Switzer Super Report
Advice you can trust

Thursday 26 November 2015

Best investment ideas

Today we quote a great investor, Peter Lynch, who said the best investment ideas you see are with your own eyes. It's a quote picked up by our good friend Charlie Aitken who shares with us his experience in the nursery! Charlie outlines a pretty good investment case for a stock that he has had personal experience with.

On the topic of best ideas**,** in today's *Switzer Super Report*, Tony Featherstone highlights an interesting 'disruptive' trend taking place in the insurance sector and 3 stocks that are positioned to do pretty well out of this disruption. We also take a peek into a trustee's fund in *My SMSF*. Paul Stephenson talks to us about managing his fund and how blokes like me helped him understand the world of investing.

Sincerely,

Peter Switzer

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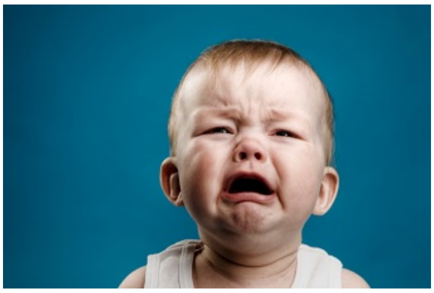

How to play the baby boom
by Charlie Aitken
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T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

How to play the baby boom

by Charlie Aitken

Many of you replied to last week's note about my more upbeat view of the Australian economy and Australian equity market with questions about the two discretionary retailers I mentioned we owned in the AIM Global High Conviction Fund, Harvey Norman (HVN) and Baby Bunting (BBN).

Thankfully both stock prices have advanced since that note with Gerry Harvey delivering an upbeat AGM outlook and Baby Bunting seeing its first analyst research since listing from respected retail analysts at Morgan's and Morgan Stanley. Both those research notes were positive with 12-month price targets above the prevailing share price.

At the macroeconomic level I believe all the factors are in place for strong Christmas spending in Australia, with the key variable being full-time employment growth since the change of Prime Minister. I believe that will be confirmed around February in the economic data for the period and retailer earnings reports for the period.

The great investor Peter Lynch believed that some of the best investment ideas you see are with your own eyes in everyday life. I also believe in that approach as I have written in these notes on many occasions.

Today I want to expand on the investment case for Baby Bunting (BBN), a newly ASX listed retailer that I have had plenty of personal experience with as a customer.

I'm sure all parents reading this note would agree that we all tend to overspend on the "nursery" in the lead up to a birth. This is particularly so around the first child.

According to retail analysts, the addressable market for baby goods retailing in Australia is around $2.3 billion per annum. Yes, $2.3 billion per annum.

The industry as a whole remains very fragmented with Baby Bunting being the largest specialty player with an estimated market share of 9%. There are many smaller scale independent operators and the industry is ripe for consolidation. If anything, the baby goods sector has been somewhat of a cottage industry with the top 10 players having less than 25% market share.

Baby goods is a defensive industry. The good news is that Australian birth rates continue to grow (population growth). Baby goods sales tend to track population growth closely. BBN is increasing its share of a structurally growing industry. In fact, BBN is now the largest specialty retailer of baby goods in Australia by store numbers (33).

BBN plans to grow to 70 stores and has invested heavily in both systems and supply chain, which is crucial in any large scale store roll out programme.

Morgan Stanley believes this will translate to FY15-FY18 EPS CAGR of 27%. "The organic store rollout should help deliver sustainable mid-teens sales growth and consistent ROIC improvement. As new store economics are highly attractive. A four-year store maturation profile is key to driving comp store sales growth above industry growth and inflation, while modest gross profit expansion and cost base leveraging drive EBITDA margin expansion to 10% over the next 5 years". Morgan Stanley forecast all of these growth drivers to be funded from operating cashflow, driving EPS well above market.

Morgan's believes "it's only just begun". There are not many listed retailers with similar levels of store footprint upside. Based on BBN's long-term store target of 70+ stores, the group is less than 45% of the way through its rollout potential. Not since JB Hi-Fi's IPO in 2003 has a similar store growth been on offer. Most importantly, BBN has invested ahead of the curve in relation to its store rollout. We expect the company is well placed to leverage this investment in coming years.

