Switzer Super Report
Advice you can trust

Thursday 12 November 2015

Time for contrarian ideas

Well the markets continued their wild ride but you our dear readers already know I'm an optimist, seeing these times as buying opportunities. After all, I am not concerned about our economic future (Thank you, Malcolm), otherwise I'd be a little wary. Charlie Aitken has often spoken about the need to look offshore, but today he shares with us some contrarian ideas in our home market.

Also in the *Switzer Super Report*, Tony Featherstone surveys the wealth management sector and reveals that it's still not too late to buy. He shares with us three star picks. Tony Negline joins the recent debate over super reform. Tony takes a close look at the Turnbull government's proposed plans to super concessions and dispels some myths along the way. And in *Buy, Sell, Hold – what the brokers say*, Fortescue is in the good book while Santos faces a downgrade.

Sincerely,

Peter

Peter Switzer

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Selective opportunities at home

by Charlie Aitken

Over the last few years I have strongly urged you to “lose the home bias” in terms of asset allocation.

Part of that was a view on the Australian dollar declining and the other part was greater growth was to be found in the rest of the world. I coined the phrase *“Australia for income, rest of world (ROW) for growth”*, but I’d have to say even after forecasting that correctly I am now surprised just how badly Australian equities as measured by the ASX200 are performing.

I thought I’d start by reminding ourselves of 2015 year -to -date performance of major world equity indices in home currency first and then in US dollar terms.

Index	% change home currency	% change in US Dollars
Dow Jones Industrial AV	-0.68%	-0.68%
S&P500	0.78%	0.78%
NASDAQ Composite	6.99%	6.99%
Euro Stoxx	9.60%	-2.64%
FTSE 100	-4.10%	-6.34%
CAC 40	15.90%	2.97%
DAX	11.20%	-1.18%
FTSE MIB (Italy)	17.70%	4.60%
Nikkei	12.90%	9.92%
Hang Seng	-5.31%	-5.25%
CSI 300	8.49%	5.71%
Shanghai Composite	12.80%	9.96%
HSCEI	-14.50%	-14.40%
ASX200	-5.33%	-18.13%

In US dollar terms, the ASX200 has underperformed the US S&P500 by -19%. That is monumental underperformance and wider than any underperformance I can remember in my career.

Quite clearly, the ASX200 has had the perfect storm against it in 2015, suffering not only from losses in its heavyweight index components, but also the double whammy fall in the AUD/USD cross rate.

The ASX Twenty Leaders Index (XTL) has been leading the broader market low. BHP & RIO in the miners, WPL, ORG, STO in energy, the four major banks, WOW and TLS has played the major role in our index underperformance of the world.

Some of those falls are driven by earnings downgrades and others by large scale equity raisings/dilution. Some by both.

In the last month alone we have seen another earnings downgrade from WOW, equity issues from ORG, STO and WBC and a very unfortunate dam collapse for BHP in Brazil, which saw BHP fall to a fresh 6-year low.

Quite frankly the description of *“perfect storm”* is correct in large cap Australia, but it is always darkest before the dawn and I am trawling through the damage looking for contrarian large cap ideas in Australia to add to my portfolio. I think the ASX200’s -19% underperformance of Wall St in US dollars is now too wide and I expect the equity issuance pressure on the ASX200 to ease a few notches into calendar year end.

As you know my fund has been running pretty high cash levels but I am starting to see specific opportunities in Australia where I can see a prospective total 12 month return well better than cash, remembering the risks to the RBA cash rate remain to the downside in 2016.

One of those opportunities is **Telstra (TLS)**, where

I've started to build an investment position on down days.

<u>Telstra has been absolutely poleaxed and I am of the view the correction in TLS is now overdone.</u>

To put this into context, TLS hasn't issued new equity, hasn't had an earnings downgrade and didn't have a dam collapse. The earnings and dividend forecasts for FY16 are marginally lower from March this year, yet the share price is down from a high of $6.67 to $5.23 currently.

