FINANCIAL REVIEW smartinvestor

HD **PORTFOLIO PERFECTION**

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Smart Investor's model growth portfolio
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Smart Investor's model income portfolio
*As at February 28. **NZ imputation credits can only be used by shareholders
to offset NZ income tax liability. ^Based on consensus analyst forecasts.
Source: afr.com, Morningstar,
company websites
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Balance your portfolio

Tony Featherstone and James Frost

Does your portfolio represent a balanced model of risk and returns or is it a dog's breakfast? Tony Featherstone and James Frost outline three portfolios for growth, income and defensive investors.

As any experienced investor knows, creating the right blend of the investments to deliver the best possible performance is part science and part art.

Not only do you need to recognise your needs and identify your tolerance for risk, but you also need to adjust particular dials and weight contributions according to your own specific requirements.

Investment horizons, required rates of return and existing assets all need to be taken into account.

That's why we've created three model portfolios to get you thinking about what the right mix of investments for you might be.

To do this we've assembled a crack team of experts to produce three portfolios: one for growth, one for income and a multi-asset portfolio to help you weather all kinds of market conditions.

To kick things off, we had fund manager Roger Montgomery of Montgomery Investment Management select 20 of the most promising stocks on the ASX and explain the approach that has made him one of the most well known value investors in the market today. We also have Escala Partners chief investment officer Giselle Roux, who explains how the pieces of a multi-asset portfolio spanning stocks, bonds and property can produce the outcomes investors need. And finally, our in-house income expert Tony Featherstone updates his long running income portfolio.

While the portfolios aren't a one-size-fits-all solution, they are useful reference points for those of us who have haphazardly bought a few stocks and hoped for the best, an approach that rarely produces the desired result no matter what the discipline.

As a wise person once said that your investment portfolio is like the most important dinner party you'll ever throw. Are you happy to make it all up as you go along, or would prefer to have a few tried and true recipes up your sleeve?

Go for growth

Few Australian investors are more closely identified with the discipline of value investing than Roger Montgomery.

The mastermind behind a powerful stock analysis tool named Skaffold, Montgomery is also the founder of a funds management **company** that runs more than half a **billion** dollars.

Since inception in August 2012, the fund has outperformed the ASX/S&P 300 Accumulation Index by 8.6 per cent.

And with more than two decades of experience, Montgomery was the perfect person to help Smart Investor build a portfolio of top-performing stocks destined to outperform.

Overleaf you'll find a list of 20 stocks handpicked by Montgomery that meet his strict criteria of what constitutes a solid investment prospect.

And lest you think that "value investing" is code for picking up dull, beaten-up stocks at the bottom of the market, we have some news for you.

Value is only part of the equation. The prospect of future growth is just as important – if not more so – than the price you pay.

"Growth and value are two required sides of the same coin; you can't assess the value of something unless you understand its growth prospects," Montgomery says.

Which is why the list is jam-packed with enough ring-a-ding mid-caps to capture the attention of even the most risk-tolerant investor.

So, what kind of performance could you expect from the Smart Investor 20? We'll let Montgomery answer that.

"The growth rate of these companies is substantially stronger than the economy. If they continue to achieve that growth, then the portfolio will do pretty well over the long run."

That's all well and good. We would expect most model portfolios to do that. So we asked him to put some hard numbers around it. This is what he says:

"The average return on **equity**, or ROE, is 26.9 per cent. If all of these companies retained all of their profits, didn't raise more capital or borrow additional money, continued to reinvest at the same ROE, and I was able to sell them on the same P/E, my return would be 26.9 per cent."

You can't be more definitive than that.

The companies themselves have been selected through a dual process. First, they have their financial statements thoroughly scrutinised by Skaffold and assigned a score between A1 and C5.

Companies that score an A exhibit low risk and compelling earnings quality. The numeral refers to business performance and continuity. Companies that score a 1 are extremely reliable and companies that score a 5 are extremely unreliable.