It's also worth noting that less than half of existing BBN stores are less than 3 years old. Given a BBN store typically takes around 4 years to reach maturity of sales, 45% of existing store sales being less than 3 years old provides another strong opportunity for sales growth. The benefit comes through in what is known as like for like sales.

Anyone reading this note from Victoria would most likely know the Baby Bunting brand better than readers in QLD and NSW. The company's heritage is in Victoria and the Victorian footprint is currently the strongest. BBN has strong brand awareness in Melbourne and Adelaide which can be replicated in the northern states once the rollout fills out the store footprint. One of the key attractions of BBN is how they are currently underexposed to NSW and QLD, which as rectified by store rollout, will drive sales growth.

Another attraction is balance sheet strength and the ability to self-fund the store rollout. Usually fast growth stories also have associated high gearing levels through capex heavy rollout stage, yet BBN is exactly the opposite with net cash of $4.6 million and NO DEBT.

The final attraction is management and shareholder interests are strongly aligned. BBN senior executives are highly incentivised to deliver strong earnings growth for shareholders over the long-term. While base wages are low (good thing), if management achieves +25% EPS CAGR and TSR OVER 5 YEARS, 4% of the groups issued capital will be issued to senior management. This is a big prize and strongly aligns management interests to shareholder interests.

I really like the management incentive structure, it's like a performance fee structure. It's also worth noting management currently own 3.7% of the issued capital of BBN and did NOT sell a share in the IPO.

The stock has performed well since IPO (+71%), with an initial burst then consolidation and profit takers (staggers) took profits. That process of staggers selling to long-term believers such as myself is now complete and I think the register is now very sticky.

This BBN investment thesis is a classic price to growth idea. On short-term P/E multiples BBN is not cheap, but if it does deliver on growth forecasts (or better) the stock will prove a cheap structural growth stock.

Let's look at the investment arithmetic (forecasts).

BBN	FY15	FY16	FY17	FY18
Revenue	$180m	$219m	$257m	$300m
EBITDA	$12m	$16m	$20m	$25m
EPS	7c	9c	12c	14c
EPS Growth	67%	29%	33%	16%
P/E		28.1x	21.8x	18.1x
PEG ratio		.96x	.66x	1.1x
ROE		11.1%	13.4%	16.4%
Dividend yield		3.00%	3.9%	4.7%
Franking		100%	100%	100%

On a current and future PEG ratio less than 1x, I believe BBN will prove cheap. Structural growth is hard to find, particularly in Australia, and when you find it you should pay a short-term P/E premium for it. However, P/E premiums are misleading if the growth is delivered.

I have great confidence in BBN's future growth prospects, and while it's only been listed for a short period, I think it will prove a solid medium-term investment.

However, I must stress to you all that BBN is a small cap company. The current market cap is around $250m. If you join me in owning BBN shares make sure it is an appropriate weighting in your portfolio to reflect the fact it is a small cap company. I leave you to judge that for yourselves.

All in all I think BBN has all the attributes that should deliver share price appreciation and better than market total returns over the next few years. The macro drivers are in place and BBN management is highly leveraged to deliver strong growth outcomes for shareholders.

I encourage you to visit a BBN store yourselves in the next few weeks and see if you agree with my opinion that this company could well be a category killer in the structurally growing baby goods sector.

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3 mid and small-cap insurers to watch

by Tony Featherstone

Few industries look riper for disruption than insurance. Imagine when sensors installed in cars provide real-time data to insurers on vehicle usage, speed and braking patterns to help them calculate driver risk with far greater precision.

Or when self-driving vehicles that rarely crash drastically reduce the need for auto insurance. Or better still, when these vehicles reduce the need to own a car – and buy insurance – as consumers order autonomous cars on demand via the cloud.

Health insurance is poised for disruption. Customers who share data from wearable fitness devices with their health insurer are already receiving policy discounts with some US insurers or loyalty-program points with Australian health insurers and airlines.