The share price has fallen -21.5% in six months, yet FY16 consensus EPS has fallen from 37c to 35.8c (-3.2%) and consensus DPS forecast from 32.2c to 31.7c (-1.5%).

So in the 21.5% pullback we have seen FY16 P/E come down from 18.5x to 14.6x and the FY16 dividend yield rise from 4.78% to 6.07%. You're basically just paying –21.5% less for all but the same EPS and DPS estimates.

I think buying Telstra on 14.6x FY16 earnings, with a dividend due in February, and a 6.07% fully franked yield is a good risk adjusted total return idea.

TLS is trading on an 8.67% grossed up annualised yield. To an Australian tax-payer, getting paid over 4x the cash rate to take the "risk" of buying the dominant telecommunications industry player seems a good risk/return equation to my way of thinking.

Even if TLS goes nowhere from here, you will receive an 8.67%pa pre-tax dividend income stream. I also think TLS shares could easily add a "p/e point" from here, which would equate to +36c in capital growth, or +6.88% from current levels. That, if it proved accurate, would equate to a total pre-tax return of +15.5% over the next 12 months.

I think new TLS CEO Andy Penn will do a good job. I know Andy personally and I am happy to back him as he attempts to position TLS for regional growth, while maintaining the dividend stream to investors.

At the end of the day, we are in a digital economy. The Australian economy quite simply can't open for business each day without TLS's mobile networks.

TLS controls absolutely critical infrastructure, yet trades on a 10 P/E point discount to other "infrastructure" stocks, such as ports, railroads and toll roads. Note well there is a contested bid for AIO right now.

All I ever observe is people using their mobile phones and more and more mobile data. My own daughter now sends me text messages! I can't see the risks to TLS EPS or DPS in the years ahead and feel this deep pullback in TLS shares is a chance to add a reliable fully franked dividend income stream that also offers the potential for capital growth.

In summary, I did cop a bit of heat for being cautious on Australia late last year and earlier this year. I'll probably now cop heat for being more constructive on Australian equities around the 5000 index level. You simply have to be a measured contrarian to capture the maximum available performance. You actually do need to *"buy in gloom".*

This week we have seen broker upgrades to ANZ and WBC, which helps the ASX200 index bottoming process. A lot of this is about sentiment and I believe sentiment is bottoming out.

I now believe Australia's underperformance of the equity world is overdone and I am adding exposure where I am confident my investors will be rewarded with a double digit total return over the next 12 months. I've started with Telstra (TLS) and I am looking for others to put in the portfolio alongside our global exposures.

I am also adding exposure to new IPO's that offer growth at a reasonable price. Broadly I do think it's time to deploy some cash at the right prices in Australian equities.

Star wealth managers: 3 quality stocks to consider

by Tony Featherstone

Somebody forgot to tell wealth-management stocks that our sharemarket is struggling. Magellan Financial Group, Henderson Group PLC and BT Investment Management have soared this year, despite volatility in global equities. So is it too late to buy the sector?

Value is harder to find. Magellan Financial Group has a one-year total return (including dividends) of 66%. Henderson has delivered 57% and BT Investment Management has returned 85%!

Sector doyen Platinum Asset Management looks tame by comparison with an 18% total return over one year. IOOF Holdings and the recovering Perpetual round out the field with a 10% and minus 2% return respectively.

Then there is Challenger. It focuses on annuities and retirement-income products and has a funds-management business that provides administration and distribution services to boutique managers. Challenger's one-year return is almost 35%.

The collective performance of wealth management stocks is exceptional in an Australian share market that has gone backwards over 12 months. The S&P ASX 200 Accumulation Index has shed 3.4% over one year, Standard & Poor's data shows. Compared to the big banks, which have mostly delivered negative total returns over 12 months, the wealth managers have starred.

They have benefited from strong funds inflow, rising interest in global equities funds, product-distribution gains offshore and the lower Australian dollar. The sustained outperformance of several wealth manager against their benchmark index – a key metric to judge these stocks – has also buoyed the sector. Australia is blessed with some fantastic global-equities managers, whose funds consistently beat the market return.

