Is the worst behind us?
Time to go to Rio?
by Peter Switzer

I know newspapers are dwelling on the night of the long knife that took Tom Albanese out of the play as CEO of Rio Tinto, but the big issue for me and any trustee of a self-managed super fund is a simple one and that’s: “Is Rio now a buy?”

Or put it another way and with apologies to Peter Allen: “Is it time to go to Rio?”

Regular readers and viewers of my Switzer program know I was talking up both BHP-Billiton and Rio when their share prices sagged on lower commodity prices and reports of a hard landing for China.

I never believed the Chinese doubters, which I argued here, so I took our SMSF long the two big miners mid-year and they helped explain why we made about 27% in 2012. I don’t expect that will always happen and I have to say I made this play because I’m a long-term investor and I knew those low share prices we saw in mid-2012 would look fantastic in a few years time. We got lucky and the future rolled in quicker than I expected. Who would have thought iron ore prices could go from US$80-something a tonne to US$150 a tonne in such a short time?

I didn’t, but I was happy to be a beneficiary.

Management concerns

By the way, I couldn’t make the same play on Fortescue, though it too has benefited, but this is a company whose management I don’t trust. I hold them as a speculative stock and have done OK but Twiggy worries me.

And on the subject of management, Rio, in my opinion has dumped a plodder and mistake maker in New Jersey native, Tom Albanese, and replaced him with a ‘reliable pair of hands’ in someone like Aussie Sam Walsh, who has headed up the iron ore division.

Lately iron ore prices have retreated to around US$145 a tonne and some silly headlines talked
about a “price slump” but the more important issue is: is Rio still a buy?

I think so but the gains could be slower than the ones we saw in late 2012.

**Positive on Rio**

This is why I like Rio:

- Walsh is a cost cutter at a time when mining costs are surging.
- Walsh knows iron ore and China, Rio’s best customer.
- His division has been the most profitable.
- It’s thought he’s a short-term CEO, but don’t count on it — Walsh is competitive and if Rio does well under his watch, the company won’t be in a hurry to lose him.
- Rio is BlackRock’s World Mining Fund’s biggest mining holding and the world’s biggest fund manager rates Walsh highly.
- Rio has put in place new facilities, which will ramp up its production capacity.
- China’s economic growth for the fourth quarter came in at an annual rate of 7.9%, which was better than expected.
- Only three days ago, the World Bank said, “Four years after the onset of the global financial crisis, the worst appears to be over”.
- Most experts on a P/E basis argue that stocks are cheap with the US market at 13 times earnings against a long-term average of 15 times.
- Thomson Reuters says analysts expect a 10.6% increase in corporate earnings this year, which should help the rally.
- Research company Lipper reported the inflow into stock funds, mutual funds and ETFs rose by $18.3 billion in the week ending January 9 and this is the fourth biggest reading since 1992.
- Experts think this will be the year for cyclicals and material stocks such as Rio and BHP Billiton fit the bill.

**No fear**

I think Rio is well-placed to have a couple of good years, helped by the likes of China and other emerging economies, where their modernisation demands the kinds of products that Rio sells. I also think stocks will go higher this year and there will be a shift towards cyclicals, as income-paying stocks look too conservative. And as more money leaves safe harbours such as term deposits, stocks will benefit. I also believe consumers and businesses start spending this year and that will help stocks and companies such as Rio.

Given all this with the bonus of the better Walsh for Albanese CEO swap, I have no fears about going to Rio.

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One of an investor’s most important assets is his network, both social and professional.

Today’s article was inspired by a line of thinking triggered by my old mate Nige. He is one of those rare creatures who makes a living as a professional investor of his own funds and usually has an out-of-the-box view of the world, or some new wacky macro trend he is researching.

