23rd June 2015

Woodhall's Blog of Ron's Published Portfolio Thinking and Operation

Ron Bewley PhD, FASSA

Introduction

Some readers have asked for guidance on constructing portfolios. I am not licensed to do such work and at 65, I don't want to create a new business. However, I can share with interested readers what I have done, and what I am doing with my own wealth. I am not suggesting that anyone should try to mimic my positions. Rather, I hope that some people might find it interesting to see how an investment professional thinks *over time*.

All of these 'chapters' have been published in magazines or websites. I do not suggest that the text is identical to the published works. I have included my submissions and the editors have the right to check for typos, change the size to fit the page, or even add a little zing.

I have only included reports that I think are directly relevant to my personal situation. That is, the included reports reflect what I am doing with my own money. I plan to add a companion blog that actually shows some of my positions and trades.

I am adding 'chapters' in reverse chronological order to ease the burden for return visitors. New readers might want to start at the end with 'Chapter 1'

Reports:

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Chapter 23: Was it time to pounce?

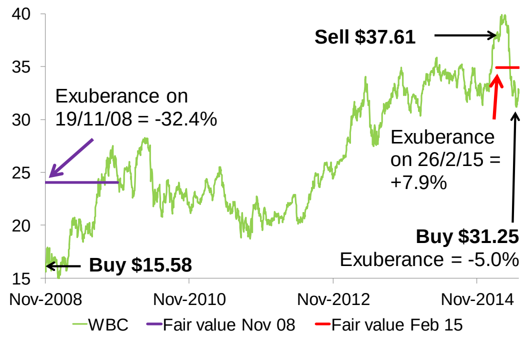
Written June 23rd 2015

Version published in Switzer Super Report

Last month, I posed the question, 'Is it time to pounce?" In my opinion, all sectors had become very reasonably priced or cheap last month. I sold some more Cochlear on the13th May as it looked like its brilliant run might end in tears. As it happened, the stock price has levelled out at around the price at which I sold. I then 'pounced' on Santos on the 4th June because it had been really quite beaten up but looked to have a great future – measured by sector forecasts and exuberance in the then equivalent of Table 1 below – and its own broker recommendations. That stock price has too has moved sideways since – for now. I think it has a great future or I wouldn't have added nearly 50% more to my previous position!

I am hoping that my trade of the month was my buy of Westpac at $31.25 on 15th June following the logic and heat spot chart I showed last month. In effect, I bought back the Westpac I sold at $37.61 on 26th February 2015 but I missed out on the dividend and franking credits amounting to about $1.33 per share. I have set out the history of this parcel of shares in Chart 1 because it so clearly explains how I use my measure of exuberance to gauge market sentiment.

Chart 1: Westpac share price and Financials sector exuberance



Source: Thomson-Reuters Datastream & Woodhall Investment Research

Back on the 19th November 2008, I had the Financials sectors seriously underpriced – by -32.4% on the day. Many people didn't take me seriously because being underpriced by -32.5% means that the 'fair value' was about 50% higher [1/(1-.324) = 1.48] than the then current price. Fair value for 19/11/08 is shown by the horizontal purple line in Chart 1. Because the fear index was then so high, it unsurprisingly took a while to reach that estimate of fair value – but then it traded largely sideways for a year or two. That helped me have even more faith in my exuberance measure.

The high-yield play from the second half of 2012 took the price of Westpac up from the mid $20s to the low to mid $30s for much of 2014. Then, at the start of February 2015, the RBA rate cut made the market go wild. I sold on 26th February because I wanted to gain greater exposure to the S&P 500 (i.e. I was rebalancing and not trading) and that looked like a good time to do it. Then, I had the sector overpriced by +7.9% and 'fair value' on 26/2/15 was as shown by the horizontal red line.

I had intended that to be the end of that story, but when Westpac's price fell sharply to $31.25 – the sector then being underpriced by -5.0% – it seemed too good to be true – especially as the senior executive was going through a very interesting shake-up – as I wrote in my Weekly on the previous Saturday. The Cochlear sale from a while earlier funded the buy. But I do not call this behaviour of mine trading – it is rebalancing based on mispricing. I now have very little spare cash (1%). By the way – all of the above action was in what I refer to as my 'other' SMSF portfolio (28%); as compared to my overseas exposure (39%) and my Hybrid Yield-Conviction portfolio (32%).

In a very different line of enquiry, I presented a paper at the 2nd Annual Asset Allocation Conference on June 12th. A copy of the slides is available on www.woodhall.com.au under the 'Investment Strategies' tab. It's a long story but the conclusion (so far) is that rebalancing my Hybrid portfolio every three months gains precious little over doing so every six months (and it requires a lot more effort and increases the risk of making a mistake!). However rebalancing every six months would have been much, much better than once a year over a dozen different start dates for these monthly portfolios. Portfolios get tired and my results-to-date suggest that once a year is too infrequent. Of course, investors who pay tax need to take any CGT into account.

Readers might recall I rebalanced the particular Hybrid portfolio that I first invested in late June 2014 after about 9 months (March 5th, 2015) based on a less rigorous assessment of the situation. So I now do not plan to rebalance that portfolio until September 2015 after the next reporting season. I so love having evidence – even if it is preliminary – to back my behaviour in the market!

So while I am sitting on my hands, I plan to evolve a suitable strategy for reducing my equity exposure for when the future looks bleak – as one day it certainly will. My thoughts so far centre on around how I currently populate my sectoral allocations of the ASX 200 with stocks. Since a stock has to pass certain hurdles to get selected from the total number allocated by my algorithm to that sector, sometimes a sector gets no stocks allocated at all. There may be no standout stocks in a sector even though the sector as a whole is reasonable. In that case I currently redistribute the sector's potential allocation across those sectors containing quality stocks.

As a first pass, instead of redistributing potential allocations to vacant sectors, that wealth can be assigned to cash. At a second pass, if there are insufficient stocks to fill the prescribed quota for a given sector then the excess allocation too could be re-assigned to cash rather than to the surviving stocks. The June 1st 2015 portfolio outlined in the aforementioned conference presentation would get about 24% cash under the first option and 35% under the second at the moment. This path seems preferable to just selling a portfolio in proportion across all stocks. I want robustness! But I do think it is far too early for me to go to cash. However, the day will come.

It is one thing to set (or buy from cash) a portfolio in times that might become turbulent but another to sell-down a legacy portfolio that was bought in happier times. There seems to be to me two guiding principles. One is to sell down as in accord with the rules outlined in the previous paragraph. Another is to partially sell down stocks in sectors that are over-exuberant. I reckon I have at least a few months to a year before I need my cash strategy in place! I'll let you know what I think is best – and hopefully in time – but I am not inclined to make up ideas on the fly just because they sound good.

For interest I am showing my current sector forecasts and exuberance – and for the index in Table 1. I can't stress enough the importance of having a great sectoral allocation plan before one tries to populate it with stocks but, with that proviso, all of the high yield sectors are have yields between 4.8% and 5.3% with modest prospective capital gains for FY16. Staples look great but the water has been muddied by the possible influx of competition from European supermarket chain and Woolworths' woes. Energy, too, looks excellent but the big boys can move commodity markets quickly. I still own and like Santos and Woodside.

It's hard not to want to own some BHP (and now, also, South 32) and RIO but I won't dig in any deeper. But I do worry about Healthcare stocks. There are many great companies in the sector but how high can investors push prices of them with such small dividends? I went through most the GFC with about 30% Healthcare stocks (which served me very well) and now I have a negligible proportion – after selling lots of Cochlear and CSL at a nice profit. I could well be proven wrong but I don't want to manage my super on the roll of the dice. I just feel a big correction coming in that sector – and sometimes gut feeling should influence hard-headed stats. Resmed took a big hit recently based on one adverse clinical trial. The sector has a great future – but isn't it going to take a breather and/or correction sometime?

Table 1: 12-month-ahead sector forecasts of exuberance, yield and capital gains

	Sector	Exuber-ance	12 month forecasts	
			yield	Cap gain
Resource-related	Energy	-2%	3.3%	37%
	Materials	-3%	3.7%	14%
	Industrials	-2%	3.7%	16%
High yield	Financials	-2%	5.3%	6%
	Property	1%	4.8%	3%
	Telco	0%	5.0%	8%
	Utilities	2%	4.9%	5%
Other	Discretionary	-5%	3.9%	17%
	Staples	-11%	5.1%	15%
	Health	-3%	2.1%	15%
	IT	-2%	2.8%	11%
	ASX 200	-3%	4.6%	11%

Source: Woodhall Investment Research; at close 22nd June 2015

Chapter 22: Is it time to pounce?

Written May 19th 2015

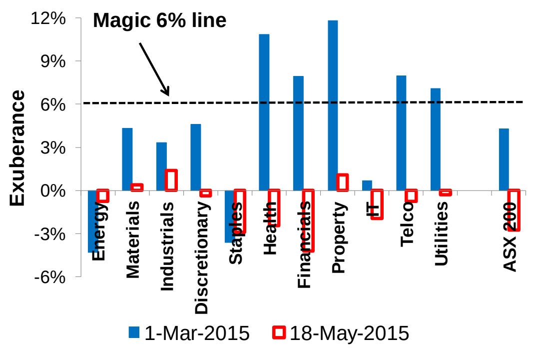
Version published in Switzer Super Report

The market has undergone a major adjustment in the last little while. Some saw it as a market correction and the demise of the High-Yield play. I see it as a time to get set with a little more confidence than normal. The backdrop for this posting is that it looks like our Financial Year forecast for 2015/16 might leave us just under 6,500 in June 2016!

Regular readers will know I measure mispricing for each of the 11 major sectors of the ASX 200 and the broader index. I call this mispricing 'exuberance' and it is a measure of how far the sector prices are from my estimate of fair value. Experience has shown that when a sector or the market is more than +6% overpriced, it is so expensive that a correction or prolonged sideways movement is foreshadowed.

In Chart 1 I show my exuberance measure at two points in time: March 1st (blue bars) and May 18th (red bars). The four high-yield sectors (Financials, Property, Telcos and Utilities) were all in correction territory (above the black dotted line) on March 1st – as was the defensive (but low yield) sector Health.