That's the good news. The bad news is valuation. Magellan and BT trade on a forecast Price Earnings (PE) multiple of almost 22 times, consensus analyst estimates show. Platinum trades on 19 times, Henderson and Perpetual are about 17 times, and IOOF is 15 times.

Magellan and BT have significant short-term momentum and good long-term growth prospects as they expand overseas. Magellan deserves a valuation premium because it continues to launch successful products and build its US distribution. BT will benefit from ongoing growth in its offshore subsidiary, JO Hambro Capital Management, and the lower Australian dollar. But both stocks look fully valued for now and best bought at lower prices.

Other wealth managers have strategic appeal. The *Super Switzer Report* has identified Challenger and IOOF Holdings in its takeover portfolio. However, they provide different types of exposures to most wealth-management stocks so are not directly comparable to BT, Platinum and Magellan. The same could be said of Perpetual, given its expanding private wealth-management business and the Perpetual Corporate Trust.

Here are three favoured wealth-management stocks at current prices:

1. Henderson Group

The UK-based fund manager has rallied from $1.50 in June 2013 to $6.18, becoming one the market's star mid-cap stocks. Dual-listed on ASX and the London Stock Exchange, Henderson had £82.1 billion in asset under management in the first half of FY2015.

Consistently strong fund outperformance is attracting new money, and triggering performance-based fees that drive higher earnings growth. Henderson said in September that 83% of its funds had outperformed their benchmark index over three years – an excellent result given most active fund managers underperform their index over long periods. Henderson is especially strong in European and global equities and alternative asset classes.

Moreover, Henderson has consistently outperformed across a range of asset classes, in different geographies. Investors have responded by pouring more money into its funds – quarter-on-quarter growth in funds inflow has been ahead of Henderson's forecasts.

Henderson is not cheap. But it trades in line with its closest UK peers, according to Macquarie Equities Research, and still at a significant discount to Magellan, Platinum and BT, its nearest Australian peers. Also, Henderson provides leverage to a lower Australian dollar, given its offshore earnings.

Seven of 10 brokers that cover Henderson have a buy recommendation, consensus estimates show. A median target price (in Australian dollars) of $6.61 suggests Henderson is slightly undervalued at recent trades around $6.20. It has the operational momentum of Magellan and BT – if perhaps not the same long-term growth prospects – at a more attractive valuation.

Henderson

Source: Yahoo!7 Finance 12 November 2015 (based on ASX listing)

2. Platinum Asset Management

It wasn't so long ago that Platinum was the automatic choice for global equities exposure, such as was its investment performance and reputation. But a period of underperformance from its International Fund has weighed on the stock, relative to its peers.

Platinum fell from $9.15 in early 2015 to $7.57, although it is still well up over two years. Average funds under management of $26.1 billion at June 2015 compared to $22.3 billion a year earlier – slower growth by Platinum's standards and compared to its peers.

The Platinum International Fund has underperformed over one, three and five years to July 31, 2015. A one-year return of 21.8% to July 31, 2015 compared to 30.2% for the MSCI All Country World Net Index. Consequently, performance-fee revenue fell $25 million in FY15.

Platinum has shown it can grow funds under management and maintain management fees even during periods of underperformance. Stronger demand for global equities is expected as the Australian dollar continues to weaken against the Greenback, and as more Self-Managed Superannuation Funds realise they are badly underweight global shares.

Moreover, Platinum has scope to launch more products. Platinum Asia Investments, a Listed Investment Company, joined ASX in September after a successful Initial Public Offering. Other listed global investment products from Platinum would make sense.

Platinum's fund inflows are improving, after a period of performance-driven outflows, and its Asia Fund is outperforming its benchmark index. If the International Fund's performance improves, Platinum will look undervalued compared to Magellan and BT. Although it has underperformed in recent years, the Fund as a long-term record of significant outperformance.

Four of nine brokers who analyse Platinum have a buy recommendation, four a hold, and one a sell, consensus estimates show. A median price target of $7.33 suggests it is fully valued at the current $7.57.