This filter ensures that the investment universe of stocks only contains those companies with tip-top financial shape. But following this process we have overlaid the screen with Montgomery's own selections.

"The 20 stocks in this list have not only the lowest possible risk of catastrophe but also contain companies that I personally believe have bright prospects," he says.

Though the portfolio is not constructed with an eye to weightings of any kind, keen readers will see certain patterns emerge with the selections. The absence of **mining** companies is one.

"The best businesses to own take a large amount of capital and reinvest at a higher rate of return. The worst **company** to own is one that takes large amounts of capital and reinvests at a low rate of return. **Mining** companies tend to be in the latter," he says.

There's another group you won't find in the list: the household names that private investors and deep-value fund managers both hold waiting to take a turn for the better, much to the detriment of individual portfolio performance.

"In theory it shouldn't be hard to beat the index," Montgomery says. "The index is always invested in companies that are big and not necessarily very good. You should be able to beat the index in the long run if you remove the rubbish from the portfolio."

Care to name any names? "NAB has added no intrinsic value over 10 years; Leighton, Lend Lease, Boral, Qantas and Virgin are all index constituents but haven't added any intrinsic value over various periods in the last 10 years," Montgomery says.

Ducking the duds can be just as important as kicking goals. Over the past decade the formula used here has helped Montgomery avoid companies such as Hastie Group, Gunns and Elders. "All investing is value investing," he says. "If you are not trying to buy something at a price that is cheaper than what it's worth, what's the point?"

One of the key pillars of Montgomery's strategy that we've adopted here is to identify companies with strong growth prospects. We've singled out these companies with a filter that measures growth across two metrics, with a particular focus on earnings per share, or EPS growth.

The average EPS growth of the companies selected is 15.5 per cent. But as Montgomery explains, there's good growth and there's bad growth.

"Good growth is when EPS is growing but high rates of return on **equity** are maintained. That will **lead** to a pleasant situation where every dollar the **company** uses to finance growth creates over a dollar of long-term market value. In order to achieve that you need a high rate of return on **equity**."

You'll also note that high-yielding stocks – the current flavour of the month – don't feature here. This is not a portfolio that would suit an income-oriented investor.

"You can overpay for stocks," he says.

"We don't chase yield. We like dividends because we can reinvest them in other businesses, but we focus on the ability of a **company** that can reinvest its profits at high rates of return."

"If a **company** is maturing and it's no longer able to reinvest at the same high rates of return we prefer that they return profits in the form of dividends so we can reinvest them elsewhere."

Aside from the concentration of **mining** and finance companies on the ASX, Montgomery says the various duopolies and oligopolies that have emerged and in some cases thrived are another unusual characteristic.

Some of these are included among our list, many displaying very high returns on **equity**. Investors who are able to recognise this and the compelling opportunity they offer will be a step ahead of the rest.

As a final observation, we'd draw your attention to the fact that some of the stocks we've included are at or close to their all-time highs. Though we will check back on the portfolio and its performance, we would caution those readers who want to mirror the portfolio and buy all 20 stocks tomorrow.

A better strategy would involve using the portfolio as a starting point, monitoring both the performance and fluctuations in the share price before dollar-cost-averaging your way into those businesses you feel most confident about.

"I like when stocks get cheaper," Montgomery says. "It's not the price that signals you've made a mistake. It's the performance of the business, or new information coming to hand. We don't take our cues from price.

"At the end of the day, the objective is to find good, quality businesses and **purchase** them at rational prices."

Defending your wealth

James Frost

Giselle Roux knows that sometimes you have to break a few eggs to make an omelette.

As the chief investment officer for Escala Partners she spends a lot of time studying the asset allocations of private client holdings in search of improvements.

Sometimes this requires challenging long-held views of extremely successful and wealthy people in order to help them attain a robust portfolio that outperforms.

"There are always going to be certain asset classes that investors have decided not to participate in for whatever reason. But you should know the role and risks borne by every asset in your portfolio," she says.