Last month, he attended a short conference on change and change leadership. The guest speaker was a futurist known as Craig Rispin, who writes for the Switzer Super Report, and who talked specifically about the speed with which mobile technology was being adopted worldwide. Out of seven billion people, more than six billion have a mobile phone, fewer than that have a toilet. The average American teenager sends over 3700 texts per month (no wonder they don’t talk). There are now over five billion mobile phone apps in the world and the growth remains enormous. Did you know that one smart phone possesses more than 4,000 times the computing power of the computers that NASA used to put men on the moon?

The world is changing rapidly and investors need to appreciate these changes and what they can do for and to a business.

Getting faster all the time

In the last year, the darling of the PC era, Intel, the company that built the engine for so many millions of PCs around the world, found itself on the wrong side of a monstrous trend. Its share price has plummeted and the market is speculating (no doubt a little early) of its demise for missing the mobile phone trend. Apparently, our smart phones don’t possess Intel chips.

The speed with which change is occurring is amazing and as investors, we try to deploy capital in order to capitalise on these tail winds and not swim against them. One of the difficulties facing all of us is that most companies capitalising on and often creating this momentum are not listed, and high profile structurally-challenged dinosaurs like Fairfax, Newscorp, Ten network, PMP and many more, are listed. At the event, Nige met representatives from a mobile phone app creator who had experienced extraordinary growth, and he asked them about potentially listing their business. Their response was simple, “we are a growing business, we will list when we are ex growth and are looking for an exit”. Of course, not all listed companies are mature and ex growth, but the pressure in the listed environment to provide short-term earnings, share price appreciation and regular dividends, coupled with the stringent compliance structure, makes it an unattractive place for many entrepreneurs. The majority of professional investors has little patience and rarely allocates capital with more than a six-month horizon. The open-ended fund, coupled with an obsession with quarterly investment returns, creates a structural challenge for investors when trying to make long-term investment decisions that may require patience.

That’s one of the reasons why I have built up a funds management business that uses Listed Investment Companies (LICs). LICs are a closed end pool of capital. When investing, they can therefore take a medium- to long-term view that, over time, leads to superior returns for their investors. The Listed Investment Company removes much of this pressure.

ASX an old age home?

Nige posed the question: is the ASX (as dominated by the larger stocks) an old age home for companies? Old, arthritic, long on experience, but suffering from inertia and just shadows of their former vibrant
entrepreneurial selves? Is the stock market just a place where good companies are sent when their best days are behind them?

He suggested that when considering a company for investment, a thorough understanding should be sought of how that company manages change. How does it foster a culture of innovation and risk taking and encourage evolution and development? Who leads this drive, and are the board and shareholders supportive of the need to take risks in order to future proof the organization? Well, at least try. Not every manager may be as good as Jack Welch, but the entrepreneurial culture fostered under his leadership led to new businesses and divisions that helped create one of the world’s biggest and most successful companies in GE. How many of our large cap ASX stocks actively encourage innovation?

Learn from mistakes

Failure is a great teacher and the demise of Fairfax is a classic example of how a dominant company, with a seemingly insurmountable moat around it, can collapse so quickly. The attitude by the board in the 1990s towards the internet was denial. Indeed, the chairman made it quite clear he didn’t want to hear any discussion around the potential loss of the classified-fuelled rivers of gold. This was a company uniquely positioned to capitalise on the internet. Instead, the board denied it. In the early 2000s, they tried to reinvest thousands but it was too late. Contrast this with what News Corporation, under the leadership of Rupert Murdoch, has achieved. Rupert became Managing Director of News Corp in 1952, when its major asset was a newspaper the Adelaide News.

Major change is with us; ignore it at your peril. We make change leadership an important subject of discussion with any company we consider investing in.

As a suggestion, look at a company’s website on your phone…do they possess a smart phone friendly website? If not, why not? An enormous amount of web browsing today is done from a smart phone….and it’s not just teenagers. The PC is history and the market risks going from an old age home to a graveyard if its constituents don’t embrace change and future proof themselves.

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Does your SMSF need insurance? The ATO says yes!
by Paul Rickard

The ATO has recently amended the Superannuation Industry (Supervision) Regulations to require trustees of self managed superannuation funds to consider insurance for their members as part of the fund’s investment strategy, and for SMSF assets to be valued at ‘market value’ for reporting purposes.

