Switzer Super Report

Issue 309, 31 July 2014

The proof is in the pudding

US economic growth has come in a full percentage point higher than expected, which is another nail in the coffin for the doomsayers. Yes I know US jobs missed expectations, but I say a 4% GDP number trumps that.

Why am I so happy? Well, a good US means a good local market and it also means a stronger US dollar (i.e. a weaker Aussie), which will be even better for many companies here. I'll tell you more about this in *Switzer on Saturday*. But today we have Charlie Aitken explaining why he thinks multi-year laggards are about to take a turn for the better and why NAB has just become one of his favourites.

Also in the *Switzer Super Report* today, we have Tony Featherstone examining the supermarkets' move into financial services and whether or not to buy, Ron Bewley has the final cut on the stocks in his income portfolio and Manny Pohl, of EC Pohl & Co, talks about the benefits of SEEK in his *Fundie's Favourite.*

In *Buy, Sell, Hold – what the brokers say*, Drillsearch gets upgraded while QBE gets a couple of downgrades and we examine buying shares for kids and GI Dynamics in *Questions of the Week.*

Sincerely,

Peter Switzer

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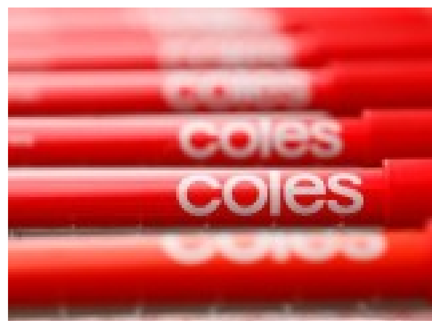

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NAB moves to my No.1 bank recommendation

by Charlie Aitken

It doesn't get much coverage but one of the clearest themes in the last three months has been a rotation from momentum stocks to multi-year laggards. The dogs are certainly barking and the pretty girls are looking a little tired.

The scenario

What I suspect is happening is the 130/30 funds and long/short equity funds have been crystallising multi-year large gains in pairs trades that favoured "good" stocks over "bad" stocks. The hedge funds and 130/30 funds short bad stocks to fund further investment in good stocks, but what happened is the valuation and performance spread between the good and bad simply got too wide and is now narrowing, as the bad deliver less incrementally bad news (if any) and the good struggle to justify their premium valuations. Similarly, merger and acquisitions aimed at multi-year laggards (as it always is), has played a role in making shorts/underweights nervous.

I have been warning for months that momentum stocks were losing momentum. The vulnerable MO list I published three months ago has handsomely underperformed the broader market and handsomely underperformed a basket of multi-year laggards.

My view is this will continue and the outperformance of multi-year laggards like **AMP, Aristocrat Leisure, Qantas, Sims Metal, CSR, Echo, Fairfax, Incitec Pivot, Primary Health Care, Whitehaven Coal, Western Areas, Alumina, Iluka, JB Hi-Fi, Leightons, Lend Lease, Treasury Wines, Tatts Group** etc. will broaden as all investors start focusing on relative value and recovery EPS/DPS growth.

Of course, QBE's 987th profit warning this week will bring out the doubters of my dogs' strategy, but that is very QBE specific and QBE was NOT part of our recovery list. I dumped enough money last year backing that thing and learned my lesson. Our recovery insurance bets remain AMP, IAG and Suncorp.

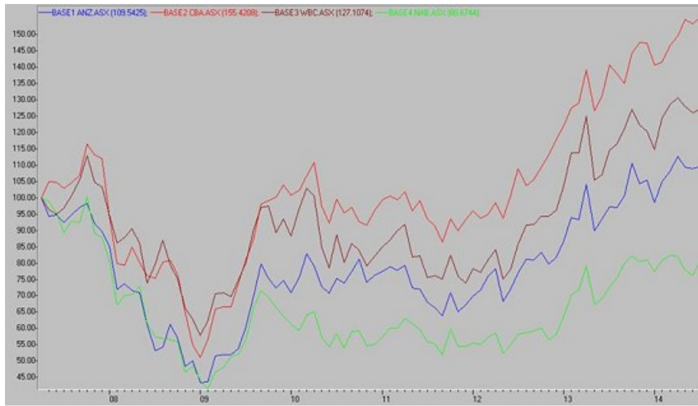
In the ASX top 20, there are very few stocks that you could truly describe as "multi-year laggards" that offer solid absolute and relative value. AMP is one, and NAB is another.

