Switzer Super Report
Advice you can trust

Monday 30 May 2016

# Dividend hunters

With interest rates low, being on the hunt for good dividend payers is not a bad idea, but where do you start? In today's note, I look at why I like the banks and what they have going for them.

Continuing with the yield theme, Paul Rickard road tests Investors Mutual Equity Income Fund – how does it compare? Also in the *Switzer Super Report*, Roger Montgomery looks at whether putting cash aside is a viable strategy. In *Buy, Sell, Hold – what the brokers say*, brokers this week put Medibank in the good books, while Graincorp is in the not-so-good books. Plus, in *Super Stock Selectors*, Origin and Spotless are on the likes list.

Sincerely,

Peter Switzer

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# Banks are a great investment but do it right!

by Peter Switzer

It beats me how experts commenting in the media assume we're all the same. According to them, we all want to invest in companies that rise in share price rapidly and if they pay a dividend, well that's good as well.

And while a lot of investors are like that, it doesn't mean all are like that or that they should all be like that.

It's OK if you want to be a punter to go for growth companies and try to time it. On my show, I have expert fund managers, who tip a company that does well but then falls. And when I ask them what happened to their tip, they say they sold out of it before it fell!

That might be true and might have been driven by the value they placed on the company. And when it went well over it, they sold. However, how many amateur investors have the skills to do this? Answer? Not many. By the way, a lot of fund managers can't do that timing piece well all of the time either.

This reality makes a lot of investors opt for yield. If you take the All Ords Accumulation Index, it shows that the average return per annum over a decade is around 10%, of which half of those returns are dividends. So being a dividend-stock hunter isn't a bad idea, if you're happy with a 10% per annum return. And who shouldn't be?

Of course, picking your own group of dividend-payers is also easier said than done but the banks and Telstra are damn good starts. These added to other historically consistent dividend-payers plus franking credits should produce a good annual return.

And that's why I still like the banks but you need to see them for what they are. They are more risky 'term deposits' but if you can live with the ups and downs of your capital, then the pretty good income stream becomes the main game.

Let's look at NAB for starters to prove my point. Its 52-week range is $23.82 to $33.67. It's now around $27.30 and if you go back to early 2009, after the GFC-crash, it was $15.08.

So when it got to $33, the capital gain was over 100% and it still is 81% and there has been seven years of dividends plus franking credits.

The CBA went within a whisker of $100 last year and I bet in my lifetime it will crack the century but I might see it at $40 again, if a crisis-created crash comes along again.

Furthermore, if we beat the 6000-level over the next 12 months, which a lot of experts expect, I bet you that the banks will be a part of that index rise — they have to because they make up such a large part of it with the Big Four taking up 25% of the index.

You invest in banks for the dividends and yes, even if those dividends do end up being cut, with franking credits they'll still be better than term deposit rates by a country mile!

Even before the latest rate cut from the Reserve Bank, Elio D'Amato, chief executive of share analyst Lincoln Indicators, argued that the dividend trade story has at least 12-18 months to run but I reckon it will always be a fair-to-great play, depending on what price you bought the stock at.

Clearly, buying CBA at $95 or so was a gamble, but even at that level, dividends plus franking credits beat term deposit rates. At current levels it's a no brainer.

Right now there are some analysts tipping bank share prices could go lower from here but with the economic outlook for the Oz economy looking pretty sound, I see any significant fall in the share prices as nothing more than a buying opportunity.

This year, the banks have had everything thrown at them: from fears that they were over-exposed to the miners, to a big short comparison with the US, to a housing crisis and a Royal Commission. All these accusations assume that the RBA and APRA are asleep at the wheel, which I don't think is true, given the forced capital raisings of late that actually explain why the share prices of our banks have dropped a peg.

At least five things make me comfortable about our banks — their dominant size, the taxpayer backing, the fact we pay back our loans, the calibre of regulation and the underlying strength of the economy.

The debt ratings agency, Fitch, basically agreed with my view, though it pointed out that one day fintech threats could undermine the banks' profitability. But even when that comes along as a threat, who will buy out the fintech disruptors? I'd say the banks!

Fund managers can bag the banks because they might want higher returns but if you're happy with 7% plus then bank stocks still appeal. And remember, if you can't take the volatility of bank share prices going up and down for the sake of dividends, then you might have to look at less rewarding, more stable investments, like term deposits or a conservative bond fund.