Chart 1: Mispricing on the ASX 200 at two points in time



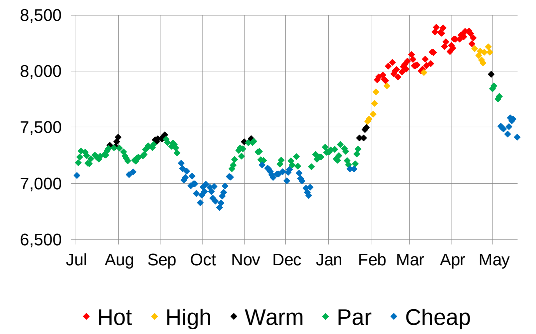
Source: Woodhall Investment Research

On March 1st, two sectors (Energy and Staples) were quite cheap. IT was about fair-price. Nearly three months later no sector was more than a little over-priced. It is unwise to buy a stock or sector that one believes it is very overpriced – even if there appears to be an attractive yield at hand. A quick snap back in price – as happened with the big banks – can erode a whole year's yield or more in a few days. Of course, investors who bought before the bubble can ignore the market gyrations. Unrealised capital gains and losses are just that – unrealised.

In Chart 2, I focus just on the Financials sector's price index and exuberance over the current Financial Year. Instead of using a simple line chart to show how the price index evolved over the financial year, I have colour-coded it to show exuberance and price in the same chart – a sort of 3-D effect. The red dots signify correction territory above the 'magic 6%' line in Chart 1. The blue dots represent a bargain – or significant negative mispricing (other conditions being satisfied as I write about on my website). The other colours fill the spectrum of mispricing. I would not buy in red or yellow territory. I am sorely tempted in green and blue. I might buy in the black if I have other good reasons.

What I see in Chart 2 is the sector was trading sideways with many buying opportunities. At the start of February, the price index grew aggressively (in yellow) and stayed in the red zone for over two months. This was a period when investors were chasing yield too aggressively after the start of February cut in the RBA rate. Eventually the bubble had to pop and it did so quickly. Interestingly, the index turned blue just after the second rate cut – possibly because the RBA did not give an outlook statement making future rate cuts seemingly less likely. As it happens, the index is now just about where it was before the February rate cut.

Table 2: Price index and exuberance in the Financials sector over time



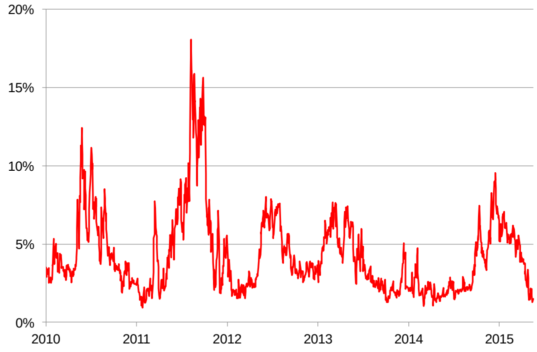
Source: Woodhall Investment Research

It is important – at least in my opinion – to appreciate that we are at a reasonably unusual point in the market cycle. In Chart 3 I have calculated the average exuberance across the 11 sectors without reference to the sign. That is the average absolute value of +2% and -2% is +2% (rather than the 'usual' average of 0%). This absolute measure gives a good idea of how balanced the market is.

While the current level of the index in Chart 3 is not at the lowest – it is pretty close to it. In my opinion, this supports getting back into the market in general

– or the high-yield sectors if that is what an investor wishes.

Chart 3: Average absolute exuberance across sector



Source: Woodhall Investment Research

In Table 1 I show my current forecasts for each sector and the index. Property is probably the weakest sector at this point in time but Financials, with a yield back above 5% (plus franking credits) and a forecast capital gain over the next 12 months of +9% looks tasty. Of course the diversification principles I discussed in my posting last month are just as relevant now. This table just makes me feel content about being in the market – or getting in if I wasn't already set.

Table 1: 12-month-ahead sector forecasts of yield and capital gains

ASX 200 -	Sectors	Yield	Cap gain
Resource-related	Energy	3.4%	37%
	Materials	3.6%	8%
	Industrials	3.6%	13%
High yield	Financials	5.4%	9%
	Property	4.8%	2%
	Telco	4.9%	8%
	Utilities	5.0%	7%
Other	Discretionary	3.9%	12%
	Staples	4.8%	8%
	Health	2.0%	14%
	IT	2.8%	11%
ASX 200		4.5%	11%

Source: Woodhall Investment Research

By the way, some readers might remember I got bullish on Cochlear when it was in the low $50's a couple of years or so ago. Not many agreed with me at the time but I sold most of what I bought then in the low 50s at an average of above $80 with some as high as $91! I still have a small holding in Cochlear and I am prepared to get in deeper again when I think the time is right. I took profits and risk off the table for a breather.

Chapter 21: Buy low, sell high

Written May 1st 2015

Version published in Professional Planner

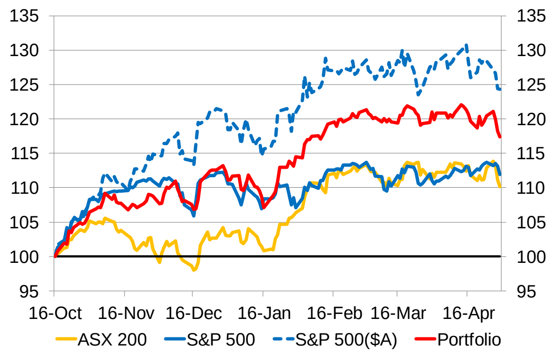
I introduced my then new concept of my geared portfolio in a submission to this magazine in late October 2014. I had just made the first play (I'll refer to it as the first tranche because this is no game – it is real money) and followed this up in late November/December with the second tranche. The principle is simple. At the time and now over-priced yield stocks have been the flavour of the month while resource stocks were suffering from falling iron ore and oil prices. While resource stocks just started to come back at the time of writing the current submission, the risk of gearing individual stocks was too high for me. By the way – there is no need to gear this strategy but, since it involves possibly long periods of being out of the market, I don't want to have to worry about what my cash is doing in those barren periods.

I invested in two ETFs representing the ASX 200 and the S&P500 in approximately equal amounts. I used iShares IOZ and IVV, respectively, as my preferred ETFs for this purpose. It is important to stress that IVV is unhedged and so will be affected by currency movements. At the time I saw the Australian dollar more likely to weaken than strengthen – and I still do. When my view on the currency changes I will switch to the hedged version of IVV, called IHVV, in part or in total. I am currently considering a rebalance on that front! The Aussie just broke $US 0.80 for a few days after having fallen to under $US 0.76.

The final step of the strategy was (and is) to buy when the indexes reach my forecast lows for the year and sell when the high is breached in my so-called 'box' forecasts that I frequently write about in this magazine and my website (www.woodhall.com.au). I bought the first tranche when both indexes just touched the low but only the ASX 200 hit the low again in late December – but the S&P 500 was then close enough for me to keep my preferred 50:50 balance.

I show what happened to the first tranche in the first six months or so in Chart 1. The yellow and blue solid lines are the standard indexes I get from Thomson Reuters. The blue dotted line is the S&P 500 converted by me into Australian dollars. The red line represents my 50:50 portfolio which should average the yellow solid line and the blue dotted line.

Chart 1: First tranche performance-to-date

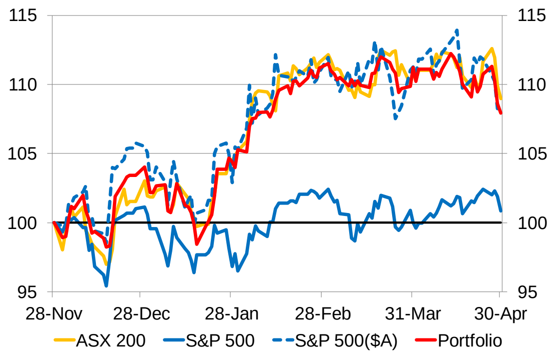


Source: Thomson Reuters and Woodhall Investment Research

By chance the two markets have gained about the same over the period – in the region of 11%. But because of the impressive devaluation, the blue dotted line has gained nearly 25% making this first tranche of my portfolio return about 17% in just over six months – much better than either market in their own currencies!

When I turn to the second tranche in Chart 2 using the same colour codes, a clearer picture emerges in my mind but the chart is unfortunately a bit busy. The S&P 500 (solid line in $US) has gone virtually nowhere in around five months. But the ASX 200 has tracked the $A-denominated S&P 500 almost blow-for-blow. I have written about this feature before in this magazine when that play lasted quite a long time – but then broke down.

Chart 2: Second tranche performance-to-date



Source: Thomson Reuters and Woodhall Investment Research

So my second tranche has only returned about 8% in the period – but much more than the S&P 500 and nearly the same as the ASX 200. So what next?

With the Fed looking increasingly likely to delay the first hike from the June forecast they made last year to maybe even a 2016 expected start now, an $A depreciation is unlikely to benefit too much from the Fed in the rest of 2015. But that doesn't stop Glenn Stevens throwing his hat in the ring and helping my strategy. Every man and his dog have been saying that our dollar didn't fall enough given the fall in commodity prices. I agree and so I am not (yet) too worried by the April nascent bounce-back in commodity prices – but I am thinking and ready to act following the end of April volatility in many markets!

Since my current forecast ‘highs’ for the ASX 200 during the rest of 2015 is 6,400 and 2,360 for the S&P 500, I could be in for more gains and even a possible sell at the original (beginning of year forecast) highs – or sell signals – of 6,200 and 2,360, respectively to take profits (or even sell out) until the next low is touched.

Would I add to my position – or buy in for the first time – now? The answer is a resounding ‘no’. Both indexes are in the middle of their respective ‘boxes’. The maxim is to buy low - sell high. Everyone knows that but my contribution, if any, is to estimate the buy and sell signals from my broker-based forecasts of returns and my method for forecasting volatility.

Chapter 20: So which is the best sector?

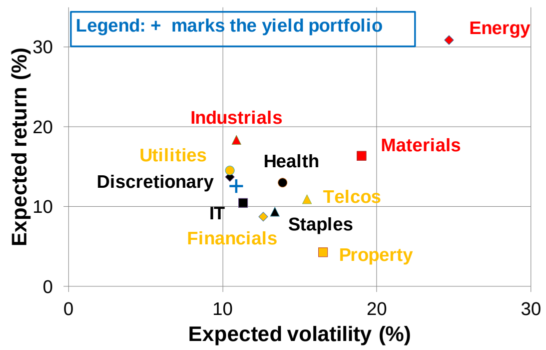
Written April 13th 2015

Version published in Switzer Super Report

Almost every time I appear on Switzer TV, Peter asks me 'which is the best sector at the moment?' There is rarely enough time left on his show for me to give a full answer. So this time, that's all I want to talk about and try to do justice to this very important question. There are papers on my website that discuss how I calculate my estimates of (broker-based) sector returns (including re-invested dividends), volatilities and a host of other relevant statistics so interested readers who wish can follow the whole investment process.

