to its Aussie dollar forecast update oil and gas producers reporting in Aussie receive a net 37% earnings forecast upgrade. The broker's sector multiple rises and Woodside is upgraded.

In the not-so-good books

Citi downgraded Origin Energy (ORG) to Neutral from Buy. Buy/Hold/Sell 5/3/0 Much has been made in energy circles of Santos' (STO) high gearing levels, yet Origin's credit rating is only one notch below Santos and gearing is materially higher. And unlike Santos, Origin has no plans in place to fix its balance sheet. Origin's energy markets growth outlook is flat.

Credit Suisse downgraded Regis Resources (RRL) to Neutral from Outperform. Buy/Hold/Sell 3/4/1 FY15 profit was head of Credit Suisse forecasts, with higher gold sales reported. The outcome is considered reasonable, given the recurrence of operational issues that limited production, but the broker downgrades to Neutral from Outperform given recent share price gains.

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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Acquiring assets from related parties

by Tony Negline

Key points

- *The super laws allow your SMSF to acquire listed shares or business real property.*
- *Your fund can buy the asset or make an in-specie contribution.*
- *If you contribute the asset into your fund, then this must be done on an arm's length basis.*

"Can I transfer the asset my business, my family trust or I personally own into my SMSF", is a question I come across often.

Put simply, the super laws only allow your fund to acquire specific types of assets from related parties including the following:

- Listed shares – that is, a security listed for quotation on the ASX and many international stock exchanges
- Business Real Property – that is, real estate used wholly and exclusively in the running of a business

What assets can't I sell to my super fund?

Basically all assets not mentioned above including residential real estate such as your holiday home or rental property, gold bullion, artwork, stamp or coin collections etc.

Also excluded are private company shares – that is, shares of companies not listed on the ASX or other recognised international exchange.

One way around this is to sell the asset you own to a third party, contribute the proceeds into super and then your super fund acquires a similar asset. If your fund acquires the same asset that you used to own from the third party then this may be seen negatively by the Tax Office under the super laws (this might trigger anti-avoidance rules and penalties) and under the tax laws (this might trigger what are known as the wash sales penalties).

Why transfer assets into your SMSF?

There are lots of reasons – you're attracted to the 15% tax rate in super before retirement, as well as the 0% tax rate after retirement.

You might also like the fact that, if you were to go bankrupt or your company insolvent, sometimes super can provide better protection for your assets and money than having these assets held personally or in your business.

Next, your super monies typically don't form part of your deceased estate, which means your super proceeds can be directly paid to one of your dependants – typically your spouse or children.

And finally, you might want to use the CGT small business tax concessions, which can involve contributing the CGT exempt proceeds into super.

The how

Now for the how – how do you want your fund to acquire this asset? In other words, do you want your fund to buy the asset or do you want to make in-specie contributions?

If the fund is going to buy the asset from you then it needs to be holding sufficient cash to affect the purchase.

If you're going to contribute the asset in-specie then you should think carefully about the various contribution caps that might apply, otherwise penalty taxes might apply.

If you contribute the asset in specie or have your super fund buy the asset then there will be a change of ownership of the asset.

The paper work

Before you do anything, you need to make sure that your fund's trust deed will allow the fund to own the particular asset. You also need to make sure that the trust deed allows the fund to acquire the asset from you or entities that you or your relatives control or are deemed to control. Just so you know, all of these people and entities are called your super fund's "related parties".

Under the super laws your fund must have an investment strategy. You must make sure that this document allows you to acquire and hold the asset you intend to contribute into the fund or have the fund acquire from you.

If you contribute the asset into your fund, then this must be done on an arm's length basis. That is, any tax deduction you might claim for the contribution needs to be based on the market value of the assets on the day the transaction took place. Equally, the super fund needs to record the transaction using the same valuation in its financial records as what it sends to the ATO as a contribution.

If your fund acquires the asset from you, then similarly the sale must be done based on an independently verifiable valuation.

Specific issues for listed shares

As your super fund will become owner of the shares then this needs to be officially registered either with your broker (if the shares are broker sponsored on the chess system) or with the share registry (if the shares are issuer sponsored).

Brokers and share registries will probably charge a fee for recording the change of name of an asset. Share registries will also demand you prove your identity however your broker should already have this.

Specific issues about real estate transactions
These transactions need to take place with appropriate documentation including a contract of sale. In addition, the title of the property must change to your super fund's trustee. Your State or Territory revenue office will charge stamp duty (there are some exemptions or concessions for business property transfers in some States).

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How to build a portfolio

by Questions of the Week

Question: I have just subscribed to the *Switzer Super Report* and I am looking to build a portfolio with 10 years to my retirement in mind. Should I try to stick to those stocks in your portfolio? Not too sure where to start, especially in this current market environment with what to dive into and when.

Answer (By Paul Rickard): The portfolios are a good place to start – but they are not the total picture, as there is no exposure to small cap stocks. Also, these are (obviously) Australian shares only – you need to consider what other assets you have, and if the mix is right?

We have two model portfolios – one more income focused, the other growth oriented. Although you have 10 years to retirement, you will need to decide which is more in keeping with your investment objectives and your appetite for risk. On paper, if you can take a longer-term view, then the growth portfolio may be more suited.

In terms of timing, you are never going to buy at the bottom – or always sell at the top. My advice would be to start soon – history shows that time in the market is more important than timing.

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