The best bank

Today I want to look at NAB because despite being neutral the banking sector, I think NAB is now the number one pick in the sector for potential total returns and relative sector outperformance.

Believe it or not, NAB now stacks up on all forward investment arithmetic better than its peers. I realise it sounds like an oxymoron, but NAB has every chance of being the best performing bank over the next 12 months, delivering the strongest relative and absolute total returns.

While the Australian banking sector has done extremely well since the peak of the GFC lows, not all bank share prices have been equal, despite the cozy domestic oligopoly. Pure domestic plays CBA and Westpac have dramatically outperformed the "diluted" domestic plays in NAB and ANZ. The chart below graphs ANZ (Blue), CBA (Red), Westpac (Brown) and NAB (Green) on a common share price performance base (not including dividends) over the last five years.



What happens from here is NAB plays relative and absolute catch up to its peers as the UK noose around its neck lessens.

This is a situation NOT to overcomplicate. NAB's PE and price to book discount to its peers will narrow as the market becomes more accepting that its exit from problem UK commercial real estate loans is a reality. Even if this occurs by NAB shares standing still and its peers falling, I can only see scenarios where NAB is the sector outperformer from this point.

NAB is currently trading on the lowest FY15 P/E and P/B ratio in the sector, yet offers the highest EPS growth in the sector, highest dividend yield and highest ROE growth. What needs to be emphasised is, as NAB exits the UK problem loan book, capital is released and ROE improves. I strongly believe that ROE and price to book ratios are linked in the bank sector. That makes fundamental sense, and as NAB's ROE improves on UK problem loan exposure reductions, you will see PB and PE expansion, both relative and absolute.

The Suncorp playbook

If you made any money backing my view on Suncorp Group (SUN) as problem loans were exited, you should listen to me on NAB. The playbook is the same as SUN and also the same as UK examples RBS and Lloyds. In simple terms, investors pay a higher multiple for reduced risk. That is how it works in financials, both globally and locally.

The other attraction of NAB is a change of CEO just as the problems in the UK are becoming less of an issue. Incoming **CEO Andrew Thorburn** will have far less distraction from the UK than Cameron Clyne had to deal with and Thorburn will be able to focus his attention on the high ROE domestic business. This will be good for NAB shareholders.

On the topic of Thorburn, I recently had lunch with a former Australian bank CEO (a very successful and well regarded one), who thought Thorburn would be fantastic for NAB. Thorburn had once worked for this person and he said he was a first class operator. It was high praise from someone very well placed to make the observation.

In my view, NAB shares potentially offer a +13.4% total return over the next 12 months, comprised of a +7.2% capital gain (ROE, PB driven) and 6.2% fully franked yield. The investment metrics are below and I encourage you to focus on the FY15 forecasts.

Earnings Forecast

Year end 30 September	2013	2014e	2015e	2016e
NPAT (reported) (A$m)	5,355	5,948	6,621	7,342
NPAT (adjusted) (A$m)	5,910	6,292	6,841	7,562
EPS (adjusted) (A¢ps)	252	266	286	312
EPS growth (%)	5%	6%	7%	9%
PER (x)	13.8	13.0	12.1	11.1
P/Book (x)	1.8	1.7	1.6	1.5
P/NTA (x)	2.1	2.0	1.9	1.7
Dividend (A¢ps)	190	202	216	230
Yield (%)	5.5%	5.8%	6.2%	6.6%
ROE (%)	14.5%	14.3%	14.7%	15.2%
NIM (%)	2.01%	1.93%	1.93%	1.93%
Franking (%)	100%	100%	100%	100%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Move to overweight

NAB represents 5.96% of the ASX200 and is easy to overweight relatively inside a balanced portfolio. Unlike CBA, you don't need 10% of your capital in it to be market weight.

NAB, to my way of thinking, should be overweighted by relative investors and a clear long for long/short or 130/30 funds versus an underweight in one of the higher rated domestic banks. I suspect the funding vehicle should be Westpac for people who need a funding vehicle. I must stress the reaffirmation of a positive view on NAB doesn't mean I want to commit more capital to the Australian bank sector. Quite the opposite: I think anyone who increases their NAB exposure should fund it by selling another bank.

The main point is "***NAB is running off UK CRE (commercial real estate) loans at a faster rate than forecast"***. That's the crux of the matter and the basis for my NAB investment thesis.