What I want to stress in this posting is that the best expected return does not usually imply the best sector. To show this I have plotted the expected returns for each sector against the relevant expected volatilities – which we often call risk for brevity – in Chart 1. But there is so much more to risk than just volatility!

Chart 1: Risk-return trade off for April 1st 2015



Source: Woodhall Investment Research

The Energy sector (top right red diamond) has by far the highest expected return of all of the sectors (31%) but also the highest risk at 25%. That means, even if the expected return is well constructed on a sound basis, the actual return over the year could finish up almost anywhere because the forecast risk is so large. About one third of the time, we would expect the actual return to be <u>outside</u> the range from 6% to 56%! There is also a chance of about one in twenty that the actual return would be <u>outside</u> the range -19% to +76%. We can do better than that!

Comparing Industrials (red triangle) with Materials (red square), the former has both a better (higher) expected return and a better (lower) risk – and so Industrials dominate Materials. The high yield sectors in yellow are clustered well below the red resource-related sectors in terms of expected returns. The black sectors 'Other' are also relatively tightly clustered as a group of relatively defensive sectors.

Property stands as a sector with no apparent useful attributes having the lowest expected return and the third highest risk. However, when a professional builds a portfolio, he or she looks into how the sectors fit together. To produce my Hybrid Yield-Conviction portfolios that I update each month, I use the information contained in Chart 1 plus the correlations between all of the sectors together with the limits or 'tilts' that I want to place on possible exposures to each sector. Without such tilts I could finish up with all of my eggs in one basket and how would that go if the expected return for a particular sector turned out not to be a good representation for the relevant sector?

So there are two quite separate risks I am writing about here. One is expected volatility – or variation around a 'good' forecast – for one or a combination of sectors. The other is the risk that our expected return might turn out to be misleading for whatever reason. Appropriate diversification across sectors helps reduce both of these risks – and often by a very large amount.

In Table 1 I show the stock allocations for portfolios constructed at three separate points in time: the original June 25th 2014 portfolio is the one I actually invested one third of my SMSF assets in and wrote about on this and my site; the March 1st 2015 portfolio is the one I rebalanced into last month – as I wrote about in my March posting of the Switzer Super Report; and, finally, the third portfolio is the latest April 1st 2015 generation. The blue cross that lies between the Discretionary black diamond and the IT black square in Chart 1 represents the estimated risk-return of that April Hybrid Yield-Conviction portfolio.

From the first row of the Table it can be noted that Santos (STO) was not present in the first two portfolios but it is in the third (two x's followed by a blank). Indeed no Energy stocks were present in those first two portfolios. Telstra has been in all three portfolios (three blanks). Importantly, Property is in all three portfolios despite its relative poor positioning in the risk-return trade-off of Chart 1!

Some of these changes in composition from month to month come about because my criteria for the inclusion of a stock in a portfolio depend upon all of – expected yield, market capitalisation, consensus recommendation and the strength of the sector measured by the estimated risk-adjusted return of the sector. For these reasons, as well as the evolving sector allocations formed from the optimisations used to get the blue '+' in Chart 1, the number of stocks in the final portfolio happen to have changed from 16 to 12 and now to 14. However, there are only 22 different stocks in the universe of stocks across all three portfolios – suggesting that churning (or high turnover/trading) is not a major feature of this style of portfolio construction. Of course this set of stocks will likely expand a little over time – but my expectation from my experience is that the universe expands only very slowly. The algorithm has been searching for about 25 stocks for each portfolio each month – but there haven't been enough good stocks around to populate the sectoral allocations!

Table 1: Three generations of the Hybrid Yield-Conviction portfolios

Sector	Code	Portfolio date		
		June '14	March '15	April '15
Energy	STO	x	x	
Materials	AWC	x		
	CSR	x	x	
Industrials	CDD		x	x
	SYD			
	TCL			
Discretionary	TAH	x		
	TTS		x	x
Health	PRY		x	x
Financials	BEN			
	BOQ			
	IFL			
	MQG			x
	PPT	x		
	SUN		x	x
	WBC	x	x	
Property	DXS		x	x
	FDC		x	x
	SGP			
Telcos	TLS			
Utilities	DUE		x	x
	SKI			
No. of stocks		16	12	14

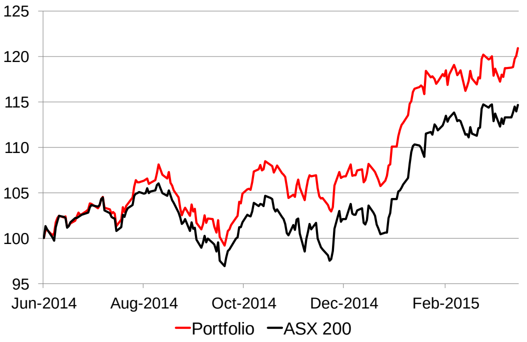
Source: Woodhall Investment Research

Note: 'x' indicates that the relevant stock was <u>not</u> present in the given portfolio (column)

I do not use equal weights (or even close to!) for the stocks within a sector or across sectors – but that's another story. The weights are produced from both the optimisation process for sector weights and the relative strengths of the stocks within each sector. The indicative weights for my current March portfolio are in my previous posting on this site.

So is all of this quantitative stuff worth the effort? I have been doing this sort of work with real money (mine and that from High Net Worth clients) for over a decade across many diverse sets of market conditions. The total return results (i.e. including reinvested dividends) for my particular Hybrid portfolio that I started in June and which was rebalanced in March are shown in Chart 2.

Chart 2: Total returns for the Hybrid Yield-Conviction portfolio and its benchmark



Source: Woodhall Investment Research

I have made a total return of about 21% in nine months against 15% for the benchmark. That comparison does not include franking credits which would likely favour my portfolio because of my yield tilt. These results are not uncommon in the work I have done over the last ten or more years. My constructed portfolio is currently winning by a comfortable margin (+6%) over the benchmark ASX 200 but, of course, outperformance is not guaranteed. We are required by law to point out that past performance is not a reliable predictor of future performance.

Importantly, the relative performance in Chart 2 is not jumping about. No one should want win a big win one day and a big loss the next. In my opinion, there has been a gentle gain in relative outperformance in my portfolio over the benchmark over the last nine months.

Readers might recall last month that I chose not to substitute Tatts (TTS) with TabCorp (TAH) in March as the algorithm recommended for a portfolio constructed from new cash. I deduced that the differences between these two particular stocks so were marginal that a substitution was not worth the effort and the transactions costs. But should I make more changes now that I have seen the April portfolio? With only new cash I would have bought the April portfolio but is a churn worthwhile?

I could have substituted Westpac (WBC) for Macquarie (MQG) but I see no strong case for that. Moreover, MQG is looking to have strong growth characteristics and one day, the high yield play that currently favours WBC will be a thing of the past – or so I believe.

To me, six to twelve months is about a reasonable rebalancing period – unless something weird suddenly starts happening. That's why I do this sort of analysis each month even though I don't plan to make any changes. I just want to make sure I am not missing anything that is obviously avoidable. Indeed, I do daily checks on certain broker statistics.

I also could have justified adding Santos and CSR but again I ignored those additions as not being necessary. At least not yet! Since I am still in the middle of a 12 – 24 month transition of my old SMSF portfolio from pre June 2014 – as I have written – I happen to already hold WBC and STO in my 'Other' part of my SMSF portfolio. I could do some cosmetic accounting and pretend that I had rebalanced into these stocks. I don't find it that easy to fool myself so I did nothing on that front! If some spare cash comes along after all of my dividends are collected, I might stick my toe in the water with a little CSR – just to show willing. All will be settled in my next big rebalance – probably around Christmas 2015.

Chapter 19: The time was right - so I rebalanced my yield portfolio

Written March 17th 2015

Version published in Switzer Super Report

Each month I build a new hybrid yield-conviction portfolio for myself to ponder over. My expectation when I 'got set' around June 25th 2014 was that I would hold (without trading) for at least three months unless something really drastic happened. But I fully intended to rebalance into a new portfolio within 12 months so as to keep it fresh.

Readers might recall that I recently started an international exposure in my SMSF but that exposure came from selling down stocks from my 'other' portfolio and not my hybrid yield. By so doing I got my international exposure up to 30% as I flagged I wanted to last month. And then I even 'over-achieved' by getting that exposure up to 37% and all of this is in the unhedged iShares ETF with code IVV that mimics the S&P 500 less a very small charge. Rebalancing my hybrid portfolio was a separate exercise that, through a number of separate circumstances, happened at about the same time as my yield rebalance at the beginning of March.

The first thing I noted that the June 25th portfolio's performance started to slip a little against the ASX 200 benchmark. Up until March 5th, the actual rebalance date, my portfolio gained 13.1%, or 17.9% if dividends but not franking credits are included, in just over eight months. The benchmark gain 9.3%, or 12.9% including dividends. Before that, my outperformance was 1% or 2% more.

The second point was that all of the high-yield sectors, plus health, were seriously overpriced using my exuberance measures suggesting a correction or a prolonged sideways movement might be imminent. The ASX 200 was less overheated at about 4.5% and below the 6% level I use to call a correction.

The new (March) portfolio contained only 12 stocks rather than the 15 I was holding because my filters again couldn't find enough good stocks to populate the new sectoral allocation. Moreover, some of my June stocks had consensus broker recommendations that had slipped below a '3' which is a hold. So DUE (+2.2%), FDC (+18.5%), PRY (10.1%) and SUN (+0.5%) had to go – where the percentages in parentheses denote the capital gains over the eight months or so. Of course they all paid dividends as well.

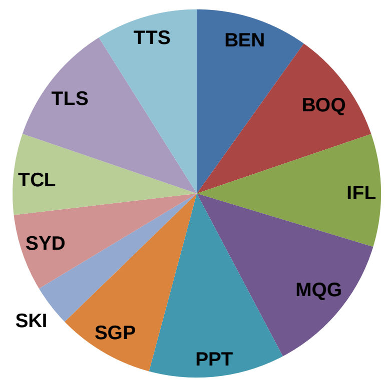
TTS (Tatts) should have been replaced by TAH (Tabcorp) – a similar sort of company – but I chose to ignore that. TTS (+31.9%) had done particularly well and its broker forecasts had just been updated and were slightly better than those for TAH.