The following multi-asset portfolio is based on the popular 60:40 balanced fund but with one important caveat: there is no direct allocation to property. "My view is you need to have a fairly large investable pool of money to participate directly in property without taking undue risk." she says.

Roux believes that among other things, the relative illiquidity, combined with the uncertainty of returns, forces her hand when it comes to making allocations to property.

"If I described an asset that produced gross yield, before costs, of 4 per cent, possible capital gain of another 4 per cent and required a three-month **sale** process, most would be reluctant to allocate any more than 10 per cent," she says.

The portfolio we've presented would be appropriate for the "average investor", which means 99 per cent of readers will need to dial components up or down in order to better reflect personal circumstances.

But don't assume that just because you are retiring that you need to sell down your **equity** holdings. Australians are retiring at the same age but living longer, creating a mismatch in liabilities.

"The vast majority of people will run out of money if they do not allow for capital growth until they are 70 or thereabouts," she says. When it comes to **equity** strategy, Roux offers some useful and practical advice. Spend more time on mid caps, make your offshore exposure meaningful and keep your portfolio focused.

"The part of the market I think people should look to are the mid caps. This is typically where companies such as CarSales.com, Ramsay Health Care and Flight Centre come from," she says.

"They are no longer high-risk companies," she says. "The big hitters in your portfolio tend to come from this space." Not that you should limit your endeavours to the ASX. Australian investors have typically eschewed international **equity** exposure because of currency risk and a lack of familiarity with international blue chips.

Roux argues that investors who make these types of excuses are selling themselves short. They should be looking for the best possible companies at the best possible price.

"The minimum allocation to international equities should be 10 per cent of the total portfolio if it is going make any difference. I would make the case that there is no reason why half your total **equity** exposure shouldn't be domestic **equity** and the other half international **equity**." She does, however, recommend a tilt toward holding income-producing equities among your domestic holdings. "Franking is a bit of a free lunch. You can't get that elsewhere. You might as well hold your income-producing equities predominantly in Australia."

In terms of your fixed-interest allocation, Roux recommends an even split between cash, investment-grade **bonds** such as government and corporate credit, and higher-yield instruments like ASX-listed **bonds** and hybrids.

As for the age-old question of whether hybrids should really be classified as part of your "fixed income" allocation at all, she offers a novel solution: split them between your growth and defensive allocations (note the 10 per cent marked "other").

"Hybrids sit in that grey area. They straddle both growth and defensive assets," she says. "Really, it depends on the security."

Dividend power

Tony Featherstone

Followers of Smart Investor's portfolio of income stocks should be doing cartwheels over the latest profit-reporting season. Distributions rose and boards hinted at more of the same next year, amid signs the corporate profit cycle is turning up.

About 64 per cent of the top 200 ASX-listed companies reported higher dividends for the first half of 2013-14 on AMP Capital numbers, from 53 per cent a year earlier. Higher dividends suggest companies are more confident.

That's great news for members of Smart Investor's Cash Club, as our hand-picked portfolio of income stocks blitzed the index.

The average total shareholder return (including capital growth and dividends) for the portfolio over one year to February 28 was almost 17 per cent.

That compares favourably with the total return from the ASX 300 Accumulation Index which delivered just over 10 per cent over the same period.

The forecast dividend yield for current Cash Club stocks, based on consensus analyst forecasts, is 5.5 per cent. The yield is closer to 8 per cent if grossed up (which allows for franking).

Over the next two years, the average dividend yield is projected to rise to 5.8 per cent, or even more if you are holding these stocks in a self-managed super fund in pension mode. Even better, all the available evidence suggests that balance sheets can support higher dividends.

Australia's largest companies are sitting on a multibillion-dollar cash mountain that should be put to work very soon through mergers and acquisitions. Buybacks and special dividends are also welcome.

Earnings growth also supports the case for higher dividends in 2013-14 and 2014-15. Macquarie forecasts 13 per cent earnings per share growth this financial year, 12 per cent in 2014-15. EPS growth was negative 3 per cent last financial year.