It can do better than the consensus price target and an expected dividend yield of 5.1%, fully franked, is another attraction.

Platinum

Source: Yahoo!7 Finance 12 November 2015

3. Perpetual

After peaking at $58.48 in early April, Perpetual fell to $45.23 during this lingering share market correction. Its 12-month total return, slightly negative, is light years behind gains in Magellan, BT and Henderson. Fund outflows in the September quarter worried investors, although recent new investment mandates should stem flows.

Perpetual's Global Share Fund has outperformed its benchmark index by 6.6% over three years to June 30, 2015.

I like Perpetual's strategy to expand faster in private wealth management and capitalise on an expected huge intergenerational wealth transfer in the coming decades. The Perpetual Global Share Fund's strong outperformance should eventually attract faster funds inflow, and the company's transformation strategy has been successfully implemented.

Management has done a good job in stabilising Perpetual, but needs to quicken growth in the group's international assets. Departures of high-profile Perpetual fund managers and outflows in Australian equities have been headwinds.

The ingredients are there to boost international assets. Strong fund performance, a well-regarded international investment team, higher expected demand for global equities, and general growth in the wealth-management industry are long-term drivers.

Six of 14 brokers who cover Perpetual rate it a buy and eight have a hold recommendation. A median price target of $46.20 suggests it is fully valued at the current price.

I expect brokers to continue upgrading their recommendation and price targets for Perpetual as its international funds under management, which seem to have reasonably conservative asset targets, grow faster than the market expects. Two months ago, only three brokers had a buy recommendation on Perpetual.

Perpetual

Source: Yahoo!7 Finance 12 November 2015

Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply stock recommendations. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis at 10 November 2015.

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Super concessions are wasted on middle Australia

by Tony Negline

The Government is talking big about tax reform and other changes to super. This week, I look at two important aspects of this discussion.

It would seem that we're facing some tax increases, especially in relation to superannuation. In my view, this would be deeply unfair and inequitable, but remember, sometimes revenge is a dish best served cold at the ballot box.

Superannuation – a product for the middle income earners

Each of us pay income tax when we have income above a certain threshold each financial year. The more we earn, the more tax we pay. This is called a progressive tax system.

Based on how much income we earn, it's possible to work out how much tax we'll pay and then work out the average tax we pay. This is simply the tax we pay, divided by our income expressed as a percentage.

So, for example, someone with an income of $100,000 will pay $26,947 income tax and Medicare. At a basic level, therefore, their average tax rate is about 27%.

Now of course someone earning this level of income might have dependant children and be eligible for Family Tax Benefit Part A, which is effectively a tax refund. Their spouse may be eligible for Family Tax Benefit Part B, which is also a tax refund. They may receive the Child Care Benefit or Rebate, again another effective tax break.

They might also receive a number of other concessions, such as tax breaks on geared property or share market investments, which may further reduce the overall amount of tax payable.

All these refunds and tax breaks effectively reduce average tax rates.

Super funds have a flat tax rate

Our super funds are taxed differently – they always have a flat tax rate. In general, in the pre-retirement phase, super funds pay 15% tax for every dollar of income and realised capital gains they earn.

At a basic level if you earned around $47,000 in a financial year then you would pay an average of 15% tax and Medicare Levy on your income.

What does this mean? Well, it means that anyone earning less than $47,000 is paying less tax on their personal income than in their super fund.

Now here's an interesting bit of information. In November 2013, the Australian Bureau of Statistics estimated that the median individual wage in Australia is just under $58,000. What is the median? It's the middle number in a series of numbers. In this case, it means half of the working population earn less that about $58,000 and half earn more.

What's the average tax rate, including Medicare Levy, for someone earning $58,000? It's just under 20%.

So a large portion of wage and salary earners are forced to save in a vehicle that penalises them from a tax perspective.

What are the super tax concessions for?

These concessions are meant to serve as an incentive to contribute to fund your own retirement. But for half the working population, super isn't tax effective, so why would they bother?