Two new stocks were added: AWC and PPT. In essence, PPT replaced SUN and AWC (Alumina) entered because a Materials stocks at last could enter the portfolio. Four stocks (SKI, SGP, TCL and TLS) attracted significant additional funding. Other rebalances were suggested but they were too small to justify the effort and cost of that part of the rebalance. The new portfolio is shown in Chart 1.

The new portfolio has not been running long enough to justify a performance check but it is currently ahead of the benchmark since the rebalance.

So my current SMSF is 31% Hybrid, 37% international, 30% Other and 2% Cash. Fortunately the 'other stocks' I sold to fund the purchase of IVV have since fallen -2.7% while IVV has only lost -0.3% so that's 3.0% on the trade.

Chart 1: The new Hybrid Yield-Conviction Portfolio



Source: Woodhall Investment Research

I sold some of those same stocks from my margin loan (outside of my SMSF) at the same time to reduce debt – or de-risk. My geared IOZ:IVV portfolio I write about (and discussed on Switzer TV on the 11th March) now constitutes about 75% of that portfolio. The margin loan stocks I sold would have lost me -7.9% had I not sold them!

My point here is not to try to show I have some special intuition. Rather the opposite, all of my recent trading was based on my mispricing measures (which I publish each week in the Woodhall Weekly on www.woodhall.com.au) and my quantitative, logical consistent assessment of broker data that defines my portfolios. But, as you can tell, I am prepared to make some slight qualitative modifications to save effort. But I put my money where my mouth is and, of course, sometimes I make poor decisions in hindsight – like everyone else.

I have no expectations to trade again this financial year in my SMSF other than to possibly take up the Macquarie offer and whatever might come out of the BHP divestment. Indeed, I might not trade again until Christmas. On the other hand, I have rules I have written about on my site that make me sell IOZ and or IVV if their respective indexes rise too high in my geared portfolio.

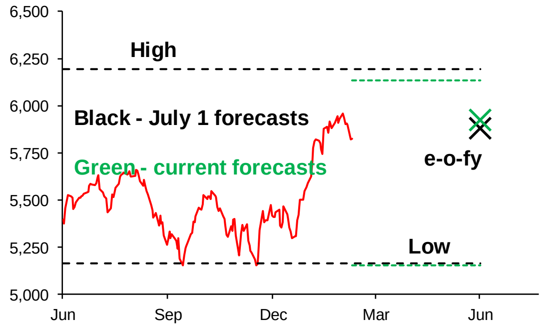
Chapter 18: An international investment strategy

Written on 11th March 2015

Version appeared on Switzer TV

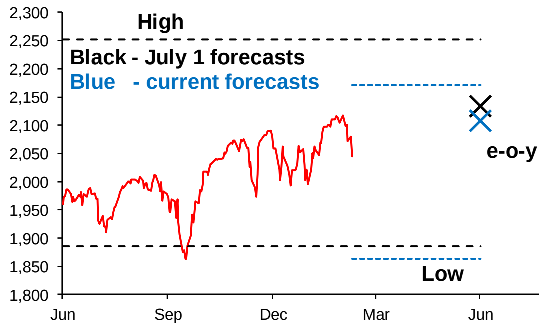
Explanatory notes are at the end for this strategy which Ron happens to gear but which need not be.

Chart 1: FY15 'Box' forecasts for ASX 200



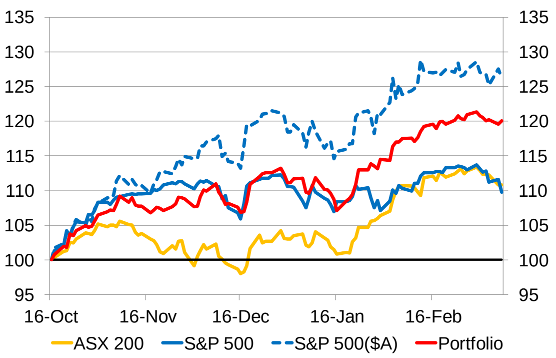
Source: Thomson-Reuters & Woodhall Investment Reseach

Chart 2: FY15 'Box' forecasts for S&P 500



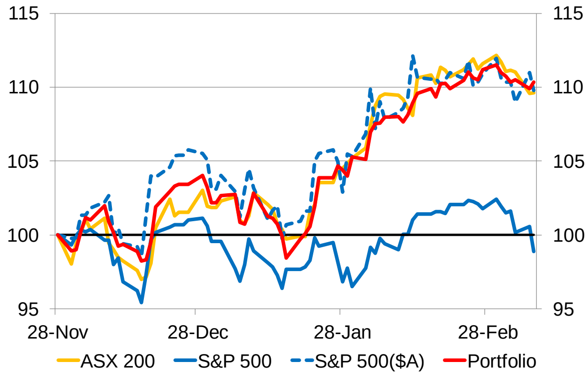
Source: Thomson-Reuters & Woodhall Investment Reseach

Chart 3: October tranche IOZ:IVV



Source: Thomson-Reuters & Woodhall Investment Reseach

Chart 4: November tranche IOZ:IVV



Source: Thomson-Reuters & Woodhall Investment Reseach

Chart 5: Current sector forecasts

	Sector	Exuber-ance (%)	12-month forecasts % yield	adj cap gain
Resource-related	Energy	-5.7	3.6	29.8
	Materials	-1.7	3.6	13.5
	Industrials	1.9	3.7	11.7
High yield	Financials	6.3	5.1	-2.1
	Property	6.8	4.8	-6.8
	Telco	2.8	4.9	3.2
	Utilities	3.3	5.0	7.2
Other	Discretionary	1.6	4.0	8.9
	Staples	-4.7	4.8	10.8
	Health	10.6	1.8	0.0
	IT	4.1	2.6	3.3
	ASX 200	2.0	4.4	5.4

Source: Thomson-Reuters & Woodhall Investment Reseach

Chart 6: Ron's gearing rules (actually, at best, just guidelines)

- IOZ is an iShares ETF for the ASX 200
- IVV is an iShares ETF for the S&P 500
- IVV is unhedged which means a depreciation in the $A increases any gain on the S&P 500 – and, importantly, the opposite is also true!!!
- Try to buy IVV and IOZ in roughly equal amounts but not necessarily at the same time.
- Buy when the ETF is at or close to the forecast 'box' minimum
- Buy more if the minimum is again reached – but only if the index has been materially above the minimum forecast in the interim

- Sell when the ETF gets close to or exceeds the maximum – possibly in stages.
- Note that the minima and maxima get updated every six months for the next 12-months ahead
- Judgement should be used during the cross-over from one chart to the update.
- Updates are given in our Weekly and papers on the strategy are also on our website.
- These Weekly updates do not overrule the existing forecasts but rather give some insight as to whether the strategy is out of or in, control.
- Past performance is certainly not a reliable indicator of future performance.
- The strategy does not need to be geared and gearing increases both upside and downside risks!
- These guidelines and charts are based on Ron's personal strategies and are not recommended for other people.
- The guidelines are being refined over time as experience is accumulated and without notice.
- New events might occur that Ron may use to end or change the strategy without prior notice.
- The table on the next slide show the actual trades made by Ron – but in proportion. That is, there is one number that can be used to multiply every 'number of shares' or 'Units' in the table that recreates Ron's actual trades.
- The scaling has been made only to protect privacy.

Chart 7: Actual, scaled (buy) trades

IOZ			IVV		
Date	Units	Price	Date	Units	Price
1st tranche					
16/10/2014	10	22.64	16/10/2014	1	212.69
16/10/2014	10	22.5	16/10/2014	1	213.09
2nd tranche					
28/11/2014	20	23.09	28/11/2014	2	246.38
1/12/2014	20	22.64	9/12/2014	2	251.09
15/12/2014	20	22.61	15/01/2015	2	247.64
15/12/2004	20	22.49	15/01/2015	2	247.55

NB: If one multiplies the 12 numbers under 'Units' by a certain factor one gets the exact number of trades Ron made.

8: Reasoning

- Our forecasts of capital gains on the ASX 200 and S&P 500 are based on Thomson-Reuters broker forecasts of dividends and earnings for the 200 or 500 companies and manipulated in a proprietary fashion. There are papers on our website describing the essence of these methods
- The forecasting methodology has not changed since mid 2010. It is based on a similar – but different – methodology used since 2005.
- The box forecasting methodology (ie also forecasting the highs and the lows) started in January 2014 and has not changed since – nor is it expected to be changed at this point in time.
- One of the major problems is to keep a 50:50 balance when the two markets are cheap or dear at different times. Work is continuing in that area.
- If we anticipate that the $A is reasonably likely to stabilise or appreciate, the allocation to the S&P 500 will be split between IVV and IHVV (the latter is also iShares but it is hedged) according to rules not yet developed.
- The sole purpose of this presentation is educational. It is not intended that anyone should attempt to mimic or follow this strategy. Rather, we believe that a lot can be learned by expanding one's mind in new directions. Then one can develop a strategy for one's own use.
- Of course the most obvious reasoning in this strategy is that, when gearing, one should swap portfolio risk for gearing risk – hence the focus on indexes. There is no obvious template to change it for use on portfolios of individual stocks.

Chapter 17: Getting the right international exposure

Written 13th February 2015

Version published in Switzer Super Report

Last month I wrote that I was happy with my 18% international exposure in my SMSF as a stepping stone to a more substantial holding. Since then, I have built models to help me work out what that optimal exposure should be for me. After discussing the results, I will then comment on how I plan to get there.

In classic tradition, the optimal allocation across asset classes is achieved by combining forecasts of expected returns, volatilities and correlations in an optimiser. The outcome is the best risk-adjusted return portfolio for a given cash rate.

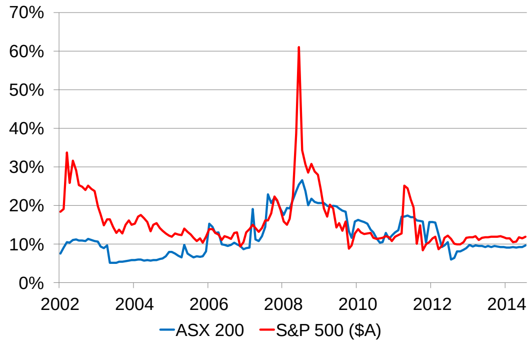
Rather than use a simplistic historical risk-return view of an international/domestic equity portfolio, I used advanced statistical methods I developed to forecast returns and volatilities that produce forward-looking expectations and are not simple historical averages.