Consider when insurers, with permission, monitor your health through wearable devices, sequence your genome and adjust the policy based on real-time data. Or when insurance companies use data from "smart houses" to calculate home and contents insurance with greater precision. Or when farming and crop insurance is calculated using satellite and drone data. I could go on with examples of how the insurance industry will radically change in the next decade or two thanks to technology. Even the consumption of insurance will change as younger consumers increasingly buy policies online – a trend that is already entrenched.

The big surprise is that insurgent entrepreneurial companies have not attacked insurance-industry incumbents with greater aggression, as they are now doing in banking and other financial services. Take care holding slow-moving large insurance companies: they could go the way of print media and department stores as technological disruption quickens. Australian investors do not have a lot of choice in insurance stocks. Big names such as the underperforming QBE Insurance, Insurance Australia Group, Medibank Private and AMP, better known for its wealth-management business, dominate the industry.

Medibank is the pick of the blue-chip insurers. Its announcement this week of a contract renewal with Healthscope for another two years bodes well for other key contract renewals next year with Ramsay Healthcare and Epworth Healthcare.

These negotiations should help Medibank curtail cost growth and should aid its profit margins. Longer term, a growing, ageing population and increased healthcare expenditure are strong tailwinds for Medibank. Regulatory risks and declining health-insurance affordability are key challenges, but Medibank has plenty of scope to grow revenue and improve efficiencies now that it is privatised.

However, I prefer smaller insurers that can make life tougher for the big players – or be acquired by an industry incumbent. NIB Holdings and iSelect are longstanding selections in the *Switzer Super Report* takeover portfolio. iSelect received a takeover approach from Providence Equity Partners in October. As foreshadowed by this newsletter, iSelect's strategic value as more consumers purchase insurance online would attract suitors.

Here are three favoured mid- or small-cap insurance stocks. I have recently outlined a favourable view on iSelect, an aggregator and distributor of insurance policies, so won't add to that here.

1. NIB Holdings

NIB's announcement this week of a partnership with Qantas to offer its health insurance to 11 million frequent fliers is a good example of how technology is affecting the industry.

The product, Qantas Assure, rewards members with frequent-flier points for being more active. Members earn frequent-flier points for paying their health-insurance policies and meeting targets through a wellness app that syncs with mobile phones and fitness trackers.

As an aside, the deal again emphasises the latent strategic value in Qantas' frequent-flier program – a topic I covered last year for the *Switzer Super Report*. With Qantas points almost like a defacto second currency, the potential to mine a database of 11 million users and attack other industries is enormous if Qantas thinks more like a technology disruptor than a traditional airline.

Qantas wants to have a 2-3% share of the $19 billion Australian private health-insurance market. The partnership should maintain and improve policyholder loyalty for NIB at a time of rising policy lapses, downgrading and switching. It should also reduce policy risks by marketing to a frequent-flier user base that is healthier and more active.

The deal, while not having a material effect on NIB's earnings or valuation, is another example of the well-run insurer's proactive approach. NIB has performed consistently for several years: its return on equity (ROE) has hovered around 20% for the past four financial years. That's a good return on shareholder funds for an insurer.

The market has mixed views on NIB. Of 11 broking firms that cover the stock, three rate it a buy, five a hold and three a sell, according to consensus analyst estimates. A median price target of $3.70 is in line with the current share price and suggests NIB is fully valued.

NIB would fit nicely with a larger insurer. But even without a takeover, it has good long-term prospects and looks well placed to benefit from industry disruption.

Chart 1: NIB

Source*: Yahoo!7 Finance, 25 November 2015*

2. Cover-More Group

The travel insurer listed on ASX through a $260 million Initial Public Offering (IPO) at $2 a share in December 2013. The float was heavily oversubscribed, but almost two years later, Cover-More trades at $2.14, despite its exposure to the international travel market.

The company provides travel insurance, medical-assistance policies and employee medical-assistance services such as health-risk assessment and physical health coaching. Travel insurance accounts for about three-quarters of revenue.

Cover-More has good prospects. A recent trading update confirmed it is growing faster than industry forecasts and is offsetting the effects of a weaker Australian dollar, which affects its offshore claims cost, on earrings.

It is growing strongly offshore. Asian sales now contribute 15% of group profit and sales growth is strong in the United Kingdom and India. China sales volumes for Cover-More's medical-assistance policies are also performing strongly.