NAB moves to my number one relative and absolute recommendation in the Australian banking sector. The sector weighting remains neutral/hold.

Go Australia, Charlie

100% of Charlie Aitken's fees for writing for the Switzer Super Report are donated to The Sydney Children's Hospital Foundation.

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Yield portfolio - the final cut

by Ron Bewley

In my previous articles on my yield portfolio, I outlined my portfolio construction methodology and presented 'Top Ten' lists for each sector. The next task is to choose the stocks. Rather than go just by yield, I also give credit for better consensus recommendations (from Thomson Reuters: 1 for a Buy down to 5 for a sell). And I also exclude stocks that worry me – for whatever reason.

Table 1: Sector top tens

Rank	Energy	Materials	Industrials	Discretionary	Health	Financials	Property	IT	Telcos	Utilities
1	WOR	ABC	SYD	MYR	PRY	SUN	FDC	IRE	TLS	DUE
2	-	ORI	MIN	TTS	-	NAB	SGP	-	MTU	SKI
3	-	ORA	DOW	TAH	-	IFL	DXS	-	SGT	APA
4	-	FBU	TCL	JBH	-	IAG	IOF	-	-	-
5	-	NST	CDD	SWM	-	BOQ	GPT	-	-	-
6	-	MGX	GWA	AAD	-	ANZ	MGR	-	-	-
7	-	PGH	MRM	SUL	-	BEN	CMW	-	-	-
8	-	AGO	SVW	AHE	-	PPT	CHC	-	-	-
9	-	MML	BKN	PMV	-	MQG	ABP	-	-	-
10	-	BCI	MMS	TME	-	CBA	-	-	-	-

Source: *Thomson Reuters Datastream & Woodhall Investment Research – as at 25 July*

I excluded from Table 1 for my portfolio:

1. WorleyParsons (WOR) WOR because it is more mining services than Energy.
2. Mineral Resources (MIN) because it is very much in the mining business and has had some poor recent performance.
3. Myer (MYR) because of the mergers, takeovers and retail woes.

That means I had no stocks – or weight – in four sectors: energy, materials, staples, and IT. I redistributed the energy and staples allocations proportionately across the other sectors – noting that the sectoral split gave neither space for Materials nor IT.

Weightings

Together with my decision rule for the number of stocks I allocate to each sector, I need to specify how much I invest in each stock. There are three obvious ways of doing this weighting:

1. Weight in proportion to market capitalisation of each stock
2. Equal weighting within each sector
3. Weight with regard to consensus recommendation

I think 1) misses the point for an SMSF. Because most sectors are dominated by one or two stocks, there is little point in going down the list as the size of the allocations falls off so quickly. Of course, by deviating more and more from market cap weights, tracking error (the variability of the fund's returns compared to those of the benchmark) increases but, to me, there is a good argument that stocks outside the top 20 are more likely to give my portfolio a kick in moderate to good times like now.

Equal weighting makes sense as it is simple and, apart from market cap weights, there is no other standard way of weighting. I prefer to weight stocks in each sector in relation to the consensus recommendations. If a stock gets a '1.5' that is a great recommendation. Such a stock seemingly has more chance of capital gains and yield as a stock with a 2.75 recommendation that scrapes through as a slight outperform.

Final stocks

My actual initial allocation is given in Table 2. But there is more to buying the stocks than dumping your cash into the market – in my opinion. I was in a hurry to get set because there were then only four days to go to the end of the financial year. I thought – and still do think – there was a good chance of a kick in July – and I've already made more than 3% capital gains in a few weeks. Tatts Group was particularly kind to me, but four other stocks have made more than 4% since I bought.

Table 2: Initial Allocation

Stock	Code	Company	Sector	Price	Dividend	Con. Rec.	Allocation
1	SYD	Sydney Airport	Industrials	4.36	5.7%	2.6	4,200
2	TCL	Transurban		7.68	5.0%	2.5	4,440
3	CDD	Cardno		6.42	6.1%	2.6	4,140
4	TTS	Tatts	Discretionary	3.04	5.5%	2.9	7,530
5	PRY	Primary Health Care	Health	4.42	5.0%	2.5	8,700
6	SUN	Suncorp Group	Financials	13.41	6.6%	2.5	9,620
7	IFL	IOOF		8.35	6.2%	2.8	8,800
8	BEN	Bendigo & Adelaide Bank		12.29	5.5%	2.4	10,260
9	BOQ	Bank of Queensland		12.47	5.5%	2.7	9,190
10	MQG	Macquarie		60.20	5.1%	2.3	10,750
11	FDC	Federation Centres	Property	2.59	6.2%	2.3	3,490
12	SGP	Stockland		3.99	6.0%	2.2	3,700
13	DXS	Dexus Property		1.16	5.6%	2.6	3,050
14	TLS	Telstra	Telco	5.19	5.8%	2.8	9,000
15	DUE	Duet	Utilities	2.45	7.1%	2.6	1,570
16	SKI	Spark Infrastructure		1.82	6.5%	2.6	1,570