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# The yield chase

by Paul Rickard

Retirees and others seeking reliable, sustainable income may want to take close notice of the table below (Charlie Aitken remarked on it last Thursday). These are forecasts from the Reserve Bank, published in their May Statement on Monetary Policy.

Critically, the RBA now expects underlying inflation over the medium term (at least out to the end of 2018) to be in the range of 1.5% to 2.5%.

This is 0.5% below their official target band. While they are not linking this explicitly to lower interest rates, the implications for investors are very clear. In a low growth, low inflation economy, interest rates are set to stay low for some considerable time.

Table 6.1: Output Growth and Inflation Forecasts[(a)]
Per cent

| | Year-ended | | | | | |
|---|---|---|---|---|---|---|
| | Dec 2015 | Jun 2016 | Dec 2016 | Jun 2017 | Dec 2017 | Jun 2018 |
| GDP growth | 3 | 2½–3½ | 2½–3½ | 2½–3½ | 2½–3½ | 3–4 |
| CPI inflation | 1.7 | 1 | 1–2 | 1½–2½ | 1½–2½ | 1½–2½ |
| Underlying inflation | 2 | 1½ | 1–2 | 1½–2½ | 1½–2½ | 1½–2½ |
| | Year-average | | | | | |
| | 2015 | 2015/16 | 2016 | 2016/17 | 2017 | 2017/18 |
| GDP growth | 2½ | 2½ | 2½–3½ | 2½–3½ | 2½–3½ | 2½–3½ |

(a) Technical assumptions include A$ at US$0.75, TWI at 62.5 and Brent crude oil price at US$47 per barrel; shaded regions are historical data

Sources: ABS; RBA

Click here to download a larger image

So, if you are searching for yield, lower your sights — franked dividend yields of 5% are going to look pretty good, as will unfranked property or infrastructure yields beginning with a 6. Term deposits with a big figure of 2 might soon start to look good!

One option to get higher yield is to take on some more risk. A longer maturity date on fixed interest securities, investing in less credit worthy notes or debentures, or increasing the proportion of growth assets in your portfolio are potentially ways to increase yield. Another alternative is to invest in a specialist fund where the manager enhances the return.

There are a number of funds that do this. One class of product is Equity Income Funds, and one of the better products in this field is Investor Mutual's Equity Income Fund. Let's do a road test.

**Investors Mutual Equity Income Fund**

Designed for retirees and others seeking a higher reliable income, the Fund provides exposure to a diversified portfolio of high yielding Australian shares. It seeks to provide a distribution yield that is more than 2% above the market, while delivering an overall return that is less volatile than the market. This means that investors should expect a distribution return pre-franking of at least 7%, with less absolute risk.

Income from Equity Income Funds

| Multiple Income Sources | Long Term Expectation p.a. | |
|---|---|---|
| Dividends | 4 % | Steady through the cycle |
| Option Income | 2 % | Greater in flat/bear markets |
| Net Realised Capital Gains | 1 % | Greater in bull markets |
| Total Distribution (paid quarterly) | 7 %* | |

* After fees, pre-franking

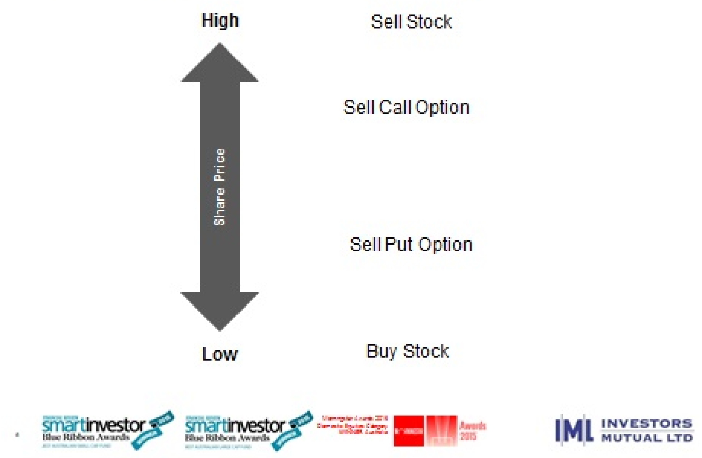
IML INVESTORS MUTUAL LTD

To do this, the Fund invests in a portfolio of quality high yielding ASX listed Australian and New Zealand shares, hybrids, bought and sold options and cash. Investors Mutual uses an active "bottom up" approach to identifying, researching and valuing companies, and seeks investments that offer one or more of the following characteristics:

- provide an absolute real return over the long term;
- pay a regular income stream;
- are less volatile (risky) than the market in which they trade.