It's also meant to compensate you for the long term nature of the investment. But again, for half of the working population, they receive no tax benefit.

There is concern about the amount of money the Government expends on the super system each year. A lot of that money is on tax deductions given to employers for the super contributions they make to super.

So here's an idea – why not make super voluntary for those earning less than say, $50,000. They can either take the 9.5% employer super contributions as salary (and pay tax on it) or contribute into super. Based on current rules, many of the lower income earners will end up on the full aged pension. So why are they forced to use a vehicle that penalises them?

An alternative solution – tax super at the greater of your average tax rate, or the 15% tax rate. Such a policy wouldn't be almost impossible to implement but it would be messy and costly to administer.

A quick note about the super-rich – in reality they don't need superannuation. They have the resources to seek top flight tax advice that would see them legally shift money between various entities and countries to reduce their overall tax burden.

So who is super meant for? It's meant for people who earn between $60,000 (add roughly $10,000 for each dependant child) and $500,000. That is, about half the workforce.

Would the Government want to be radical and restrict compulsory super to only half of all wage and salary earners? I doubt it.

What might happen if the preservation age were increased?

Your preservation age is when you can begin accessing your super.

For those born after July 1960, their preservation age is 60 but under current rules these people won't be able to access the age pension until age 67. The Coalition Government has a policy to increase the minimum age pension age to 70.

Clearly there is a mismatch here.

The Productivity Commission has been looking into this issue and found that aligning this preservation age and the age pension age will not automatically mean many of us will work longer and therefore have larger retirement savings. It found that some of us:

- Stop work due to poor health or to care for a loved one – this applies to 28% of men and 25% of women aged between 60 and 64.
- Lose our job and can't find new employment – this applies to 20% of men and 11% of women in the same age bracket.

The Commission's modelling suggests that raising the preservation age would increase the number of people aged between 50 and 64 by 2%. It also thinks, on average, these people would work for an additional two years and their super balances would be 10% higher when they finally retire. A good outcome that probably comes at too great a political cost it would seem.

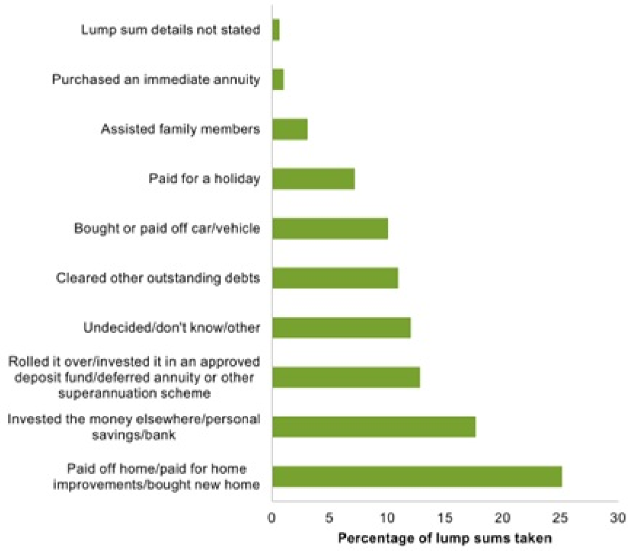
Is there any evidence that people are wasting their super lump sum withdrawals?

According to the Productivity Commission, gaining access to consistent data is difficult, but it says that it appears "both the absolute value and proportion of superannuation benefits taken as an income stream is increasing over time". That is at present only about 16% of super money is withdrawn as a lump sum. Moreover, the majority of people who take pensions elect to receive the minimum pension.

So it would seem that overall retirees aren't wasting their super monies. Anecdotally, I had reached this conclusion but it's good to see some substantial research about this potential problem.

Most people, who take a full lump sum, have a modest amount in super. In any event there is little evidence that these monies are being wasted as the graph below indicates.

Figure 10 **Main uses of superannuation lump sums[a,b]**
2012-13



So it would seem that there is no need to ban lump sum withdrawals from the super system.