Source: *Woodhall Investment Research*

The dividend is a forecast and allocation is a dollar value for a nominal $100,000 portfolio. I divided my notional '$100,000' total investment into four portions to take advantage of my estimates of sectoral mispricing, ex-dividend dates and general 'dollar-cost-averaging'. Because the end of financial year was looming large when I was committed on June 25th, I placed the trades much more quickly than I would otherwise have done. I was set by the close on Friday 27th June.

Of course, the allocations at current prices are no longer the same as market prices have already changed over time. In the beginning, my expected yield was 5.7%, against 4.6% for the ASX 200 index. My 'grossed-up' estimate of dividends (with estimated franking credits) was 7.5% against 6.0% for the index.

My capital gains forecast, using sector-averages, was 7.7%. I do not make forecasts at the stock level. I do use broker target forecasts as a rough guide. I think brokers tend to downplay these 12-month price targets so as not to get caught out. They can always inch these valuations up as they go along. My initial target-based capital-gains forecast was +2.7% but that has already been upgraded to +3.9% in less than a month!

The bias

So I am thinking the bias in the 'target forecasts' is currently of the order of 4% points. In other words, I am expecting a grossed up yield of 7.5% with a capital gain of about +6.5%, making a total return of around 14%. If I compare that to my index forecast of 6% with a dividend of 4.6% for a grossed-up total return of 12.0%. It may not seem worth all this effort for an extra 2% (14% – 12%) but there is more to it than that:

1. Will I get the yield component without too many surprises? That is, will my companies deliver on expected dividends better than the rest, or fall short?
2. Will my flexibility to invest my dividends wherever, over simply re-investing in the companies that generated them, gain an advantage?
3. Will future rebalancing help my portfolio over the index?

I'll give you an update after my August holiday in the Motherland. In September, I will focus on how to judge how well you are travelling.

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Can Coles make it a Big 5?

by Tony Featherstone

With bank stocks near record highs, the thought of the giant retailers entering the home-loan market is captivating. Done well, it could help offset sluggish retail sales growth and provide a new long-term earnings growth engine.

The real disruption

The big question, however, is not *whether* Woolworths and Wesfarmers, via Coles, can make inroads in personal lending. Of course they can. Rather, it's the size and timing of those inroads, the effect on earnings, and whether the retailers' valuations already capture the upside.

An even better question is: could the market be underestimating the disruptive effect of the big retailers exploiting their massive databases, customer analytics and data-mining skills, and their ability to cross-promote products and financial services, and provide point rewards?

Coles' unveiling this month of plans to issue personal loans, and its potential alliance with GE Capital, captured headlines, even though its push into retail financial services has been building for some time. There is longstanding speculation that Coles will apply for a banking licence, which would enable it to accept deposits. At this stage, Coles' broader intentions in financial services are unclear.

Woolworths also attracted headlines, albeit unwanted, about its "banking" services. Newspapers reported that Woolworths had incorrectly used the word "bank" in its advertisements, and risked irking the Australian Prudential Regulation Authority (APRA).

Some perspective is needed. Prominent British retailer, Tesco, provides a useful benchmark for Woolies and Coles' potential foray into home loans. It had built a £700 million loan book at the end of 2013 – about a 0.05% share of the British mortgage market – in 18 months since launch.

A fifth force?

Extrapolating that to Australia, a 0.05% share of our $1.37 trillion market equates to a $680 million loan book for Coles. If Woolies did the same, the retailers would have 0.1% market share in their first 18 months – hardly a fifth force in banking.

The big-four banks control about 84% of owner-occupied and investment housing loans, according to ARPA. The top 10 market players have a combined 96% share. Market leader Commonwealth Bank has a 27.2% share, according to ARPA.