The Fund uses option strategies to generate additional income and help manage risk. It illustrates this approach to using options within its portfolio:

IML option strategy – Execution of buy/sell discipline




The Fund doesn't use derivatives to speculate, nor to gear the fund.

## Performance

The Fund benchmarks its performance against the S&P/ASX 300 accumulation index. Over the medium term, the performance has been very credible.

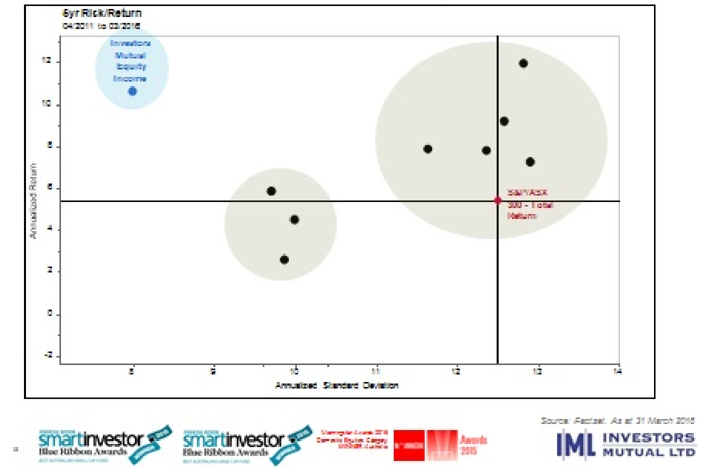
### Performance to 30 April 2016

| | 3 months | 1 year | 3 years | 5 years | Since inception* |
|---|---|---|---|---|---|
| Equity Income Fund | 3.26% | 4.25% | 9.82% pa | 10.90% pa | 11.14% pa |
| S&P/ASX 300 | 6.41% | -4.67% | 4.97% pa | 6.21% pa | 6.36% pa |

** 1 January 2011*

Investors Mutual says that it has also delivered on its other objective of lower risk, as measured by the annualized standard deviation of the returns. The Fund is running around 8%, while the market (S&P/ASX 300) is around 12.5%.

IML Equity Income Fund – lower volatility keeps investors invested




## The Manager

Investors Mutual has around $5.9bn in funds under management. Established by Anton Tagliaferro in 1998, it specialises in managing Australian equities.

The Equity Income Fund is managed by Jason Teh, and is approximately $285m.

Investors Mutual charges a management fee of 0.993% pa. There are no performance fees.

## Our View

Investors Mutual isn't the only provider of this style of equity income fund that uses options to enhance returns. Other managers include Armytage, Colonial First State and Zurich (via Denning Pryce).

One downside with some of these funds is that in recent times, the high distribution return has been earned partly at the expense of a negative capital return, as shown by a fall in the unit price.

Fortunately, Investors Mutual is not in this category and on track record, is probably the pick of the managers.

Distributions paid quarterly (expected to be around

7% to 9% pa) will be very attractive to many investors, although the franking percentage (37.3% in 2015) is relatively low. The minimum investment is $50,000.

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# Don't be afraid of cash

by Roger Montgomery

Each time I have written for you, I have discussed a company whose business and prospects are both attractive and whose share price even more so. But with aggregate earnings revisions declining precipitously, and price to earnings multiples at meaningful historic highs, it's worth counselling investors about the merits of having some cash for a rainy day.

Asset prices generally are described by some as "horrific" and they have of course been buoyed by low interest rates that make the fully franked dividend yields offered by large caps attractive.

But while many investors would be happy with the 5.49% on offer today (Telstra's dividends are unlikely to decline any time soon), I wonder whether you'd appreciate generating a yield of 6.85% or 8.00%. To receive those yields, you need Telstra's shares to decline 20% and 31% respectively.

Can't happen? If you are a net buyer of stocks, you should be hoping so.

The share price has indeed fallen by that quantum five or six times in its listed life, indeed it fell by 21% just recently from its high of $6.61 in February 2015. Of course, relative yields may have something to do with that but the fact the company's earnings haven't grown (they are extremely stable however), means that the share price could be vulnerable to a change in general market sentiment that inevitably occurs from time to time.