I start by considering only two assets: domestic equities (represented by ASX 200) and US equities (represented by S&P 500) but valued in Australian dollars. In that sense, the international exposure is unhedged. I personally choose to use the iShares ETF, IVV, to make my international investments. Unhedged means that the S&P 500 return – expressed in $US – will be increased when the $A depreciates against the $US and vice versa.

I used the same volatility forecasting method I use in my domestic equity sectoral allocations and share portfolios for both indexes. I show my rolling volatility forecasts for 12-months ahead for both of the ASX 200 and the S&P 500 in Chart 1 to the end of 2014. The essence of the model is that volatility is assumed to go through periods of stability – but this 'mean' occasionally shifts to a new regime – and sometimes sharply. Recently, the ASX 200 has been stable and a little less volatile than the US index – but sometimes in the past, the deviations have been quite large. The Woodhall methodology paper under the Market Updates tab on www.woodhall.com.au gives more details for both returns and volatilities forecasts.

My January 1 estimates for yield from Thomson Reuters data were 2.2% for the S&P 500 and 4.8% for the ASX 200. When franking credits are included for an Aussie SMSF in pension mode, my total returns forecasts, including dividends and franking credits, for 2015 were 9.6% for Wall Street and 11.1% for the ASX 200. Since my broker-based forecasts for both are cast in their local currencies, I am implicitly assuming that the $A will not change over the course of the year ahead.

Chart 1: 12-month-ahead forecasts of volatility



Source: Thomson Reuters and Woodhall Investment Research

Since the forecast correlation between the two indexes is only 0.21, there is ample scope to gain from diversifying across both indexes. The ASX 200 gets a 70% share and the S&P 500 gets 30% in the best risk-adjusted return portfolio.

The expected portfolio return is a simple weighted average of the two expected returns and is equal to 10.7% in this case. But there are some nice gains to be had in lowering expected volatility. The portfolio is expected to have a volatility of 8.2% against 9.6% for the ASX 200 and 11.8% for the unhedged S&P 500. Note that 8% was the level of volatility over the 'quiet days' of 2003 – 2005 on the ASX 200.

If a depreciation of 10% in the $A were to be expected over 2015 – and many analysts expect that or more – the optimal allocation changes to 37% ASX 200 and 63% S&P 500. Currency forecasts are notoriously difficult to make and a no-change forecast is often thought to be about as good as one can do on average. However, from a risk perspective, I assume that a depreciation of the $A against the greenback is more likely than an appreciation. Therefore, I will err towards a higher exposure to international than my no-change calculations of 30%. But I will not go anywhere near the full way to 63%. If, at some point, I feel that the $A might start to appreciate, I would change my exposure to a hedged ETF, such as iShares' IHVV, as I wouldn't want the appreciation to erode any gains on the S&P 500. More likely is to keep the aggregate exposure of IVV and IHVV constant but change the balance of the two international ETFs.

In related work, I found that I could not justify a broader international exposure than just to the S&P 500. I found that the Rest of the World attracted a zero weight using my assumptions and reasonable variations from them. So my new target IVV exposure is 30% 'or more'. At a current 18% IVV exposure I have a long way to go even to get to 30%! However, data from January 1st 2015 shows me that I didn't lose much by my tardiness. The

S&P 500 has been relatively flat so far for 2015 and the $A has not fallen a lot. The ASX 200 is well ahead over this period and my domestic portfolio is well ahead of the ASX 200. Even had I been losing from not moving quicker, I am in favour of taking measured steps rather than jumping in with both feet.

I funded my original 18% international exposure by selling all of my Bradken and some of each of my CBA, Cochlear and Westpac holdings. At the time (8th December 2014) I noted that I had very positive feelings for CBA, COH and WBC but I needed to de-risk my portfolio. As it turns out Bradken fell in a big hole after I sold but the others all did well. In aggregate I gained about 10% over the recent period from the rebalancing transactions even though CBA, COH and WBC all subsequently reached all time highs.

Cochlear came in with some stunning results in this reporting season and CBA had a strong result. I will sell down part of my exposure of each sometime after I have collected the dividends. I will watch my BHP and RIO stocks for any changes in dividends, buy-backs and related activity. It is too soon to sell them down. I'm holding on to Santos and Woodside for some time as I expect oil prices to rise over 2015. I am not yet sure what to do about Westpac so WBC is on hold.

So my plan over the next month or so is to sell some domestic stocks so as to be able to increase my exposure in IVV. I am keeping my holdings in my Hybrid-Yield portfolio because it is still doing really well – about 7% better than the ASX 200 including dividends. Note that I do not hold an ETF for the ASX 200 as I feel my Hybrid plus my 'other' portfolio will give me outperformance for a similar level of expected volatility.

Next month I will look at the broad sectors of the ASX 200 – and update you on how my internationalisation is going.

Chapter 16: 'Do the Wall Street Shuffle'

Written 1st February 2015

Version published in Professional Planner

When 10cc, the Manchester rock band, hit the Charts with the 'Shuffle' in 1974 they were 13 years before Michael Douglas' Wall Street movie and 39 years before Jordon Belfort's 'Wolf of Wall Street'. The issue never goes away. How much exposure should we have to Wall Street when it's rocking?

I have previously (and often) written on this topic for Professional Planner but now that I have a significant personal exposure to an unhedged S&P 500 ETF (iShares; ticker IVV) I felt the need to lift my game. In late 2012 I argued in this magazine that a 50:50 ASX 200 / world index had merits based on long-run historical volatilities and returns. Late last year I wrote about starting a 50:50 ASX 200 / S&P 500 geared portfolio, and at the start of this year I revealed my 18% exposure to Wall Street (with the rest in ASX 200 stocks) in my continually evolving SMSF.

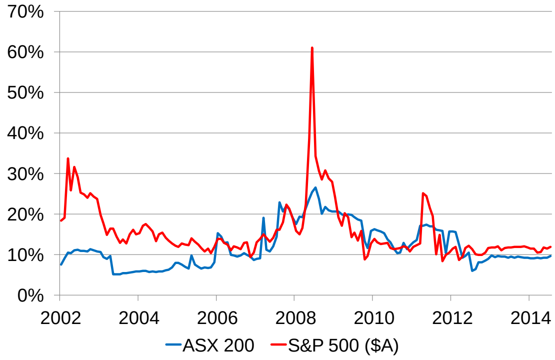
Rather than use a simplistic historical risk-return view of an international/domestic equity portfolio, I recently brought in the big guys. I used my seriously complicated volatility forecasting model – which I have written about on my website – that I use in my direct Australian equity portfolio construction methodology. And I have equivalent total returns' forecasting models for both of the ASX 200 and the S&P 500 that are forward looking – by drawing on broker forecasts of dividends and earnings.

I considered two possible allocations. The first was a simple Aussie/Wall Street split. The second also included the World Equities Index ex-USA (MSCI) as a third, non-overlapping asset class. I show my rolling volatility forecasts for 12-months ahead for both of the ASX 200 and the S&P 500 in Chart 1.

The S&P 500 index has been converted to $A to mimic an unhedged index. The essence of the model is that volatility goes through periods of stability but the 'mean' occasionally shifts to a new regime – and sometimes sharply. Recently, the ASX 200 has been stable and a little less volatile than the US index – but sometimes in the past the deviations have been quite large.

My January 1 estimates for yield from Thomson Reuters data was 2.2% for Wall Street and 4.8% for Australia. When franking credits are included for an Aussie SMSF in pension mode, my total returns forecasts are 9.6% for Wall Street and 11.1% for the ASX 200.

Chart 1: 12-month-ahead forecasts of volatility



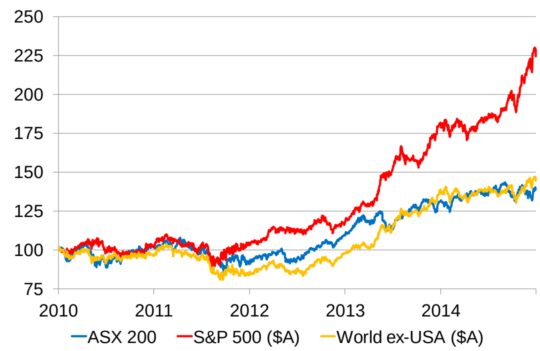
Source: Thomson Reuters and Woodhall Investment Research

It should be no surprise that with a higher expected return and a lower predicted risk, that the ASX 200 gets the lion's share of the strategic allocation. The ASX 200 gets a 70% share and the S&P 500 gets 30%.

Only fools and horses try to predict exchange rate movements. The 70:30 split is based on a no-change exchange rate assumption. If a depreciation of 10% were to be expected – and many analysts expect that or more – the optimal allocation changes to 37% ASX 200 and 63% S&P 500.

But what about the Rest-of-the-World (RoW)? Using the MSCI World Index (ex USA) valued in $A, I can see from Chart 2 that – although we have lagged Wall Street – we have been on a par with the RoW.

Chart 2: Ratio of High-Yield and ASX 200 indexes



Source: Thomson-Reuters and Woodhall Investment Research

I do not have a formal forecasting procedure for the RoW. If I use the same methodology to make an asset allocation (and at the same expected rate of return for the RoW as Wall Street), the RoW World gets no allocation at all! The RoW needs about 2% better expected outperformance than Wall Street to get a serious allocation. Given recent behaviour in Chart 2, I am not prepared to make such a forecast – even though the ECB just launched an impressive QE programme.

So let's cut to the chase. I will ignore the RoW for at least a little while but my 18% allocation to Wall Street seems to be far too low. I am looking for an opportunity to raise my stake to around 30% - 40%. But I am aware that when the US Fed changes its course, I might need to react quickly both in allocation and in exposure to the unhedged variation of the S&P 500! In any case, from now I will update my strategic asset allocation model each quarter.