At best, Woolworths and Coles would build a small market share, at least in the short term, assuming they successfully entered the home-lending market. And assuming that the competitive response from the big-four banks, which acutely understand the long-term threat, does not stop the retailers in their tracks.

Moreover, Coles' $680 million home loan book would deliver $4 million in earnings before interest and tax (EBIT) for Wesfarmers, using Macquarie Equity Research numbers. With EBIT of $3.53 billion in 2013-14, an extra $4 million for Wesfarmers is barely material, although it would grow over time.

The market understands the limited effect on Wesfarmers' earnings, and for Woolworths if it followed its rival's lead. Wesfarmers has a one-year total shareholder return (including dividends) of 11.6% to July 29, 2014. Woolies is up 11.8%. Both have underperformed the 15.6% gain in the S&P/ASX 200 Accumulation Index over one year.

So why even bother analysing the retailers' potential in home lending if the most likely outcome is a tiny market share and a minimal effect on earnings? It's because the market, as is its way, is looking 18 months ahead when the long-term investors, such as SMSFs, should take a multi-year view on core equity investments.

The long-term

On a longer-term view (five years plus), the retailers' likely move into home lending has intriguing potential. The market is probably underestimating the confluence of technological trends, as consumers move to electronic "wallets" in coming years (with smartphones replacing traditional wallets) and the increasing power of "big data" as retailers mine customer information.

Imagine the potential of Woolworths and Coles analysing 18 million transactions each week, and learning more about their customers than ever, thanks to smartphones being used as payment devices. Potentially, they'll be able to tell which customers are in the market for a new home loan, or to refinance an existing loan, well before the banks, based on spending habits.

If Target in the US can figure out when women are pregnant well before they have told friends or family, based on their changing spending habits, I'm sure the big retailers can tell which customers are in the market for finance, and respond with tailored in-store offers.

The other potential is linking home loans to discounts for Woolworths and Coles' supermarket, alcohol, hardware and petrol products. The big banks' credit-card points programs are not nearly as immediate as in-store food or petrol discounts, or juicy discounts at Bunnings for a new homeowner, who suddenly spends every second Saturday morning there, for example.

If you think it through, the retailers have two potential advantages over the banks. They have more transaction touch points with customers, and thus more data to mine. And better ability to exploit "radical adjacencies"' that combine technology, finance and retail.

One could see Woolworths and Coles each overtaking the fifth-largest mortgage provider, ING Bank (Australia), which has 3% market share, by the end of this decade. But they would still be a long way behind the fourth player, ANZ Banking Group, and its 15.3% share.

Realistic valuations

The final issue is valuation. Both retailers look fully valued in the short term, if not a touch expensive. Consensus analysts have Woolworths and Wesfarmers on a prospective 2014-15 Price Earnings (PE) ratio of 17.4 times and 19.2 times respectively. The multiple could well be higher if earnings-per-share forecasts disappoint because of Australia's challenged household sector. More will be known when both retailers report full-year earnings.

Even so, current owners should continue to hold both stocks, and prospective owners should look to buy on significant price weakness. Both are still core portfolio holdings and a bigger push into personal lending strengthens their long-term appeal.

Great companies have a knack of juggling different streams of innovation: short-term gains from continual productivity improvements; medium-term gains from moving horizontally or vertically into related markets; and long-term gains from radical, game-changing disruptions.

The retailers' potential move into home lending fits the third category. If they combine their offer with technology, big data, and aggressive cross-promotion of other retail products, Australia could see the boundaries of personal financial services radically reshaped. But it's still some way off and not enough to build a case to buy Woolies or Wesfarmers at current prices.

Tony Featherstone is a former managing editor of BRW and Shares magazines. All prices and analysis at 29 July 2014.

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SEEK no further for a solid stock

by Fundie's Favourite

How long have you held SEEK (SEK)?

We've owned SEEK for a long time. I believe we first invested in the company around 2006.

What do you like about it?

SEEK is the largest online global jobs marketplace by market cap and profitability. Domestically, SEEK is the job ad market. It accounts for approximately 70% of job ads and facilitated approximately 26% of job placements in F13 (placing approximately eight times more jobs than their nearest competitor). While the domestic business doesn't have the tailwinds of growth that it used to, SEEK's international investment portfolio should provide similar levels of growth into the future. Compared with the other online companies in Australia, SEEK started its move offshore quite some time ago, and it looks to be bearing fruit.