Given this research, it may be that we're not close to seeing any limitation on taking a lump sum from super.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

ANZ Banking Group upgraded to Buy from Neutral by UBS. The bank's share price has struggled but the broker believes that while concerns are justified, a lot of the negative news is now factored in. The broker reviews the current multiples and finds the share price is already incorporating a significant increase in institutional impairments.

Incitec (IPL) upgraded to Neutral from Underperform by Credit Suisse. Incitec's result came in line with expectation, reflecting a solid performance in tough fertilizer and explosives markets, the broker says. The lower A$ provided a handy tailwind.

Fortescue Metals Group (FMG) upgraded to Hold from Sell by Deutsche Bank. Deutsche Bank is encouraged by the upgrades that have allowed a large drop in the strip ratios at the Chichester Hub, which has lifted recoveries. The broker is more confident that costs can fall below US$15/wmt in fiscal 2017.

Tiger Resources (TGS) upgraded to Outpeform from Neutral by Macquarie. Tiger posted record copper production in the September quarter. Earlier this month, the company announced a favourable refinancing deal which will afford the company considerably more options, Macquarie notes.

Previously, the broker had assumed Tiger would remain capex-constrained and limited to stockpiles only. Macquarie has now subsequently lifted longer term earnings forecasts.

In the not-so-good books

Newscorp (NWS) downgraded to Neutral from Outperform by Credit Suisse. The analyst views weak first quarter earnings as as growth in digital real estate and Fox Sports was unable to offset weakness in news and books. The broker has lowered fiscal 2106 earnings by 3.7%

REA Group (REA) downgraded to Neutral from Buy by UBS. First quarter revenue growth accelerated with the analyst noting it would have been even higher if not for the deferral of depth revenues booked at the end of September. Cost growth was contained.

Santos (STO) downgraded to Equal-weight from Overweight by Morgan Stanley. The strategic review has concluded and Morgan Stanley analysts do not hide their sense of disappointment.

One highly dilutive capital raising plus a sensible end to the progressive dividend policy with a whole lot less conviction in deep value in the company's assets is the end result, the broker says.

Seven Group Holdings (SVW) downgraded to Underperform from Neutral by Macquarie. Seven Group's WesTrac Caterpillar distribution business provides some 61% of Seven Group earnings, and some 65% of those earnings come from the mining industry.

The broker notes that the outlook for equipment manufacturers looks tough as mining continues to wind down. A further fall in earnings will bring into question the balance between debt and capital management.

A 20% fall in earning in FY16 would imply a cash flow below the current dividend payout.

Seymour Whyte (SWL) downgraded to Hold from Add by Morgans. The company has identified two problem contracts which have affected profitability.

Morgans is disappointed in the fiscal 2016 update, given this was supposed to be a better year. Profit is expected to be lower than fiscal 2015.

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Santos, yield and hybrids

by Questions of the Week

Question: What are your thoughts on Santos and Origin over the next four years?

Answer (by Paul Rickard): I have covered Santos today in my article on *Switzer Daily* today – see here.

Both stocks are captive to the oil price.

Over the next four years, probably OK – however I can't but not feel that it is too early to buy.

Question: Like all retired investors I am seeking maximum yield. I already have substantial holdings in shares that are providing good returns.

I wish to maintain diversity but am finding it difficult to justify placing funds on term deposit at the current low rates.

Your thoughts on CME Capital Aust would be appreciated. They are currently offering what appear to be well above market rates and I therefore would have concerns about the security of my capital.

Answer (by Paul Rickard): High returns usually means high risk. You are right to be very concerned. Investing in an unsecured note carries risk. Be careful.

Question: If you had the money today to buy AMP shares or AMP Capital Notes, which would you buy please?

Answer (by Paul Rickard): Because of lower investment risk and potentially higher short term income returns, I would invest in AMP Capital Notes.

If however you were after a capital return – then I would invest in AMP shares as there will be no capital return from AMP Notes.

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Don't miss this!

Just what is short selling, and why is it important for investors? Peter Switzer and Paul Rickard tell you everything you need to know in this week's Super Session.