Is right now a great time to be investing or, if you have some spare cash, should you be waiting?

Back in 1981, the US risk free rate of return as represented by 5-year US Treasuries, was 15%. Real rates were close to 5%, debt was about half of what it is now and companies were restructuring, getting back to 'core operations' and taking a very disciplined approach to investing shareholder capital – thanks to that 15% hurdle rate!

Thanks to management getting their companies in order, thanks to the credit boom that followed and thanks to low asset prices, what followed was one of the greatest stock market booms in history.

The aggregate peak in US company operating cash flow was five years ago in 2010 and it has turned negative year over year since then and even as net debt continues to grow at an incredibly fast pace. Think about that for a minute. Typically debt is used to grow earnings. If you give me more money, you would expect me to put it to work and earn more next year or the year after than I earned this year. That has not happened. Why?

The reason is that the use of that debt in this cycle has changed. It has not been put to productive use. It has been used for financial engineering, for share buybacks and mergers and acquisitions. And remembering the aggregate decline in earnings I mentioned a moment ago, it seems the mergers and acquisitions must have destroyed value.

Despite no increase in interest rates, while growing borrowings by US$1.7 trillion, the profit share of the corporate sector peaked in 2012.

In 1982, the market sold for seven times earnings, those earnings were depressed and there were dozens of rate cuts as well as productivity improvements ahead.

Today, with rates at zero, debt to the gills, declining margins, rising wages, a questionable allocation of capital and earnings arguably inflated, we're at a price to earnings ratio of 18 times.

I think there is nothing wrong with wanting to generate a higher yield than what is available on cash. Obviously, putting all your money in cash is not the solution because you are, over the longer run, guaranteed to earn a return that will see you lose purchasing power.

Putting some of your cash aside however at 2.5% is sensible because it gives you an option; an option to buy the wonderful companies we have spoken about, here in the past, at even more attractive prices.

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# Buy, Sell, Hold – what the brokers say

by Rudi Filapek-Vandyck

**In the good books**

**DUET GROUP (DUE) Upgrade to Outperform from Neutral by Macquarie B/H/S: 2/4/2**

The regulator's re-set decision has delivered a good outcome for DUET, in Macquarie's view. The company benefits from the shift in depreciation methodology and also from smoothed revenue for its core business.

The company is still disputing some issues and the broker expects an appeal to follow this final decision. In the medium term, the developments are considered positive and Macquarie upgrades to Outperform from Neutral. Target rises to $2.44 from $2.38.

**ILUKA RESOURCES LIMITED (ILU) Upgrade to Overweight from Equal-weight by Morgan Stanley B/H/S: 2/1/3**

Weakness in mineral sands has been a key factor in the performance of the stock over the year-to-date but Morgan Stanley observes signs of improvement in end markets, which should mean demand and prices stabilise.

This should allow the company to work through inventory and reduce the risk currently priced in by the market. The broker upgrades to Overweight from Equal-weight as a relative call versus its ASX mining coverage. In-Line industry view retained. Target is raised to $6.80 from $6.10.

**Upgrades**

| Order | Company | New Rating | Old Rating | Broker |
|---|---|---|---|---|
| 1 | Aconex | Buy | Neutral | UBS |
| 2 | AP Eagers | Buy | Neutral | Morgans |
| 3 | CYBG PLC | Buy | Neutral | Morgans |
| 4 | Duet Group | Buy | Neutral | Macquarie |
| 5 | Flight Centre | Buy | Neutral | Credit Suisse |
| 6 | Iluka Resources | Buy | Neutral | Morgan Stanley |
| 7 | Lifehealthcare Group | Buy | Neutral | UBS |
| 8 | Medibank Private | Neutral | Sell | UBS |
| 9 | Programmed Maintenance Services | Buy | Neutral | Deutsche Bank |
| 10 | Resolute Mining | Neutral | Sell | Morgan Stanley |
| 11 | Wesfarmers | Neutral | Sell | Ord Minnett |
| 12 | Westpac Banking Corp | Buy | Neutral | Macquarie |

**MEDIBANK PRIVATE LIMITED (MPL) Upgrade to Neutral from Sell by UBS B/H/S: 1/6/0**

UBS has acknowledged the operational leverage in the stock, for what is probably another soft quarter of hospital utilisation growth and the regulatory backdrop is unlikely to be an issue in the medium term.