The bad news is Australia's economy faces a tough transition as the resource investment boom fades and unemployment rises.

It wouldn't take much for companies to keep more cash, rather than return it through higher dividends, if the global economy wobbles. And, other than dividends, the latest profit season was solid rather than spectacular.

There were few signs of top-line revenue growth, and many companies provided cautious profit guidance.

Smart Investor Cash Club seeks companies that can deliver consistent dividend growth in good and bad markets. That is why Cash Club is full of utilities, banks, consumer-staples companies and the occasional insurer. We love boring, high-quality monopolists, duopolists or other protected species that churn out earnings and dividend growth year in, year out.

They are the real sharemarket stars.

Sometimes Cash Club flirts with including an undervalued discretionary-goods retailer, wealth-management provider or property-related **company**. We would love to include healthcare companies, for their defensive qualities, but dividend yields are too low.

We overlook high yield for more modest, reliable returns that come with the prospect of solid capital growth. This simple strategy has worked well since Cash Club launched in 2008, especially in the past few years (total return over the 12 months to February 2013 was 37 per cent).

The 10 stocks in the latest instalment admirably fit our criteria. Two have been added. The well-run ANZ gets a Cash Club spot on the strength of its latest quarterly result and continued strong performance. It replaces Bank of Queensland, which has rallied in the past 12 months.

The New Zealand-based Mighty River Power, which replaces SP AusNet, has a good market position, solid yield, and looks undervalued. SP AusNet, a good performer over the years, faces a more challenging regulatory environment.

Smart Investor’s model income portfolio

Commentary

APA Group

Every decent income portfolio needs an **energy** utility or two, and few are better than APA Group. It is Australia's largest natural gas infrastructure business, delivers about half of the nation's gas usage, and has an irreplaceable gas network. Better still, its earnings are highly defensive and less regulated than some of its peers, allowing for higher returns. Normalised underlying earnings before interest, tax, depreciation and amortisation for first-half fiscal 2014 rose 24 per cent to $399 **million**, and the distribution was slightly higher at 17.5¢ per security. Soft domestic demand and higher gas prices are headwinds for APA, but it has good long-term prospects as Australia's rising population underpins higher gas demand.

ANZ Bank

ANZ Banking Group deservedly secures a Cash Club ticket after reporting a strong December quarter trading update. Unaudited cash profit rose 13 per cent on the same period last year to $1.73 **billion**, slightly ahead of market expectations. Solid revenue growth, good cost control and lower bad debts suggest it, and the other big banks, are in an earnings sweet spot. It is hard to disagree with ANZ's view that has it made a good start to 2014 and is on track to deliver a solid performance. In the longer term, ANZ's super-regional strategy to expand in Asia is a winner. Even after solid price gains over one year, ANZ looks marginally undervalued. An expected 5.4 per cent fully franked dividend yield is another attraction.

Commonwealth

Bank of Australia

The Cash Club king looks statelier with each profit report. Commonwealth Bank delivered a record-breaking half-year result for fiscal 2014: cash net profit rose 14 per cent to $4.26 **billion**, and the fully franked interim dividend increased 12 per cent to $1.83. The result was slightly above market expectations, thanks to lower bad debts and consistent performance across the business. So much for the doomsayers who said CBA was among the world's dearest bank stocks, and that bank stocks would struggle to outperform in a subdued credit-growth environment. If CBA can impress in a sluggish domestic economy, what will it do when growth eventually improves?

Insurance Australia

Group

Cash Club is always in two minds about insurance stocks. Good yields are offset by the potential for higher earnings volatility and less reliable dividends. Still, there is a lot to like about Insurance Australia Group's unfolding turnaround, and its operational consistency under chief executive Mike Wilkins. A cracking 2012-13 result secured IAG's Cash Club debut last year, and the latest half-year result showed further gains. Cash net profit was slightly lower at $653 **million**, in line with expectations. More impressive was a 2¢ rise in the fully franked interim dividend to 18¢. At $5.43, IAG is likely to yield 6.5 per cent in 2013-14; more after franking credits. Cash Club believes IAG can do better and that it is marginally undervalued at current prices.

