Switzer Super Report

Issue 102, 19 July 2012

Income stocks

For most investors, especially SMSF trustees, the solid and steady approach is often best when it comes to stocks. In today's note, I explain why I like great companies that can be held for the long term.

Also today, Paul Rickard reviews Westpac's new hybrid issue, which he says is as straightforward as a hybrid gets. Charlie Aitken has taken another look at his high conviction large cap recommended portfolio and made some adjustments. Find out the stocks that are in, and what has been cut. Plus, with the concessional contributions tax to increase, Andrew Bloore reveals how to use franking credits to boost your super.

Sincerely,

Peter Switzer

Inside this Issue

How to use franking credits to boost your super
by Andrew Bloore
07

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Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
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Income stocks are now in vogue

by Peter Switzer

Months ago when stocks stunk to the noses of normal people, my co-founder of the Switzer Super Report, Hall of Fame stockbroker and the founding boss of a 'pretty' successful business called CommSec (please note the intentional understatement) Paul Rickard put together a portfolio of good dividend-paying stocks.

Anyone who has followed my columns in this Report or happens to be a client of Switzer Financial Planning knows I like great companies that pay good dividends, which I want to hold for a long time.

I don't want to be influenced by the short-termers (traders, stockbrokers, media mouths and many normal investors) who are like punters at the racetrack, always trying to be on a winner in every race.

Sure, if you can get it right in the short to medium term, if you can use the trend as your friend and make smart decisions like professional fund managers, then you might do okay but history has shown that one-third of active fund managers are lucky to beat the index!

Right now, people — and its often brokers or media experts who have been influenced by brokers — say you can't hold a stock for a long time. I disagree and so it was heartening when an award-winning fund's managing director told me that his fund can hold for 10 years and even longer.

Tim Samway of Hyperion Asset Management said that they look for companies that will pay dividends in the future, not just now.

They want companies with "strong organic growth paths", high return on capital, low capital intensity and importantly — low debt!

So what kinds of companies is he talking about? Well, as Tim ran through these company qualities with me, I asked: "What companies?" And then he and I in sync both suggested Seek. He then threw in REA, Carsales, Wotif, etc.

"They're great businesses, their dividends are growing strongly, their earnings per share growth is up there in the 20s and above, they're the businesses that will keep spinning off dividends for many years to come," he explained.

These companies have eaten into the business of traditional print media and Samway sees this continuing. I made the point that these companies are takeover targets as well, and he agreed, but he doesn't want that to happen.

"If the prices stay low [they're targets] and that's our fear that a company like that gets taken out at a 20 per cent premium, where we think we can make three times that money by holding it for five years."

Companies such as Hyperion have a team of analysts that keep watching a company. They get to know what makes it tick and effectively they understand the business. They're a great lesson to SMSF trustees who are in charge of their investment decisions.

In market boom times there will be others who will shoot the lights out but for most investors, and especially SMSF trustees, the solid and steady approach looks like the right game plan.

New Westpac hybrid issue to consider

by Paul Rickard

Following the success of the recent NAB issue, and a general tightening in margins, Westpac has launched a new hybrid issue. Reflecting investors' preferences for simpler hybrid structures, this is as straightforward as a hybrid gets.

It's a 10-year floating rate note callable after five years, paying interest quarterly at a margin of between 2.75% and 2.95% over the 90-day bank bill rate. With the bank bill rate around 3.54%, this is equivalent to 6.29% per annum for the first quarter.

The notes are subordinated and unsecured. They rank behind all deposits, bonds and unsecured creditors, and ahead of other Westpac hybrid Issues (WCTPA, WBCPA, WBCPB and WBCPC) and Westpac ordinary shares. Interest payments cannot be deferred and are not discretionary, however interest will not be paid if Westpac is not solvent.

The Notes will qualify as Tier 2 capital. With the approval of APRA, Westpac may elect to redeem the Notes five years out (from 23 August 2017 and then on every interest date thereafter), by repaying the outstanding principal and interest.

Details of the issue are:

Issue Size	$500m, with right to accept more
Security Type	Subordinated, unsecured term debt
Listing	ASX, stock code WBCHA, expected 24 August
Issue Price	$100 per Note
Term	10 years, maturing 23 August 2022
Optional Redemption by WBC	23 Aug 2017, and then on every interest payment date
Interest	Paid quarterly, 23 February, 23 May, 23 August, 23 November
Interest Rate	90 Day Bank Bill rate + Margin
Margin	Range of 2.75% to 2.95% (set in book build)
Interest Payments	No deferral – only if Westpac is not solvent
Ranking	Behind all senior obligations and unsecured creditors, ahead of subordinated perpetual debt, preference shares and WBC ordinary shares
Offer Opens	23 July 2012
Offer Closes (scheduled)	16 August 2012
Issue Date	23 August 2012
Minimum Subscription	$5,000 or 50 Notes, then in multiples of $1,000 or 10 Notes

The institutional book build on Friday evening will set the final margin. At the lower end of 2.75%, this implies an interest rate of around 6.29% for the first quarter – at the higher end of 2.95% the rate would be 6.49%.