These changes were originally recommended by the Cooper Review and are now part of the ‘Stronger Super’ reform process. They haven’t received a lot of coverage, and while the impact is limited, it will mean some extra work for many trustees.

Considering insurance?

Less than 15% of SMSFs take out insurance cover for their members, which is probably why the ATO is introducing this new regulation. There are some advantages and disadvantages of taking insurance through your SMSF, which are set out in Andrew Bloore’s article ‘Should I take out insurance using my SMSF’.

While there is no requirement to take out insurance, there is also no requirement to take it out for all members of your fund. You might consider that insurance is appropriate for one member, and not for another member. For example, if your adult child was a member and they were reasonably financially independent and had no dependants, life insurance may not make a lot of sense. Conversely, it might make sense for you.

In the absence of any formal guidelines as to how you evidence your “consideration”, we suggest the following:

- At least once a year, the Trustees meet formally to review their fund’s investment strategy;
- As part of this review, consideration should be given as to the needs of each member, and the appropriateness or not of applicable insurance cover; and
- The trustees record in the minutes that the “financial, investment and insurance needs of the individual members were considered”, and any arising decision (eg. “The Trustees decided to defer consideration of the purchase of life insurance for Jane”).

Assets at “market value” for reporting purposes

Put simply, this regulation now requires that the fund’s assets be valued at “market” in the SMSF’s financial accounts and statements. Most funds have been valuing, for some time, listed assets, such as shares and managed funds at “market” value in the year end accounts, so in that regard it is not new. It now formalises the practice in relation to all other assets, such as property and unlisted securities.

It follows earlier and more onerous regulations covering the sale or transfer of collectables (such as artwork) and personal use assets to related parties. Collectables and personal use assets acquired since 1 July 2011 must be valued at market by a qualified independent valuer when transferred or sold to a related party, and for those assets acquired before July 2011, this will apply from 1 July 2016.

What is “market value”?

The ATO defines market value as:

“The amount that could be expected to be received in an orderly market – that is, what a willing buyer could reasonably be expected to pay to acquire the asset from a willing seller if:

- The buyer and seller deal with each other on an arm’s length basis; and
• The sale occurs after proper marketing of the asset; and
• The buyer and seller acted knowledgeably and prudentially in relation to the sale."

Will I need an external valuation?

The ATO has not mandated the use of external valuers. Generally, the valuation can be undertaken by anyone, as long as it is based on objective and supportable data. A qualified independent valuation should be obtained if the asset represents a significant proportion of the fund’s value, or the nature of the asset suggests that the valuation is likely to be complex.

Nor does the valuation have to be annual. If a ‘significant event’ has occurred since it was last valued, such as a natural disaster, changes in the character of the asset, market volatility or macro-economic events, then a valuation will be required.

Property

While you are required to consider the value of the property in your fund each year, you are not required to obtain an external valuation. A recent valuation will be required if a significant event has occurred that may have impacted the value of the property since it was last valued.

The valuation can be undertaken by anyone as long as it is based on objective and supportable data. A valuation undertaken by a property valuation service provider, including online services or a real estate agent, is acceptable.

Unlisted Securities

If you are holding unlisted bonds or debentures, you can probably obtain a market value from the broker or other agent you purchased them through.

With unlisted shares in a private company, the ATO suggests that you may need to take into account several factors, including the value of the entity’s assets (translated into a ‘per share basis’), and the purchase price paid to acquire the shares.

Investments without a ready market

While it may be difficult for the fund to substantiate the reason for holding those assets, the ATO acknowledges that there may be instances where investments fail. Potentially, the asset may be recorded at nil or nominal amount.

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The broker wrap – 40 upgrades and downgrades!

by Rudi Filapek-Vandyck

Securities analysts in Australia have started the new calendar year with a frenzy in downgrades and
upgrades and the week past delivered more of the same with no less than 40 upgrades and downgrades made to Australian listed stocks.