I like the long-term thematics for Cover-More. As I have outlined previously for the [Super Switzer Report](), tourism is set to boom, boosted by expected strong growth in Asian middle-class consumption, and as younger and retired consumers in developed nations increasingly travel overseas. For Cover-More, that means more customers buying its travel-insurance policies through an excellent distribution platform.

The threat of terrorism and rising health and safety fears when travelling overseas will surely encourage more travellers to take out travel insurance, of which Cover-More dominates.

The market is paying more attention to Cover-More at the current price. Six of seven broking firms rate it a buy and one rates it a hold. A median price target of $2.70 suggests it is undervalued at the current price – a price forecast that looks about right, given Cover-More's potential to grow earnings.

A forecast Price Earnings (PE) multiple of about 18 times is arguably not demanding for a company with genuine global growth prospects and such a strong industry position. A 4.7% dividend yield, fully franked, is another attraction.

Chart 2: Cover-More Group

__Source__: Yahoo!7 Finance, 25 November 2015

3. CBL Corporation

The recently listed insurer is worth following by investors comfortable with holding small-cap stocks. CBL listed on ASX through an $80 million IPO in October. Its $1.41 issued shares have rallied to $1.75 and some savvy small-cap fund managers have been buying the stock.

CBL sells and underwrites insurance in 25 countries. The New Zealand-based company focuses on identifying profitable, non-traditional insurance lines in local and offshore construction and property industries.

It is particularly strong in compulsory building insurance in France. Builders take out insurance to protect the homeowner when undertaking renovations, or against the risk of home defects when constructing a property.

Builder's warranty insurance is an interesting business. CBL limits its risk by dealing with smaller builders that construct a few homes each year, and focuses on simpler properties that have few non-completion, construction or repair risks. That minimises the risk of claims against policies CBL provides.

CBL has delivered consistently strong growth in gross written premiums and operating profit since 2009-10. It has successfully acquired several businesses and this month announced plans to buy a UK tax-protection insurance provider – another example of CBL's strategy to target non-traditional, niche insurance markets.

CBL is obviously well managed, and management owning a larger chunk of shares in a company is invariably a good sign. The $384 million stock is one to watch.

Chart 3: CBL Corporation

__Source__: Yahoo!7 Finance, 25 November 2015

• *Tony Featherstone is a former managing editor of BRW and Shares magazines. This column does not imply any stock recommendations or offer financial advice. 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 October 21, 2015*

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

Myer (MYR) Upgrade to Neutral from Underperform by Credit Suisse B/H/S: 4/1/2. First quarter sales were better than the broker expected, up 3.9% on a like-for-like basis. Guidance was re-affirmed and if sales growth continues at a similar rate the broker expects upside to guidance. The broker upgrades the retailer because of a weak share price and better sales momentum.

Technology One (TNE) Upgrade to Outperform from Neutral by Macquarie B/H/S: 1/1/0. Technology One reported a 16% increase in profit for 2015, in line with Macquarie's forecast. The final dividend is up 10% and a 2c special will also be paid. Client migration to the cloud is the company's medium term driver, the broker notes. Cloud migration is not without its risks, but the broker sees considerable leverage to be realised from new products, providing Tech One with the opportunity to up-sell clients to stickier and/or higher value solutions.

In the not so good books

The A2 Milk Company (A2M) Downgrade to Underperform from Outperform by Credit Suisse B/H/S: 1/1/1. Credit Suisse has reviewed its risk/reward assumptions after a 26% rally in the stock over the past week. The broker respects management's expertise and execution to date in Australia, but confidence that this can be duplicated elsewhere requires further evidence.

Primary Health Care Limited (PRY) Downgrade to Neutral from Buy by Citi B/H/S: 2/4/2. The company's trading update translated into a profit warning and Citi analysts have responded with a downgrade. The analysts point at pathology revenue growth, which is ahead of Medicare market data, yet below Primary's expectations.