The stock is not expected to meaningfully under perform, given the earnings momentum over the next 12 months, While upgrading to Neutral from Sell, the broker does retain a negative longer-term bias at current valuation. Target is raised to $3.00 from $2.50.

**In the not-so-good books**

**GRAINCORP LIMITED (GNC) Downgrade to Neutral from Outperform by Credit Suisse B/H/S: 1/2/1**

Credit Suisse is downgrading to Neutral from

Outperform as the share price has risen beyond its target (steady at $8.41). The broker's analysis does reflect potential positives from transactions, such as selling an interest in port assets.

There appears to be insufficient rainfall and planting intentions in north west NSW to produce a bumper crop, while rainfall in southern NSW and Victoria is likely to support an average crop. Hence, there is modest potential for crop production-driven upgrades to near-term earnings forecasts, the broker contends.

| Downgrades | | | | |
|---|---|---|---|---|
| Order | Company | New Rating | Old Rating | Broker |
| 1 | APA Group | Neutral | Buy | Citi |
| 2 | Beach Energy | Sell | Neutral | Citi |
| 3 | Bluescope Steel | Neutral | Buy | UBS |
| 4 | Bluescope Steel | Neutral | Buy | Ord Minnett |
| 5 | Commonwealth Bank of Australia | Sell | Neutral | Macquarie |
| 6 | Evolution Mining | Neutral | Buy | Macquarie |
| 7 | Flight Centre | Neutral | Buy | Deutsche Bank |
| 8 | Graincorp | Neutral | Buy | Credit Suisse |
| 9 | JB Hi-Fi | Sell | Neutral | Citi |
| 10 | Kathmandu Holdings | Neutral | Buy | Morgan Stanley |
| 11 | Oil Search | Sell | Neutral | Citi |
| 12 | Regis Resources | Sell | Neutral | Macquarie |
| 13 | Regis Resources | Neutral | Buy | Citi |
| 14 | South32 | Neutral | Buy | Credit Suisse |
| 15 | Suncorp Group | Neutral | Buy | UBS |
| 16 | Suncorp Group | Neutral | Buy | Credit Suisse |

**KATHMANDU HOLDINGS LIMITED (KMD) Downgrade to Equal-weight from Overweight by Morgan Stanley B/H/S: 0/4/0**

Kathmandu is dependent on three key trading periods and Easter was under pressure given the timing, while winter sales have been affected by warm weather, Morgan Stanley observes.

The broker expects the emergence of a new competitor in newly restructured Ray's Outdoors, owned by Super Retail (SUL), will mean more clearance activity in the near term.

Kathmandu's turnaround is expected to take longer than previously estimated and Morgan Stanley downgrades to Equal-weight from Overweight. Target is lowered to $1.45 from $1.90. Industry view is In-Line.

**OIL SEARCH LIMITED (OSH) Downgrade to Sell from Neutral by Citi B/H/S: 3/1/2**

Citi thinks Oil Search is paying dearly for InterOil. The deal is made accretive through Oil Search raising fresh capital at an elevated share price, in the analysts view.

Price target falls to $6.41 from $6.70. Downgrade to Sell from Neutral. Citi also sees a negative read through for PNG T3 from the InterOil deal.