Much of the change came as a result of broad based sector reviews, with commodity prices andFX related marking to market exercises changing the tone of many valuation pictures. Stockbrokers otherwise got down to the more mundane task of getting back to business.

As has been the case in the early stages of January, downgrades continue to significantly outnumber upgrades. The week past saw 26 down versus only 14 up. Neutral ratings remain the largest group with a 43.81% share of total ratings.

**Upgrades**

BA-Merrill Lynch lifted Bank of Queensland (BOQ) to Buy from Neutral on improving volumes and a quicker than expected bad debt recovery. The stock remains positively regarded, with nothing but Buys and Holds in the FNArena Database. Although, the current share price is at a slight premium to consensus opinion.

It was a busy week for Billabong (BBG) after a new bid emerged and drew both Credit Suisse and JP Morgan into upgrading their calls. CS moved to Buy from Neutral, while JPM is just up to Neutral. The sentiment read in the database has pushed into positive territory, but it’s mostly on the back of potential M&A upside.

Boral (BLD) also received a double upgrade, with Deutsche Bank and Credit Suisse both lifting their calls one notch to Buy on news the company plans to book $105m in cost savings. Unfortunately for Boral, the same news sparked two downgrades, with both CIMB and JP Morgan cutting to Sell. The changes see the stock at a flat Neutral sentiment in the database.

Cockatoo Coal (COK) was bumped up one notch to Buy from Neutral by Credit Suisse, as was experimental drug maker Mesoblast (MSB). The latter was lifted on a positive outcome for a Phase-2 lumbar spinal fusion trial, with the broker positive given the news means the company can now meet with the US FDA to discuss a Phase-3 trial. The stock is positively regarded in the FNArena Database, with the upgrade making it three Buys and one Hold, with 22% upside to the consensus target.

Credit Suisse also took a look at gaming stocks, upgrading Crown (CWN) from Hold to Buy and Tatts Group (TTS) from Sell to Hold. The upside for Crown comes from upgraded MPEL earnings forecasts on the back of growing momentum in Macau, while Tatts is lifted to reflect the broker’s view that shares will continue to re-rate over the months ahead. Crown boasts a near perfect sentiment in the database with seven Buys versus just one Hold, while Tatts’ record is a bit patchier, with four Holds, three Sells and just one Buy.

Commonwealth Property Office (CPA) was lifted to Hold from Sell by JP Morgan on a positive view of the A-REIT space. The broker also lifted James Hardie (JHX) to Hold from Sell, as part of a sector review that contained mostly downgrades.

JP Morgan also lifted OzMinerals (OZL) to Hold from Buy on valuation grounds, with there being more than 20% upside to the broker price target. However, a close look at the database shows only 3.3% upside to the consensus price target, while two Buys, three Sells and two Holds keep the sentiment level slightly below Neutral.

The last two upgrades are from BA-Merrill Lynch, with Gindalbie Metals (GBG) and Grange Resources (GRR) both receiving double bumps from Sell to Buy on new iron ore price expectations. The stocks both sit in positive territory sentiment wise, with mixed Buys and Holds on record.

**Downgrades**

Conversely, BA-ML downgraded Adelaide Brighton (ABC) to Sell from Neutral on an expectation the company’s growth profile will slow considerably over the coming months and this will in turn lead to a general de-rating. The downgrade leaves the stock in positive sentiment territory, with four Buys, three Holds and the new Sell call on record.

More from the A-REIT space, with JP Morgan making two moves from Neutral to Sell last week. Both
Australand (ALZ) and Investa Office (IOF) were downgraded on relative valuation grounds. While the cut does little harm to ALZ, which remains in positive sentiment territory in the database, Investa has dropped well into negative territory on one Buy, two Sells and three Holds. A related view that building materials stocks have rallied too hard on hope/anticipation rather than on actual improvements in profits also sees the broker cut Fletcher Building (FBU) to Sell.