Chapter 15: Plan B

Written 13th January 2015

Version published in Switzer Super Report

Many SMSF investors with direct equity portfolios might soon be in for a shock. About half of our ASX 200 index is accounted for by the so-called High-Yield sectors (Financials, Property, Telcos and Utilities). It so happens that an index of just these four sectors (with market capitalisation weights) out of the eleven sectors of the ASX 200 *outperformed* the broader index by an average 7.6% over the last four years – and the worst outperformance in that period was as high as 6.6%! If dividends – but not franking credits – were reinvested, the average *outperformance* rises to 9.8% with the lowest outperformance being 8.3%.

It follows that anyone focused on picking a yield portfolio from these sectors in recent years would have found it hard *not* to outperform the ASX 200! A dart board, twenty darts and a list of the top 100 stocks from those sectors was unlikely not to have produced a superior performance in each of these last four years.

But far from my trying to rain on your parade (including mine and anyone else's), there is an important lesson to be learnt before it is too late. In the previous eight years (2003 – 2010) – the longest period for which data are available – there was only one year when the high-yield index outperformed the ASX 200 on price (+1.1% in 2006). There were only two from eight years when total returns outperformed the ASX 200 (+2.3% in 2006 and +0.1% in 2009). The average underperformance of high yield was 4.6% on price and 3.3% on total returns.

My main point is simple. Most SMSFers didn't start managing their own investments until recently and so they could easily be misled by their own possibly superb track-records. ASIC requires licensed professionals to make a disclaimer highlighting that "past performance is not a reliable indicator of future performance".

So what does the future hold? The simple answer is that no one knows with any real degree of certainty. The best answer is "create a strategy that balances the expected risks and returns".

As I wrote last month – and I listed all of the specific ASX-listed stocks – I am now very happy with my current SMSF portfolio but I know I need a 'Plan B' for when I sense a new direction is starting to emerge.

The yield-seeking trend of recent years will almost certainly end – and possibly within the next 12-18 months. The question is when. Four successive years of yield-seeking came into being because yields on bonds and interest rates became so low that investors were forced to look elsewhere for income. Australia is still one of the few AAA-rated countries around and our companies pay almost twice the dividends of their US counterparts. On top of that Australian residents often receive franking credits. As long as this low interest regime exists, it is reasonable to continue to invest in the yield play. When it stops, share prices on high-yield stocks might tumble – and quickly – as investors flee 'risky equities' for the safety of bonds and cash at home or overseas. So do I need a hard hat and a high-viz vest? If so, when?

My current SMSF portfolio is 3% cash, 18% international (an ETF from iShares called IVV), 28% "Hybrid Yield-Conviction portfolio" (that I regularly write about in this column), and 51% 'Other' (a portfolio of ASX-listed Blue Chips). Although I am extremely happy with my portfolio (at the moment), I need a Plan B scenario analysis more now than in recent past:-

1) If the $A does depreciate significantly, as I anticipate, at some point I will consider the $A may have bottomed or over-sold. As a rough approximation, I can add my expected depreciation in the $A to my expected total return for the S&P 500, which currently stands at about 11.5% for 2015, to get a return on IVV of about 21.5% for a 10% depreciation in the $A and 31.5% for a 20% depreciation.

2) If I *then* expect the $A to rise, possibly after having overshot some fair value, I don't want to stay in the unhedged ETF as the appreciation will then work against me. I will trade IVV for another iShares ETF, called IHVV, which is the *hedged* version of IVV. I will make the transition smooth inthe sense that I will sell off my IVV in about three parcels over time and place the proceeds straight into IHVV to keep my sum of IVV and IHVV about the same throughout the process.

3) If at some time I expect the $A to depreciate but I expect the S&P 500 to go nowhere or down, I need to invest in a *hedged* US fixed income fund (rather than equities) but, as yet, I have not located a suitable US fixed income ETF. I'll keep you posted.

4) If I see the yield play ending 'soon' – and I have two indicators to help me read the

market – I will rebalance my Hybrid portfolio into its new incarnation. Please recall that I produce a new Hybrid portfolio each month but I *only* rebalance into the new one when significant events take place making it an efficient trade.

5) Since my Hybrid portfolio strategy self-corrects into an appropriate balance – possibly across all sectors – this rebalance will require no other action in terms of what sectors and stocks to choose. In that sense, my Hybrid strategy is dynamic.

6) My current 'Other' portfolio contains seven stocks in four groups. It is a legacy portfolio that I am slowly transitioning into my new strategy. In the first group, BHP and RIO will be sold down further if stock prices rise sufficiently and the proceeds will be put into the Hybrid portfolio or the international portfolio as the then current conditions dictate.

7) Similarly, STO and WPL will follow the same rules as for BHP and RIO but I think oil price increases may not happen for some time and so I do consider these two stocks separately from BHP and RIO. Energy is a longer-term strategy.

8) CBA and WBC form the third pair. I am likely to hold onto these stocks as very long term strategic plays. I much prefer these two banks from the big four – but nothing lasts forever. I did once own multiples of these stocks that I now own and I am now sitting on ballpark 100% capital gains. I find it hard to dismiss them.

9) Finally, COH (Cochlear) has been flying high of late. I typically buy Cochlear in the fifties and sell at just above $80. This strategy has served me very well over the last eight years. Its price has risen from about $72 to $81 in about a month. While I would normally sell some at this point, my anticipated fall in the $A is likely to boost its earnings from exports. Secondly, it is still, in my opinion, recovering from a recall of a device (N5) a few years ago and I am anticipating better things from N6 which is still going through the process of adoption. COH is *very* poorly rated by analysts (and has been for years) – but they did miss the last $30 improvement in the stock prices! Moreover, the likes of CSL, RHC and RMD in the Health sector have made massive gains in recent times and investors might soon be looking for a new stock, such as COH, in the same defensive sector but that is less over-priced.

So with my Plan B now firmly in place, I am about to start working on Plan C. I work on my strategy – for my own money – at least six days a week. There is a reason that fund managers want a management fee and, sometimes, an outperformance fee for doing this sort of work!

Chapter 14: Don't chase yield forever

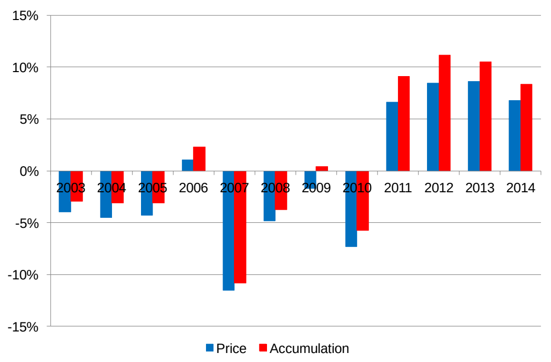
Written January 9th 2015

Version published in Professional Planner

Whenever people talk about SMSF share portfolios, high yielding stocks seem to take centre stage. In the April edition of this magazine last year I showed that over a long period of time, the choice between sectors was largely one of convenience for harvesting an income stream rather than making greater total returns. However, markets do go through cycles. In Chart 1, I show the collective outperformance of the four High-Yield sectors (Financials, Property, Telcos and Utilities) – using market capitalisation weights – over the ASX 200. Of course, High-Yield accounts for about half of the ASX 200 index so the difference between High-Yield and the 'rest' would be much more exaggerated. Here I am focusing on an investor who might be choosing between, say, an index-hugging managed fund and a High-Yield direct equity exposure.

While the average outperformance of High-Yield over the whole period 12-year period including dividends is quite close to zero, there is a distinctive pattern. For the last four years, High-Yield has consistently outperformed the ASX 200 by around 6% - 9% for capital gains and 8% - 11% for total returns. It doesn't take rocket science to realise this outperformance will not last forever!

Chart 1: Outperformance of High-Yield sectors over the ASX 200



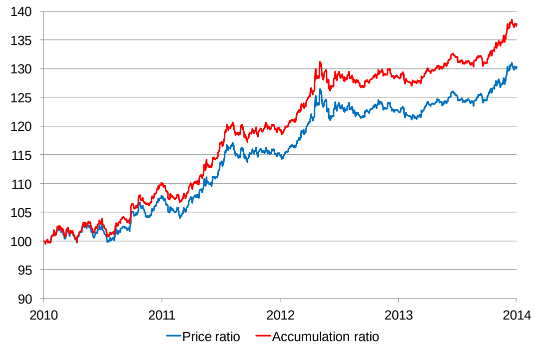
Source: Thomson Reuters and Woodhall Investment Research

But the important point here is that a dartboard and a list of High-Yield Stocks (preferably top 100 names) – together with sector weights (Financials (73%), Property (13%), Telcos (11%) and Utilities (3%)) would probably have outperformed an ASX 200 benchmark by a considerable amount in recent years. The key to success going forward is to be ready – or nimble enough – to take advantage of swings in sectoral outperformance when the music stops.

In Chart 2, I show the ratio of a daily High-Yield price index I created to the ASX 200 price index – and a similar ratio for the accumulation indexes. What I note from this chart is the steady improvement in relative performance of the High-Yield sector indexes. In the previous eight years the trend was in the opposite direction and much more volatile. I will be watching this series closely for a signal that the 'high yield play' trend is coming to an end.

I chose to preposition myself for future changes in case they transition too quickly when the market turns. I believe – like many others – that when the US Federal Reserve starts to seriously raise rates, the action might start. I think that might be as late as 2016 but many expect it to happen in the middle of 2015.

Chart 2: Ratio of High-Yield and ASX 200 indexes



I have four components in my SMSF after my December rebalance. I invested 28% in my own version of a High Yield portfolio which has a tilt towards growth – as I discussed in this magazine. It is little changed in composition from when I instigated it in June 2014. Because I see a much strengthening US economy and a US dollar to go with it, I invested 18% in an unhedged ETF replicating the S&P 500 (iShares IVV). I have 3% in cash 'just in case'. The remaining 51% is invested in stocks I already held (but I sold down in part to be able to buy IVV) to define a blue chip 'other' portfolio – BHP, CBA, COH, RIO, STO, WBC, WPL.

I believe oil prices will bounce back sometime later in 2015. Iron ore prices might rise a little. In that event, my 'over-sold' BHP, RIO, STO and WPL might bounce back. There is also the chance of some strong dividends and buy-backs from this set. I will consider selling even more of these exposures if prices move as I expect. CBA and WBC are my preferred big banks and are not present in my yield portfolio.