Mighty River Power

The New Zealand electricity provider debuts after replacing Cash Club veteran SP AusNet. Mighty River Power listed on the ASX in May 2013 after raising $1.35 **billion** at $2.01 a share. Although it has mostly struggled to trade above its issue price, Mighty River has solid Cash Club attributes. It produces about 17 per cent of New Zealand's electricity output, has operated in a favourable regulatory environment, and is expected to yield 6.7 per cent in 2014 at the current price. A change of government after the New Zealand election later this year could create regulatory risk for the sector, but Mighty River looks a steady performer. It reaffirmed its 2013-14 guidance at the recent profit result, in drought-affected conditions, and its shares look marginally undervalued.

Suncorp Group

Although first-half earnings for fiscal 2014 were below market expectations, the Queensland-based bank and insurance group declared a fully franked dividend of 35¢, up 40 per cent on the previous period. This means the interim dividend is equal to the total dividends Suncorp Group paid in 2010 and 2011. After several years of restructuring and disappointing performance, Suncorp is improving. Its board must be confident of future earnings growth to deliver such strong dividend growth, and the market may still be under-appreciating the scope of Suncorp's unfolding turnaround. But another lower than expected profit result later in 2014 could make its stay in Cash Club short-lived.

Sydney Airport

The Cash Club mainstay posted yet another solid profit and dividend increase. Its underlying earnings rose 7.3 per cent to $910 **million** for 2013, and a 22.5¢ distribution was up 1.5¢ on a year earlier. Better still, Sydney Airport increased its 2014 distribution guidance to 23.5¢, implying a 5.8 per cent yield for 2014 at the current price. Cash Club's thesis for Sydney Airport remains firmly intact: it owns a fabulous monopoly asset that is benefiting from international passenger growth, particularly from **China**, and has good long-term growth prospects across its aeronautical, retail, property and car-parking assets.

Telstra Corporation

Is this the start of higher dividends from the telco giant? Telstra Corp's army of income-seeking shareholders will receive a fully franked 14.5¢ interim dividend for the half-year to December 2013 – a 0.5¢ increase on a year ago, and the first dividend rise in eight years. The higher dividend was underpinned by a 9.7 per cent increase in net profit to $1.7 **billion**. Telstra's critics say its dividend growth is unsustainable, but that underestimates its expanding customer base, economies of scale, and market-leading mobile and network infrastructure. These defensive characteristics and Telstra's high dividend are ideal Cash Club characteristics.

Wesfarmers

The retail gorilla is neither the cheapest Cash Club stock nor the simplest for conservative income investors, given its conglomerate structure. But Wesfarmers keeps delivering solid earnings growth, and an expected fully franked yield of 4.5 per cent in 2013-14 on consensus analyst forecasts is attractive. Revenue for the December 2013 half rose 4 per cent to $31.8 **billion**, net profit increased 11.2 per cent to $1.4 **billion**, and the interim dividend was 8¢ higher at 85¢. With Coles continuing to impress, and Bunnings benefiting from a better home-improvement market, Wesfarmers is capable of delivering higher than expected dividends in the next few years.

Woolworths

A 3.8 per cent fully franked dividend yield is the lowest of any Cash Club member, but it is almost impossible to leave out Australia's leading retailer, such is its market position, consistent performance and reliable dividends. Woolworths reported a 14.5 per cent rise in net profit to $1.32 **billion** for the half-year ended January 5, 2014, declared a 65¢ interim dividend, up from 62¢ in the same period in the previous year, and upgraded its full-year guidance for net profit. If Woolworths can achieve solid growth in a listless economy, imagine what it will do when the economy picks up, discretionary retail sales start to rise, and the renovations market strengthens.

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