Next on the list is Woodside (WPL), Beach Energy (BPT), Roc Oil (ROC), and Horizon Oil (HZN), with UBS dropping its call on all of these stock from Buy to Hold on the view investors will remain cautious on LNG exposed stocks, given the large cost blowouts in 2012. The broker also downgraded Tox Free Solutions (TOX) following a strong rally in the share price, although UBS’ expectations remain for a strong year ahead, with growth firmly supported by last year’s Dolomatrix acquisition.

BA-Merrill Lynch downgraded a couple of Bs last week, those being BHP Billiton (BHP) and BlueScope (BSL). The broker’s view on BHP is simply that the recent run in the share price has made shares not only too expensive, but over-owned as well. Macquarie downgraded BHP last week on the belief the stock will underperform during the sector rally that it expects. The two downgrades have chipped away at sentiment for BHP stock, and while still marginally positive, it is far less so than it started the year. Meanwhile, the downgrade on BlueScope was made on the broker’s expectation of a catalyst free 1H, the high AUD, low spreads and generally weak domestic demand. Three Buys and one Hold mean the stock retains quite a positive sentiment skew in the database.

The broker also downgraded its call on Bradken (BKN), as did JP Morgan, with both cutting from Buy on valuation grounds. BA-ML went all the way down to Sell, saying improving macro sentiment and metals prices are unlikely to deliver the higher earnings/valuation needed over the medium term. While the stock remains in positive sentiment territory, the two downgrades do make a dent, with three Buys, three Holds and one Sell now on record. JP Morgan trimmed Boart Longyear (BLY) to Sell from Hold on the view current macro economic uncertainty will weigh on the share price, as miners remain conservative in their exploration capex. Four Sells, two Buys and two Holds leave the stock well in negative sentiment territory.

Challenger (CGF) picked up a blemish on its near perfect scorecard, with JP Morgan dropping from Buy to Hold following the recent share price rally. The stock remains positively regarded in the database, with five Buys and two Holds on offer. Meanwhile, Citi dropped Flight Centre (FLT) to Hold on slowing departures trends, which has the broker expecting far less chance of any sort of material earnings surprises from here. Incitec Pivot (IPL) had to wear two downgrades, from Hold to Sell by Citi and from Buy to Hold by CIMB. Citi believes an underlying negative trend in the company’s end markets is emerging and this will outweigh any of the

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upside, while CIMB notes the share price has run 23% over the past six months and now sits just shy of its revised target. Sentiment for the stock nonetheless retains a positive skew, with three Holds and one Sell outweighed by four Buy calls.

CIMB and BA-ML combined in a double downgrade for UGL (UGL), with the former going from Buy to Hold and the latter dropping from Hold to Sell. BA-ML’s issue is a negative view on the FY13-14 earnings outlook, given a weak domestic macro outlook and longer term concerns about the push into property services. CIMB also cited problems with the outlook. The downgrades leave the stock at a flat neutral as far as sentiment goes.

Telstra (TLS) was cut to Sell from Neutral by CIMB on a very stretched looking valuation, which pulls the stock a little further into negative sentiment territory. Yancoal (YAL) received the same treatment from Credit Suisse, also cut to Sell from Hold on high cost production, high debt levels, limited liquidity and a dominant exposure to weaker met coal markets. Sentiment is also firmly in negative territory.

The last two we look at are both downgrades from JP Morgan. Senex Energy (SXY) is dropped to Neutral from Buy after a run in the share price, while Wesfarmers (WES) is cut to Sell from Neutral on the exact same reason. With UBS downgrading to Hold last week, the latter stock has moved firmly into negative sentiment territory, with three Sells, four Holds and just one Buy recorded.

There were a few significant jumps in target share prices recorded last week as well. BlueScope’s target jumped nearly 40% and Technology One (TNE) up more than 11%. Both were due to positive revisions by BA-ML, with the latter up on a strong product and sales pipeline. Also, Fortescue (FMG) saw its consensus target lifted by 10% as brokers look to adjust for the recent spike in iron ore prices.