**Earnings Forecasts**

| Positive Change Covered by > 2 Brokers | | | | | | |
|---|---|---|---|---|---|---|
| Order | Symbol | Company | New EF | Previous EF | Change | Recs |
| 1 | BHP | BHP Billiton | 4.97 | 1.36 | 266.15% | 8 |
| 2 | STO | Santos | 0.89 | -0.55 | 261.93% | 8 |
| 3 | PRG | Programmed Maintenance Services | 23.48 | 19.89 | 18.02% | 4 |
| 4 | PRU | Perseus Mining | -1.17 | -1.37 | 14.33% | 5 |
| 5 | JHX | James Hardie Industries | 87.01 | 76.41 | 13.88% | 7 |
| 6 | BSL | Bluescope Steel | 47.36 | 41.83 | 13.24% | 7 |
| 7 | NXT | NextDC | 1.69 | 1.50 | 12.37% | 7 |
| 8 | OZL | Oz Minerals | 25.45 | 22.75 | 11.87% | 8 |
| 9 | WPL | Woodside Petroleum | 123.76 | 114.68 | 7.91% | 8 |
| 10 | FMG | Fortescue Metals Group | 33.02 | 31.13 | 6.08% | 7 |
| **Negative Change Covered by > 2 Brokers** | | | | | | |
| Order | Symbol | Company | New EF | Previous EF | Change | Recs |
| 1 | SXY | Senex Energy | 13.17 | 15.64 | -15.81% | 7 |
| 2 | IGO | Independence Group NL | 8.46 | 9.03 | -6.32% | 6 |
| 3 | FLT | Flight Centre | 252.00 | 266.69 | -5.51% | 7 |
| 4 | SAI | SAI Global | 27.72 | 29.10 | -4.76% | 6 |
| 5 | CYB | CYBG PLC | 23.06 | 24.19 | -4.70% | 5 |
| 6 | RRL | Regis Resources | 19.38 | 20.24 | -4.23% | 7 |
| 7 | WOR | WorleyParsons | 83.87 | 86.65 | -3.21% | 5 |
| 8 | SUN | Suncorp Group | 86.10 | 87.91 | -2.06% | 8 |
| 9 | BDR | Beadell Resources | 5.28 | 5.35 | -1.31% | 3 |
| 10 | KAR | Karoon Gas Australia | -3.12 | -3.08 | -1.30% | 4 |

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# Super Stock Selectors – Origin Energy and Qantas

by Staff Reporter

This week, one company with a delicious outlook is Collins Food Limited. Stock Selector Elio D'Amato from Lincoln Indicators says the company has satisfactory financial health and delivered a positive move last week, confirming the acquisition of 13 KFC restaurants as the business moves into NSW and Victoria.

"The business has flagged the closure of underperforming Sizzler restaurants, as the business directs focus to the strategic expansion of KFC," D'Amato says.

But Flight Centre has flown into D'Amato's dislikes list this week.

The Australian travel agency and provider of global travel services for leisure and business travellers recently produced a trading update, which flagged underlying FY16 profit before tax (PBT) to come in below the initial target.

"Challenges arising during the seasonably stronger second half include pricing competition and falling domestic travel," D'Amato says.

Another travel related stock – Qantas Airways – doesn't look in good shape, according to our technical chartist, Gary Stone. He says the share price, which fell below a significant support zone between $3.10 and $3.25 (with higher than average volume traded) could head for levels around $2.50.

Spotless Group Holdings is in favour with CMC Market's chief market strategist Michael McCarthy, because it's out of favour with the market!

| | Stock I like | Stock I don't like |
|---|---|---|
| **Raymond Chan, managing partner, Morgans** | Origin Energy (ORG) | Fortescue Metals Group (FMG) |
| **Elio D'Amato, CEO Lincoln Indicators** | Collins Food Limited (CKF) | Flight Centre (FLT) |
| **Michael McCarthy, Chief Market Strategist, CMC Markets** | Spotless (SPO) | Treasury Wine Estates (TWE) |
| **Gary Stone, founder of Share Wealth Systems** | Computershare Limited (CPU) | Qantas Airways Limited (QAN) |
| **ST Wong, Senior Portfolio Manager Prime Value** | MotorCycle Holdings (MTO) | Clydesdale Bank (CYB) |

"After the December 2015 downgrade associated with a number of missteps, SPO is out of favour. However, the share price may have bottomed and stabilised, and at a P/E ratio around 9x, looks cheap to me," McCarthy says.

The performance of Treasury Wine Estates, with a share price that's doubled in less than 12 months, looks overdone to McCarthy. He's placed this company in the dislikes column this week.

"Even if I double last year's earnings, I still get a P/E of well over 30x. Good stock but overbought."

And MotorCycle Holdings is in the likes list for Senior Portfolio Manager at Prime Value, ST Wong. Despite the decline in its share price, he believes in this company's growth potential.

"MotorCycle's share price has declined in the past few weeks, probably due to profit taking after a strong IPO debut. The company's prospects are underpinned by market leadership in a fragmented motor cycle retail sector," he says.

"We expect the company to grow sales both organically and by acquisitions."

On the other side of the token, Wong says you might consider trimming your position and taking some profits in Scotland commercial bank, Clydesdale, after its recent price run.

"The share price has risen 27% so far this month, backed by a better-than-expected result announcement," he says.

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