SEEK (SEK)

Source: *Yahoo! 7 Finance*

SEEK has had strong revenue growth averaging 30% over the past three years. It has had consistently high returns on equity (51% FY13), which have increased the last few years as its growth initiatives have begun to pay off.

How is it better than its competitors?

While SEEK dominates the domestic job ads market, it is starting to see alternative forms of competition emerge. What we like about SEEK and its management, is that it's absolutely focused on its competitors and is very aware that it needs to keep innovating to keep its competitive edge. The company is very well resourced and able to funnel those resources into product development and new areas of growth.

What do you like about its management?

SEEK has had a very stable management team, who have been with the business for a long time. They have a deep understanding of the markets that they operate in and have been excellent custodians of the business for their shareholders. They've delivered consistent earnings and dividend growth and have remained focused on their strategy to be the world's leading job marketplace.

What is your target price?

We don't have one as we see ourselves as a long-term owner of a business, not a trader.

At what point would you sell it?

We would sell SEEK if our expected future three year return was lower than the current cash rate, plus our required risk premium for equities. Any material change to the business model or senior management would prompt a review of the holding.

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

Excess return of the portfolio over the benchmark is approximately 9%, of which SEEK contributed 2.87% of that excess performance. The stock itself has had a total return of approximately 20% over that same

period.

Where do you see the value?

While SEEK's domestic business is quite correlated to the jobs market, we think that the market underappreciates the leverage that the business can generate as things improve. In addition, there is significant value in its offshore businesses, which is years behind Australia in terms of its adoption of the online classifieds and advertising markets. Those tailwinds should be significant in their own right. Adding to that, its ability in running these types of businesses, provides a potent combination for future growth.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

Financial services – mainly insurers – featured on the downside of brokers' ledgers in the early part of the week, while miners and energy companies are in the good books for a change.

In the good books

BA-Merrill Lynch upgraded Atlas Iron (AGO to Neutral from Underperform as weak results have now been laid bare and iron ore prices have stabilised, limiting near-term downside.

JP Morgan upgraded Drillsearch Energy (DLS) to Neutral from Underweight based on the improved sector-relative valuation as the stock retreats from its April highs. The target is raised to $1.60 from $1.56 and JP Morgan increases FY15 earnings forecasts by 8%. The quarterly result beat on revenue, capex and cash flow. Further improvements will depend on the longer-term outlook and the broker awaits the investor briefing on August 1.

In the not-so-good books

BA-Merrill Lynch downgraded Bendigo and Adelaide Bank (BEN) to Neutral from Buy. The bank is fundamentally attractive and better positioned from a regulatory perspective compared with the majors but its recent performance is reflected in the share price. The stock is up 14% since April while the sector is up 3%. The broker acknowledges a key risk in relation to the Great Southern class action has now been removed, as an agreement has been concluded with investors.

Macquarie downgraded Insurance Australia Group (IAG) to Neutral from Outperform following a pre-announcement of an insurance margin well ahead of guidance. But notwithstanding synergies from the incorporation of the Wesfarmers' business, the rate of premium growth is slowing and IAG's share price is currently reflecting a favourable claims environment. Having pre-released its result "surprise", there'll be no more surprises at the actual result release.

Credit Suisse downgraded Nufarm (NUF) to Neutral from Outperform. A month ago, the broker was confident in its Outperform rating for Nufarm, driven by growth in Brazil. But in the interim, soft commodity prices have fallen in the region and may yet fall further, pressuring farmers to turn to cheaper pesticides, the broker suggests.

Credit Suisse downgraded QBE Insurance Group (QBE) to Neutral from Outperform and Macquarie cut from Neutral to Underperform, following a profit warning that lowered first half guidance to 22% below Macquarie's forecast. While the balance sheet continues to improve – funded by a lack of dividends in Credit Suisse's opinion – reserving issues continue to hold back recovery.

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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The ATO makes partial commutations easier

by Tony Negline

For each pension that your super fund runs, it must pay a minimum income payment every year.

In addition, those pension payments have to be made with cash or cash equivalent, such as cheques or direct debit.

Making the minimum payment

These rules are quite well known. Now you probably also know that the minimum income is based on your age at the start of each financial year and the market value of assets at that time. As you get older, the government's super laws increase the minimum that has to be paid.