Pricing

The Westpac issue is almost identical to the recent NABHB and ANZHA issues – with the former launched in May and maturing on 18 June 2022, and the latter in March and maturing on 20 June 2022. Both pay interest at bank bill plus 2.75%, and are trading on the ASX at small premiums to their issue price (NABHB closed Wednesday at $100.89, which includes $0.60 in accrued interest; ANZHA quoted at $100.90, which includes $0.57 in accrued interest). On an expected five-year term, ANZHA is trading at a margin of bank bill plus 2.67%.

At a likely margin of 2.75%, this issue is fairly priced and marginally better value than available on the secondary market.

For those seeking diversification away from financial stocks and willing to accept more complex hybrid structures, have a look at ORGHA and AGKHA – the Origin issue trading at a margin of around 3.75% and the AGL issue at 3.85%.

Overall

There is some misguided comment in the press about the state of the hybrid market because borrowers like Westpac are opportunistic – that is, they only issue paper when it is more favourable than accessing the wholesale markets. There is nothing wrong with this – this is just being commercial. With an ASX issue like this, they face issue costs of around 1.5% to 2.0% of gross proceeds, plus ongoing registry costs, plus issue risk – so it is not surprising that there is a reasonable spread between "wholesale" and "retail" rates. Our challenge as non-institutional investors is that it is very hard to access the wholesale market.

Wholesale rates have come down a touch, and investors have demonstrated a preference for simpler structures. Unless there is a raft of new issues, our view is that this issue will be well supported at the 2.75% margin.

Large cap portfolio: which stocks to swap

by Charlie Aitken

I was having a look at my high conviction large cap recommended portfolio to see whether it needed some adjustment. While it's got some riskier stocks, it's actually quite conservative and full of high yield industrials already.

While Seven Group (SVW), Santos (STO), BHP Billiton (BHP) and Fortescue (FMG) have underperformed, the rest of it has been respectable. As I have grown older, I have realised the key to a successful model portfolio management is actually resisting the temptation to sell winners. The real trick is to cut losers.

I wrote a few months ago that Santos (STO) didn't have yield support and had capex risk. I wrote that I would give it the benefit of the doubt in the portfolio and stick with it. That was a mistake, as a couple of weeks ago they came out with a capex blowout that took the stock down another leg. It was a bad call of mine not to cut it on the first hiccup.

So today I am going to belatedly fall on my sword and remove STO from my high conviction portfolio. We still have a buy rating and $18.42 price target on STO, but inside my model portfolio I don't need two LNG stocks. I am going to play LNG through Woodside (WPL) where at least they appear to be through the capex blowout stage and are supported by a sustainable dividend yield. I also get US gas exposure via BHP Billiton.

I am going to replace STO with Wesfarmers (WES). WES is a stock I haven't written about for a long time but it fits all the criteria I believe will drive outperformance in the year ahead. It's a big cap, is high quality, has diverse earnings streams, a strong balance sheet, excellent management and a high sustainable fully franked dividend stream. It also has clear leverage through Bunnings, Coles, Target and K-Mart to the improving East Coast economy, while Blackwoods gives you mining service leverage (industrial & safety). They are also involved in chemicals, energy, coking coal (where prices have bottomed), fertilisers and LPG, and I also like the insurance broking business. The Board is strong and Richard Goyder has proven himself a very capable and consistent CEO.

On full-year 2013 consensus estimates, the stock is cheap for its quality, remembering the defensive supermarket earnings are the largest profit driver. The full year 2013 (FY13) price to earnings ratio (P/E) drops to 14-times, EV/EBITDA to 7-times, and price to book to 1.33-times. Return on equity (ROE) edges up to 10%, while earnings per share (EPS) growth is forecast to be 12% and dividends per share (DPS) growth 12.7% to a fully franked yield of 5.90% based off an 88% payout ratio. Group sales rise to over $60 billion in FY13.

Globally, big consumer stocks are being re-rated daily, led by Wal-Mart, yet WES offers triple the dividend yield of major global consumer stocks, higher growth, and a lower P/E. I think WES is every chance of getting support from global investors as it looks cheap versus its peers. I am really adding WES as my play on Australian consumer confidence bottoming. Interestingly, I did notice on the radio driving in this morning an advertisement for Coles car insurance issued by Wesfarmers General Insurance. Who knew supermarkets and insurance had synergies!

WES, from a technical perspective, should head back to the top end of the three-year trading band at $34.00. That should occur as FY12 earnings and dividends are confirmed in August. WES is a solid 3.6% of the ASX200 and I don't know many investors who are overweight.

So my new high conviction large cap portfolio has a lot of stocks starting with “W” in it:

ANZ, AMP, BHP, CWN, FMG, NAB, SUN, SVW, TLS, WBC, WES and WPL.

Seven Group Holdings (SVW) – Buy

The share price of Seven Group has continued to deteriorate along with CAT in the US and the deteriorating value in the media investments, particularly Seven West Media (SWM), which has announced a $440 million capital raising to pay down debt. Seven West has indicated an intention to take up its entitlement in the raising, suggesting a funding requirement of about $146 million on the part of SVW.