The run of sector reviews on the back of new commodity prices, FX assumptions, macro outlooks etc. has played havoc with earnings forecasts across the market. The changes are outlined in the below tables and are otherwise too numerous to address on a point by point basis.

Note: FN Arena monitors eight leading stockbrokers on a daily basis and the tables below are based on data analysis from the week past concerning these eight equity market experts. The eight experts in casu are: BA-Merrill Lynch, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie, CIMB (former RBS) and UBS.

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Equity markets rally after Shanghai bottoms

by Lance Lai

In our first report back in 2013, we have surveyed the Globe and have chosen Shanghai’s index because it appears the first signs of the long awaited bottom is with us, and most equity markets have also rallied hard since the bottom was seen in Shanghai on 5 December 2012.

A low was looked for at 1,962, first mentioned in my report of 29 October 2012 and then on “Switzer” on Sky News Business Channel on 29 November 2012.

On 5 December 2012 we got what is most likely the bottom of 1,949. Only 13 points lower or half a percent lower than sought. That same day, Shanghai closed at 1,975 or 13 points above, so the level of 1,962 was right in the middle of these trading ranges.

Typical of markets though, when you are at a bottom, it does not just go up a little, it goes up by arguably too much.

Shanghai has done just that, having gone up 18.8% since 5 December, i.e. in 6 weeks.

It appears that world markets and Shanghai are in need of a pull back.

A pull back in the order of 5.4% to 2,190 should be a minimum. A pull back to 2,134 or 7.9% would be ideal.

For most of last year, we were vigilantly watching this index on the expectation that this is how the globe will muddle through the impact of the GFC. This month is the first time in almost 18 months we are able to weigh seven positive aspects in the chart against 2 negative aspects. This is a very positive turn around.

If you haven’t already bought into this global rally, including Australian Equities, a better time ought to present in coming weeks.

This “bottoming formation” has implications for Equities in for the next 12 months of 2013. The muddle through seems to be working, and if we see this market continue to stabilise by not falling much below abovementioned “pull back levels”, we can rest easier that the worst should be behind us.

Positives

1. 200-day moving average has flattened out
2. A bounce was looked for in my show of 29 November, when it was at 1,975, for it to bounce at 1,962. On 4 December, five days later, the index bottomed at 1,949, about half a percent lower than my sought for level.
3. Ideal pull back level of 2,134 or 7.9% lower.
4. Crossed the 200-day moving average on a strong move up on 25 December 2012.
5. Crossed the major level of 2,134 on a strong move up on 14 December 2012.
6. The bottom that the chart was trying to form over the past four months appears to be constructive.
7. This is the second time the 200-day moving average has been crossed by price from below since it was crossed for the last time.
from above in late May 2011.

**Negatives**

1. The index is now up 19% from these lows. This is too much indicating a pull back is now needed.
2. A first level to pull back to is 2,190 or 5.4% lower, then 2,134 or 7.9% lower.

**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.

**Also in the Switzer Super Report:**

- **Peter Switzer:** Time to go to Rio?
- **Geoff Wilson:** Which companies have missed the tech boat?
- **Paul Rickard:** Does your SMSF need insurance? The ATO says yes!
- **Rudi Filapek-Vandyck:** The broker wrap: 40 upgrades and 40 downgrades!
- **Tony Negline:** Use catch-all clause or get caught out!
Go to Rio?

With Sam Walsh taking the reigns as the new CEO of Rio Tinto, the big question for SMSF trustees right now is simple: is it time to go to Rio? I look at the company in detail in today's note.

Also in today’s Switzer Super Report, Paul Rickard outlines what you need to know about new ATO regulations, Tony Negline explains the catch-all clause for SMSFs, and Geoff Wilson reveals why smart investors keep up with technology. Plus, plenty of upgrades and downgrades in Rudi Filapek-Vandyck’s broker wrap, and Lance Lai reveals his chart of the week.

Have a great day.

Sincerely,

Peter Switzer

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