An Australian dollar under pressure favours COH – the hearing aid implant company with international sales – and the unhedged IVV ETF. Using my broker-based forecasts for the ASX 200 and the S&P 500 (starting from December 31st), I expect a total return of about 12% (excluding franking credits) for my whole SMSF portfolio if the $A holds steady. A 10% devaluation in the $A over 2015 might lead to a total return of 14.5% and a 20% devaluation might produce a 16.5% total return. I monitor my portfolio regularly but I do not expect to do any rebalancing until at least June.

Chapter 13: Planning for 2015

Written 16th December 2014

Version published in Switzer Super Report

I was asked to write about what I would be doing with my SMSF share fund for 2015. Rather than just write about it, I first did it! I find it is so easy to fall into the trap of thinking of what to do when it is not followed by action – only to finish up finding out that one has only done half of the job. There is nothing like making trades to focus the mind.

Readers might recall from my November contribution, I was puzzled by the conflict between good broker forecasts and the poor price activity of Cardno (CDD) in my Hybrid Yield-Conviction portfolio. Well, soon after I wrote that piece, the profit downgrade came – so I sold out. Naturally I made a significant loss but it would have been a lot worse if I had not sold then.

As a result of the apparent conflict, I have decided that, should something similar happen again, I will sell half of my exposure in the relevant stock while I am thinking. Downgrades can cause savage price cuts. My rule will be to consider selling when a stock falls by 10% or more below the portfolio return even if the consensus recommendations are still strong.

Since my Hybrid portfolio was a little under a third of my SMSF equity exposure, and it was almost six months old, I was ready for a possible big rebalance. But the Hybrid portfolio was doing very well – returning +3.9% (including dividends) to the close on the15th December against a total return on the index of -1.9% so I wasn't in a rush to run away from it. Incidentally, the stocks I sold in June to fund the purchase of my Hybrid portfolio had collectively fallen -5.0%, also including dividends. I took comfort in the fact that events had supported my rebalance.

After the success I was also enjoying with my new international exposure via the iShares ETF for the S&P 500 (unhedged) – ticker IVV – which I wrote also about in November, I decided it was time to go international in my SMSF. While my October 16th investment in IVV was up +14.7% to the close on 15th December, the S&P 500 was only up +7.5%. The difference is the contribution of the $A currency fall! But, naturally, I first contacted my accountant to check that this ETF was allowed under my SMSF strategy!

To fund the purchase of IVV, I first got rid of the rats and mice that I had been a bit slow to eject from my portfolio during the year. But the main funding was from sales of Cochlear (COH), Commonwealth Bank (CBA) and Westpac (WBC). I really like these stocks and I had made substantial capital gains – but I needed to sell something 'good' as I had little cash and no 'bad' stocks left. That is the pain that comes with rebalancing. I still have substantial holdings in these three stocks after the sales but a little less than one fifth of my portfolio is now invested in IVV.

That leaves around 4% in cash and around 50% in seven blue chips (BHP, CBA, COH, RIO, STO, WBC and WPL). I am not panicking about oil prices. STO and WPL are long-term holds for me. STO has a great long-term outlook and I wasn't quick enough to get out before the recent price fall. CBA and WBC are great companies but at least I am no longer 'over exposed' to any regulation changes that might affect the big banks. COH has long been a favourite of mine for many years and it could benefit from any future currency falls.

So my New Year should be free from making any resolutions – at least financial ones. If BHP and RIO come back in price during 2015 – which I expect – I will sell down part of my exposures in those two and consider putting the proceeds in IVV – providing conditions still warrant the investment. In mid 2015 I will consider a big rebalance of my Hybrid portfolio on its first anniversary which I might add to by selling even more of my Blue Chips to gain some more yield with growth.

So my key expectations for 2015 are:-

1) Downward pressure on our dollar to continue – so my leaning towards unhedged exposure in the US.
2) A much stronger US economy compared to Australia – so my leaning towards a material exposure in the S&P 500.
3) The high-yield play to still have legs well into 2015 – so my leaning to building on my Hybrid portfolio exposure.

And I would like to close the year with wishing readers a Merry Christmas and a very Prosperous New Year.

Chapter 12: Thinking inside the box (II)

Written 13th November 2014

Version published in Switzer Super Report

Last month on this site (14th October), I made my usual strong statements (with my usual high degree of conviction) about the market. I was so convinced by my argument that, a couple of days later, I borrowed a material amount of money against my home equity and invested it in a 50:50 portfolio of ETFs representing the ASX 200 and S&P 500 (IOZ and IVV in my case). Because of the time it takes in analysing and writing, I am using the 10th November closing prices for my analysis in this article.

In less than a month, I am up about 9% on that geared (outside of super) portfolio. My notion was (and is) that I forecast a 'box' each six months as I discussed last month. The box gives not only my 12-month-ahead forecast but also the high and low that might occur during that 12-month period. It so happened that the ASX 200 and the S&P 500 both just touched my predicted lows when I wrote last month. As soon as my Fear Index gave the signal to buy (two days later), I bought (and discussed it on Switzer TV on the 21st October).

I am 65 and strongly believe that I should make money wherever I think I can. I cannot gear within super, so I did it legitimately outside. If I make enough money outside of super, I can put any significant profits into my SMSF as non-concessional contributions (up to the prescribed limits). If I am an average person, I should live about another 20 years. With my family history, I could well live another 30 years or more before I hang up my spurs. In my mind, my financial situation is no different from a 35 year old thinking about what life might be like at 65!

Please allow me first to reflect on my 'Hybrid' Yield-Conviction portfolio before I write about what troubles me at the moment. I wrote during the first half of 2014 about how I was building a special SMSF portfolio (for myself) and detailed the actual portfolio I invested in.

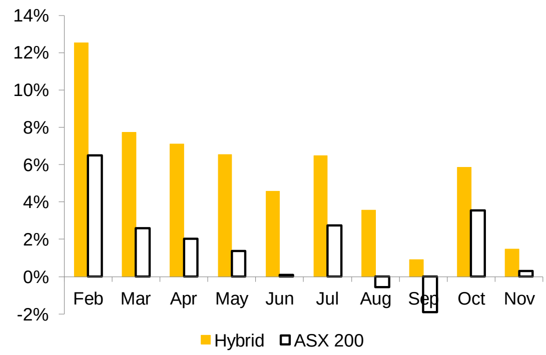
Each month I create new portfolios but I do not expect anyone would or should chop and change each month. Rather, I think in terms of owning my car. If the manufacturer brings out a new model with a better styling of the dash or nicer headlights, etc, I don't trade up. If it, or some other company, brings in a significant new feature (or my car starts to fade in performance), I might trade up. It's the same with portfolios. I 'bought' my portfolio at the end of June and the only change I have since made was to get involved in the Telstra buy-back.

I show the capital gains for each of my Hybrid portfolios (and the ASX 200 index) in Chart 1. I show the outperformance in Chart 2. Since each month from February 2014 a new portfolio is born, each portfolio should be viewed differently. The February portfolio has been alive for about nine months. The November portfolio has only had a couple of weeks to make gains.

I note that the ASX 200 made losses for the periods starting in August and September but all of the Hybrid portfolios made gains and outperformed the index. It is important to note that the stocks and the weights attached to them in the Hybrid portfolios evolve over time and yet there seems to have been some consistency in the realised returns.

The consistency of the approach is more apparent in Chart 2 which shows the outperformance. Of course, as we go from left to right in that chart there has been less time to outperform. However, there is a degree of smoothness in this natural decline. The particular portfolio I invested in near the end of June has returned 5.16% against 2.90% for the ASX 200. The dividend yield is also ahead of that for the ASX 200 but, until there is a full cycle of dividend payments, such a comparison is not a full representation of the differences in yield. Selected statistics for the component stocks are presented in Table 1.

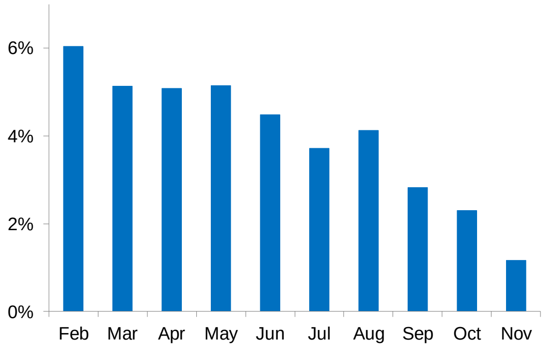
Chart 1: Cumulative capital gains for the Hybrid portfolio and the ASX 200



Source: Thomson Reuters and Woodhall Investment Research

It can be noted form Table 1 that the median capital gain for the stocks was +6.4% which is a little above that for the portfolio at +5.2%. Only two stocks posted losses to date: Cardno and Bank of Queensland. Since Cardno's price fall is well out of line with all of the other stocks, it is worth considering cutting my losses and selling it. Cardno's target price has also been cut – but by only -2.8% – and the latest target price of $6.75 is well above the current share price of $5.27 giving it plenty of upside. Moreover, the consensus recommendation has actually improved from 2.70 to 2.60.

Chart 2: Outperformance for the Hybrid portfolio over the ASX 200



Source: Thomson Reuters and Woodhall Investment Research

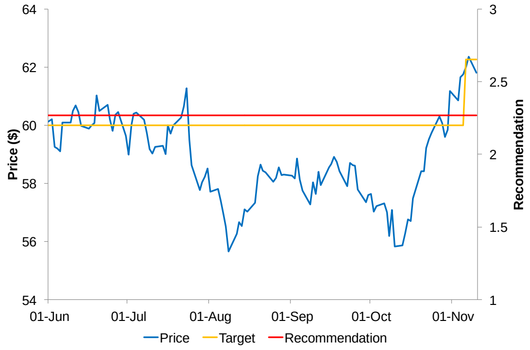
Table 1: Statistical analysis of the late June Hybrid Portfolio