With headline net debt at SVW likely to exceed $2.3 billion at year end or about 3.5-times FY13 estimated reported earnings before interest, tax, depreciation and amortisation (EBITDA) – 3.7-times adjusted for SWM – the market has been concerned with SVW’s debt balance, though we believe these concerns are overstated.

The industrial elements of SVW are now trading at 5.1-times FY13 estimated EBITDA, undemanding when compared to the peer group. Gearing of the core Industrial businesses is substantially lower than headline numbers would suggest (FY13 estimated Net Debt/EBITDA of 2.35-times).

- Recommendation: Buy (unchanged)
- Target price (12 months): $10.90 (previously $11.30)
- Capital growth: 62.7%
- Dividend yield: 5.4%
- Total expected return: 68.1%

Important information: *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. Anyone should consider the appropriateness of the information in regards to their circumstances.*

How to use franking credits to boost your super

by Andrew Bloore

Whilst not yet legislated, concessional contributions tax will increase from 15% to 30% for people with income over $300,000. This gives even greater importance to franking credits for these individuals seeking ways to reduce the tax increase. Instead of abandoning super, individuals may be looking at directing a portion of the SMSF investments into high-yielding, fully franked Australian shares to offset the increased contributions tax. However, additional considerations such as the risk profile of the SMSF members and the market performance will dictate whether this is a worthwhile strategy to pursue.

What are franking credits?

Australia has a dividend imputation system, which means that it acknowledges the amount of tax already paid by a company on profits, which is then paid out as a dividend to its shareholders. Shareholders are then required to pay tax on that dividend at their marginal tax rate. A franking credit, which is attached to the dividend, essentially refunds the amount of the company tax paid to avoid double taxation on the dividend.

Dividends have varying levels of franking. Some may be fully franked, meaning the full 30% company tax paid will be refunded, some partially franked, or unfranked.

Why are franking credits so beneficial in an SMSF?

Companies pay tax on income at 30%. The maximum amount of tax paid by an SMSF on income is 15%.

Therefore, when an SMSF receives a fully franked dividend in accumulation phase, the franking credit can offset the tax payable on the dividend by the SMSF, as well as tax payable on other income of the SMSF. This includes concessional contributions and capital gains tax. If the SMSF has no other income tax to offset, the ATO will refund the excess franking credit in cash.

In pension phase, where tax is reduced to 0%, the full amount of the franking credit may be refunded to the SMSF.

Minimising concessional contributions tax

Concessional contributions are taxed at 15% to the SMSF. The following example shows how concessional contributions tax can be minimised using franking credits.

An SMSF has a share portfolio worth $250,000. The shares pay a fully franked dividend of $12,500 in FY 2012/13.

Dividend	$12,500	
Franking credit	$5,357	Dividend x 3/7
Grossed up dividend	$17,857	Dividend + franking credit
Tax payable by SMSF	$2,679	15% x Grossed up dividend
Less franking credit	-$5,357	
Tax refund back to SMSF	**$2,678**	**Tax payable less franking credit**

The SMSF received concessional contributions of $25,000 in FY 2012/13.

Concessional Contribution	$25,000	
Tax payable by SMSF	$3,750	15% x concessional contribution
Tax refund from franking credits	-$2,678	
Net tax payable by SMSF	**$1,072**	**Tax payable less tax refund**

Using franking credits within the SMSF in this example, the concessional contributions tax has reduced from $3,750 to $1,072.

Another way to look at it is that the SMSF could receive concessional contributions of $17,853 (i.e. tax refund of $2,678/15% tax rate) before it pays contributions tax.

Franking credits in pension phase

Where the SMSF is solely in pension phase, and no contributions are made to the fund, the full amount of the franking credit may be refunded to the SMSF in cash. Using the same example as above:

Dividend	$12,500	
Franking credit	$5,357	Dividend x 3/7
Grossed up dividend	$17,857	Dividend + franking credit
Tax payable by SMSF	$0	No tax in pension phase
Less franking credit	-$5,357	
Tax refund back to SMSF	**$5,357**	**Tax payable less franking credit**

In this case, the whole amount of the franking credit of $5,357 will be refunded to the SMSF as there is 0% tax when the fund is solely in pension phase. This is a welcome cash bonus to the SMSF.

Requirements to receive franking credits

To be entitled to franking credits, the SMSF must hold the shares 'at risk' for a certain period of time. For ordinary shares, this is at least 45 days, not counting the day of acquisition or disposal.

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Did you know?

About 98% of self-managed super funds (SMSFs) held some investments in cash and term deposits in 2010, while 68.2% were invested in listed shares, ATO figures show.

Meanwhile, 11% of SMSFs owned business real property and 3.6% of SMSFs had residential property.

Other investments, which include art and collectables and other assets, like wine and racehorses, made up 5.1% of total SMSF assets during the year.

Don't miss this!

JP Goldman tells all about BetaShares' new BEAR fund that allows retail investors to profit from falling share prices. This week, Paul Rickard reviews the fund and also names some alternative hedging options.

- Paul Rickard: Review: Betashares' new BEAR fund
- JP Goldman: A new way to profit from falling stocks