South 32 Limited (S32) Downgrade to Neutral from Buy by UBS B/H/S: 5/2/0. South32 is downgraded given the challenging outlook for key commodities. Aluminium is expected to follow the steel industry trajectory, where expanding low-cost Chinese production exports surpluses around the world. UBS has downgraded long-term price forecasts for both aluminium and alumina.

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My SMSF

by Paul Stephenson

Paul Stephenson

Age: 61

How big is your SMSF and how many members are in the fund?

The fund is now $1.6 million. I only have one other member of the fund – my beautiful wife Jenny.

Why did you start a SMSF?

I have been managing the fund since 2006. I was a senior executive manager for a global corporation, which was sold to an international private equity firm. We had the opportunity to invest in the new company. I decided to invest in the deal through a self-managed superannuation fund rather than under my own name. So it pretty much started from that small transaction.

Is it more or less difficult to manage than you thought it would be?

It was easy in the early days but it has become complex as the fund has grown. You can easily fall through the cracks. That's why we decided to get an administrator. They make it easy but it isn't cheap! It's a fixed fee so obviously the larger the fund the better the fee % (laughs). I still have control over my investments but compliance and administration is all done for me. They sometimes tap me on the shoulder if an investment idea pops up. It's now the best of both worlds.

Do you enjoy managing it?

When I started my SMSF, I really became committed to educating myself. It was the best investment I made. I read a lot of books, finance magazines. I also enjoy watching Peter Switzer on his show on Foxtel. He is a terrific bloke and very very knowledgeable. It helped me to understand strategies like salary sacrifice, super contributions and tax free pensions which all add to overall performance of the fund.

Are you pleased with its performance?

We are very happy with the fund's performance. Some periods have been a bit scary but overall the fund has performed well. The fund has achieved a 35% performance over five years (before costs and pension payments) and 10% over the 1-year period (after costs and pension payments- a very good year). We are moderate conservative investors. Our mantra is don't be too aggressive " to sleep well at night".

What is your asset allocation?

The asset allocation is as follows:
Cash: 13%
Income investments (term deposits, bank debt securities, corporate bonds): 31%
Gold: 2%
International property: 14%
Commercial property: 8 %
Australian shares: 12%
International shares: 8%
International listed unit trusts: 12%

What are your favourite investments/stocks and why?

My favourite investment is the US Masters Residential Property Fund. The investment has done really well for us. We bought it when it was A$1.03 to US$ and the price has since grown by 70% with strengthening real estate market. It pays a dividend of around 5% a year. Around 34% of the total fund is exposed overseas so we are also getting a lot of benefits from the falling Australian dollar.

What investments do you have outside of superannuation?

We have our house (with two extensions), which we have fully paid off. We still have two adult children at home but they have plans to do their own thing. I have always preferred investing into my own superannuation because of the tax benefits. This may partly change on full retirement and any legislative changes.

I am currently working three days week (plus two days on the golf course!), and with my wife earning a small income, we are at the stage where it makes sense to focus on our super.

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TPG Telecom and hybrids

by Staff Reporter

Question: I have been offered shares in TPG Telecom Limited. These shares are in our superannuation fund. Do we take up the offer? Would you take the maximum amount of $15,000?

Answer (Paul Rickard): TPG Telecom (TPM) is conducting a $50 million share purchase plan (SPP) following the completion of a $300 million placement to institutions that was used to reduce debt following the acquisition of iiNet.

The purchase price will be the lesser of:

a) $10.40 (the same price paid by the institutions); and

b) a 2% discount to the weighted average on market trading price of TPM shares next week (week ending 4 Dec).

With TPM shares trading today at $10.50, the purchase price (a maximum of $10.40) is relatively attractive.

Taking a long-term view, TPG is a well run company and on the basis of the strong institutional support for the placement (only a 3.9% discount in somewhat soft market), I would be inclined to back the company and participate in the SPP up to the max. One note of hesitation – it has had a pretty good run this last 12 months, and the analysts feel it is fairly fully priced.

Bottom line – apart from the potential for a trading profit, my participation would probably depend on my exposure.

Question: Will the higher margins on the recent AMP and now Macquarie Notes 2 (MCN2) hybrids (over 5%) affect the pricing of other hybrids?