There are two reasons for these compulsory minimum income increases. Firstly, it means that less of your money is held in super as you get older because the minimum will be more than the income your fund can earn. Secondly, the Government assumes your pension account balance will fall over time and hence the higher minimum goes part of the way to making sure your income doesn't fall.

What you may not know is that, if the rules of your pension (found in the documentation of your pension and your fund's trust deed) permit you to take a partial lump sum out of your pension, then that lump sum can count towards your minimum income amount. These small lump sums are often called a partial commutation.

These partial commutations can count towards your pension's minimum income requirements. However, it has long been thought that these partial lump sums have to be made with cash, cheque or direct debit. If they're made with other assets – valued at their prevailing market value when paid to you – then it has been assumed they wouldn't count towards meeting the minimum income requirement.

In a document released in early April, the Tax Office said that it would allow a partial commutation paid with assets other than cash to be counted towards the minimum.

How it works

My wife and I run our own super fund. Apart from a small amount of cash, we are fully invested in Australian shares that pay dividends that increase at least as fast as the inflation rate. As dividends are paid and contributions are made, we invest in more shares to receive an ever-increasing stream of dividends. We avoid overseas equities because of the volatility and uncertainty created by currency fluctuations.

Our plan is that I'll work until the super fund is receiving dividends that are at least 125% of our income needs in retirement. Why 125%? During the GFC, the value of S&P/ASX200 shares fell by over 50% but the dividends paid by the companies in this index fell by about 20%. You could say that the 125% income payment target is our risk management strategy.

Just before retirement, we'll hopefully have no debt and we'll also know what our income needs are down to the last dime.

Why this strategy? It's simple, very cheap to implement and, most importantly, it works.

If the value of our super fund's investments increases, then it's likely that the minimum pension demanded by the super laws will be higher than what we need to live on.

For example, suppose when we reach age 80, then we will have to be paid 7% of the market value of each pensions' assets (my wife and I are roughly the

same age). Suppose at the time these pensions have a market value of $3 million. That means we would have to receive $210,000 in income. Now assume that we only need $150,000 that year to live on.

In the past I had simply accepted that the super fund may have to sell some shares, pay us minimum income and then we would purchase the same investments in our own name with the excess income. In this example, the super would have sold $60,000 worth of shares and we would then purchase those shares in our name.

Now all we will need to do is take a $60,000 partial commutation using the market value of shares used for this payment. We can then hold these shares in our name, reinvest the income if we don't need it and distribute the shareholdings via our deceased estate. As you can see, the Tax Office has made these transactions much simpler and also a bit cheaper.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Tricky kids and tricky companies

by Questions of the Week

Question: I have eight grandchildren from age 10 down to 14 months. Unfortunately when I opened a CHESS account to buy shares for them, I put the chess register under my name as trustee for each child. My problem is I still earn an income and my partner does not. Who pays the tax if I sell the shares: my partner or me? This problem came about because I purchased LNG shares at 38c for the two oldest children and they are now $3.25 and I want to sell half. They have only held these shares for five months.

Answer (By Paul Rickard): I am not sure I follow how you have registered the shares in CHESS. However, it is most likely that your grandchild will be liable for any capital gains tax – not you or your partner. It all depends on the situation. If the child is legitimately the owner of the shares and all the income through dividends goes back to the child, then they will be liable for any tax. The first $416 of income will be tax free – after that, the effective tax rate is 66%. I have attached the ATO's link that provides different examples – see situation two here.

There is a link here to a copy of an article we published on this subject in January that explains the best mechanisms to buy shares for children or grandchildren.

Question 2: Do you have any recommendations on GI Dynamics (GID) that Charlie Aitken recommended recently, I bought them at 49 cents and they keep dropping, now at 42 cents, not sure to hang in there or cop my loss.

Answer (By Paul Rickard): I think GI Dynamics is in the "speculative" category. This means that you might need to wear some pain.

It has been a one-way train since they issued their second quarter update on 2 July 2014 and it is a little hard to say when the market might reassess. They are currently trading on a 52-week low.

If you are uncomfortable with the position, then cop your loss and move on. If you believe in the vision and the position is not material in your portfolio, then you probably hang on. They had $US71.7 million in cash at the end of June. They released their most recent quarterly statement today.

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Did you know?

Are you wondering what to do about BHP and Rio, given the falls in commodity prices? Watch my video with Paul Rickard to find out what we're doing with them in our portfolios.