Answer (By Paul Rickard): Whenever there is new supply, existing issues tend to get sold off a touch (that is, a lower price means a higher effective margin).

As it is only around $400 million, it is not that big – so I wouldn't expect too much impact and from what I have seen to date, there hasn't been that much movement in the prices of other hybrids

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Fraud prevention strategies for SMSFs

by Tony Negline

Increasingly criminals are inventing financial investments and then stealing money by aggressively cold calling or emailing investors about their "investment product".

Believe it or not, often those duped by scammers and criminals are level-headed and well educated investors. Many victims are men over fifty who have invested well in the past.

These issues are becoming massive problems because our lives are increasingly online and we often perform financial transactions in exposed environments.

It often takes an experienced criminal only quarter to half an hour to steal many thousands of dollars from either your bank accounts or credit cards.

Now this isn't only a problem for you personally. It's also an issue for your super fund monies.

Earlier this year, the Australian Crime Commission released research which revealed their insights and concerns into the super industry and the incidence of theft, fraud and other crimes.

The ACC said SMSFs are particularly vulnerable to criminals: Key findings included:

- SMSFs using a trusted professional such as a financial planner who is collaborating in a fraud; as advisers know their way around the complex web of financial services laws, products and providers they're in danger of being coerced or exploited into being party to illegal activities;
- Intentionally using complex, multi-layered and opaque investment arrangements which are based overseas;
- Often using technology and cybercrime – this involves phishing, key-logging scams and stealing sensitive data (see below for a fascinating case I recently heard about); and
- Operate in gangs that remain one step ahead of the authorities

Criminals can pretend to be you to your professional advisers

I have heard stories of criminals pretending to be clients of advisers and requesting the transfer of money from SMSF bank accounts to other bank accounts. This appears to be done in a number of ways but sometimes this can occur by gaining access to online email accounts and learning from those accounts not only how you express yourself, but also what is going on in your life and using that to demand a quick transfer of cash.

How can you protect yourself?

The first point is to remain vigilant.

Earlier this year, APRA issued a lengthy practise statement to the large super funds it regulates advising them on how they might avoid fraud. They provided a long list of issues including the following:

- Claiming that an investment is exclusive to you and not available to anyone else;
- An investment manager who has no track record;
- The investment or its manager is located offshore;
- The investment is unlisted;
- The investment is complex and difficult to understand; and
- The investment isn't a standalone investment

While those rules apply to larger funds, Liam Shorte, a Sydney based financial adviser provided the following six-point plan to help SMSFs avoid investing in dud investments:

- It's really easy to make websites look professional so don't invest solely on what these say or how they look;
- If the investment is based in Australia, then check that the product has been offered by the holder of a valid Australian Financial Service Licence;
- Before investing, ask for and thoroughly review the full Product Disclosure Statement then ask your advisers to check out this document for you;
- Search for the owners and directors online. If their "Neville nobodies" then the offer is probably suspicious and speculative;
- Physically check their nominated business address as this might be a broom cupboard; and
- Review the ACCC's website www.scamwatch.gov.au and the super scam page of ASIC's consumer website Money Smart www.moneysmart.gov.au. However not being listed on these websites doesn't mean the product offering is genuine.

My Own Experience

Thankfully to the best of my knowledge, my identity hasn't been stolen and I don't believe we have had thieves swindle our bank accounts.

Like most of you I've received the silly emails and phone text messages that tell me I've won the lottery or am eligible for a tax refund and so on. I've been lucky enough not to be caught by any of these attempts.

However, recently I have received unsolicited phone calls from people pushing various different investment options. One was an opportunity to invest into an initial public offering for a Chinese business. The main selling point was that they had listed Alibaba! I asked them to send me information via email so I could forward it to ASIC and the ACC but it never arrived.

Another was an opportunity to invest in options. I have nothing against options and futures but I personally avoid them because of my lack of knowledge. The cold-caller arranged for a return phone call with his "expert" but that call has never turned up.

Have you or your super fund been targeted by criminals?

If yes, please write to me (tony.negline@ftsolutions.com.au) and tell me what happened. I think this is one topic that we have to learn from each other so we can all keep our personal and super life savings safe with your details kept confidential if that is your preference.

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