	Price		Gain	Recommendation		-Gain	Target		Gain
Name	25-Jun-2014	10-Nov-2014		25-Jun-2014	10-Nov-2014		25-Jun-2014	10-Nov-2014	
SYDNEY AIRPORT	4.33	4.48	3.6%	2.64	2.58	0.06	4.20	4.40	4.8%
TRANSURBAN GROUP	7.56	8.23	8.9%	2.46	2.58	-0.12	7.43	8.05	8.4%
CARDNO	6.48	5.27	-18.7%	2.70	2.60	0.10	6.95	6.75	-2.8%
TATTS GROUP	3.00	3.44	14.9%	2.92	3.00	-0.08	3.15	3.40	7.9%
PRIMARY HEALTH CARE	4.48	4.66	4.0%	2.47	2.64	-0.17	5.21	4.94	-5.2%
SUNCORP GROUP	13.43	14.99	11.6%	2.40	2.73	-0.33	13.40	14.40	7.5%
IOOF HOLDINGS	8.43	9.10	7.9%	2.77	2.46	0.31	9.30	9.60	3.2%
BENDIGO & ADELAIDE BANK	12.42	12.71	2.3%	2.33	2.81	-0.48	12.20	12.70	4.1%
BANK OF QLND.	12.37	12.23	-1.1%	2.65	2.38	0.28	12.75	12.95	1.6%
MACQUARIE GROUP	60.88	61.80	1.5%	2.27	2.27	0.00	60.00	62.26	3.8%
FEDERATION CENTRES	2.54	2.74	7.9%	2.23	2.62	-0.39	2.52	2.74	8.7%
STOCKLAND	3.95	4.22	7.0%	2.18	2.23	-0.05	4.16	4.38	5.4%
DEXUS PROPERTY GROUP	6.80	7.39	8.7%	2.64	2.86	-0.22	6.89	7.08	2.7%
TELSTRA	5.21	5.73	10.0%	2.80	2.88	-0.08	5.14	5.60	8.9%
DUET GROUP	2.47	2.52	2.2%	2.62	2.92	-0.30	2.23	2.49	11.9%
SPARK INFRASTRUCTURE GP.	1.83	1.94	5.7%	2.62	2.50	0.12	1.91	2.01	5.0%
Median			6.4%	2.62	2.61	-0.08			4.9%

Source: Thomson Reuters andWoodhall Investment Research
Note: data are to the close on 10th November 2014

This behaviour reminds me of that for Macquarie Group which I set out in Chart 3. Its share price tumbled shortly after I got my portfolio set but the target price and recommendation held. Very recently, the share price bounced back and the target price lifted $2.26. I am glad that I held MQG.

Chart 3: Macquarie Group statistics since June 2014



Source: Thomson Reuters and Woodhall Investment Research

Since these portfolios were designed for yield, capital gains are of less importance. However, if Cardno's target price or recommendations are significantly cut, I will bail out. For now I am holding.

I used my dividend cheques to buy Woodside Petroleum. When I set my portfolio in June, the system wanted to choose an exposure to Energy but no stocks then passed my filters. Woodside is now only a little outside one of the filters – but it was so close I ignored it. Sometimes I am human!

Chapter 11: Thinking inside the box

Written 27th October 2014

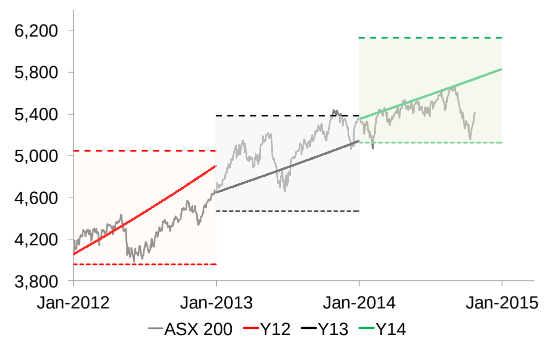
Version published in Professional Planner

I introduced my new 'box' forecasts in the February 2014 edition of this magazine. In essence, I supplemented my normal one-year-ahead forecasts with a predicted high point and a predicted low point during the year for the ASX 200 and separately for the S&P 500. The high and the low are designed to be equally likely at the beginning of the year but the high and low forecasts are not independent. Once, say, a low has been reached, the high is then less likely as there is less time to go to the end-of-the-year and the high is further away from the current index value than it was at the beginning of the year.

Since February I have been back-testing the box forecasts and updating them. The base-line forecasts are exactly the same as I produced them in real time – it is just the high and the low forecasts that have been added. I used the same methodology in producing the high and low forecasts in back testing as I used in the February issue.

To prevent the clutter of overlapping boxes, I show the calendar year and financial year forecasts in separate charts – Chart 1 and 2 respectively.

Chart 1: Calendar year box forecasts for the ASX 200



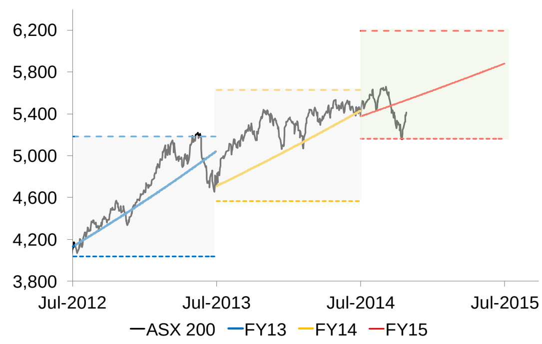
Source: Thomson Reuters and Woodhall Investment Research

I judge the process to have been quite successful. The index hardly ever got outside the boxes and usually came very close to one or the other bound as I hoped for. As a result, I designed a new gearing strategy for myself. The idea was to wait for the index to reach a lower bound and then buy the index. Portfolio theory strongly suggests that when gearing, portfolio risk is exchanged for gearing risk and so an ETF representing the ASX 200 is an ideal candidate to gear.

As it happened, the ASX 200 and S&P 500 both got within a fraction of the lower bound on October 13th. Since my Fear Index was elevated, I waited for that index to settle down – which happened on October 16th. I borrowed to buy two ETFs, IOZ and IVV, in approximately equal values on that day.

The strategy is that, when next the index gets close to the high forecast, I plan to sell unless that breach of the high happens very near the end of a year. In that case, the end-of-year forecast would be close to the index in a rising market. I will then hold until the next breach of a high. When a low comes along, I will buy back in. And if it hits a low again before I sell, I will double up my holding.

Chart 2: Financial year box forecasts for the ASX 200



Source: Thomson Reuters and Woodhall Investment Research

Of course, the index might breach the low again while I am holding the ETF but, as the low typically rises with each new forecast year, I am prepared to live with this simple strategy. I am also a strong believer in putting my money where my mouth is so I borrowed a significant amount (for me!) to test my idea.

My exuberance indicator suggested that the ASX 200 was underpriced by about -7% when I bought and I had an adjusted (for exuberance) 12-month capital gains forecast of 15%. For the S&P 500, I had the market underpriced by -6% and a 12-month adjusted forecast of 18%. I estimate that the dividends will cover much more than half of the interest costs but, as my S&P 500 ETF is unhedged, I might also gain or lose from currency movements. Naturally, I will report back.

To me, the big 'known' risk at the moment is an escalation of the Ebola outbreak. If an event such as that eventuates, I reserve the right to exit my strategy. Until then I will continue thinking inside the box and leave Edward de Bono outside!

Chapter 10: Surviving another market correction

Written 14th October 2014

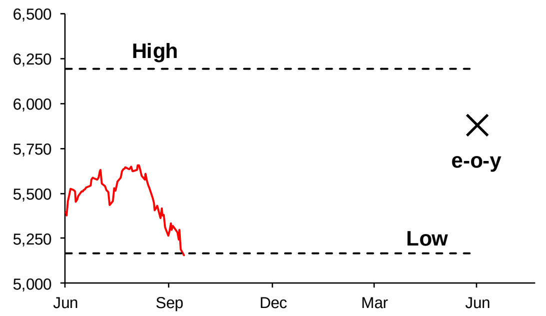
Version published in Switzer Super Report

The last month or so has been miserable for most investors on the ASX 200. Event after event (Ukraine, ISIS, Gaza, Hong Kong, and Ebola, etc) bombarded world order. On top of that, the effect of bilateral sanctions from the Russia-Ukraine situation have taken their toll on German economic performance with the latest stats showing falls of around -5% on the like of exports and industrial production.

While the market tumble has been merciless, it hasn't (yet) been out of 'the box'. Each six months I push out a 12-month forecast of the ASX 200 for the calendar or fiscal year ahead. I not only try to predict the ending number for the index, I also try to pick the high or the low along the way (all using scientific methods) – and those limits define 'the box' in my terminology. Of course, if the low is realised, the high is now much less likely as the remaining time period is shorter and the distance further away – and *vice versa*. At the start, the high and the low are equally likely.

In Chart 1, I show my July 1st 2014 predicted high, low and end point for FY '15 together with the index to the close on Monday 13th October. While the financial year started well, reaching 5,659 on September 2nd, the period since has already wiped of all of the gains for calendar 2014. However, at the time of writing, the market's last close was only 6 points above the low forecast (dotted line). In that sense, the end-of-year forecast of 5,900 is still in the gun-sights but the high is now much less likely!

Chart 1: ASX 200 and July 1st forecasts for FY 2015 – 'the box'.



Source: Thomson Reuters and Woodhall Investment Research

In my opinion it is too early to worry (too much). Markets always move around and that is why my high forecast of 6,200 and my low of 5,150 are so far apart from the e-o-fy mark and the July 1st starting point. Interested readers might wish to check out when I presented these forecasts on Switzer TV (26th May, 2014) – the video should be on archive on that website – www.switzer.com.au.

Importantly, the late sell off on Tuesday in Wall Street took the S&P 500 to spot on the equivalent dotted line in the corresponding Chart 1 for that index. Is it possible that the bottoms for both markets have been more or less reached?

But what is more important to me is whether my particular portfolio is doing well. After all, it is my money! I will just focus here on my Yield Portfolio in my SMSF which I started at the end of June 2014 and I have regularly written about on this site. I have another portfolio in my SMSF as I haven't yet transitioned all of my assets into the new portfolio. I also have a geared portfolio outside of super which naturally has different objectives.

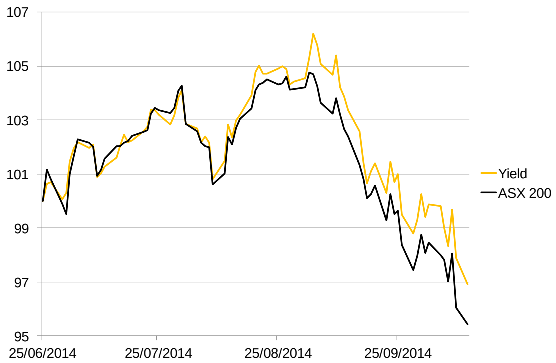
I designed my Yield Portfolio to produce a high expected yield but also with a good chance of not falling behind the ASX 200 in capital gains. In Chart 2, I show the capital gains performance of my portfolio and the ASX 200 – both excluding dividends. Given recent events, it is unsurprising that both performances are currently under water. I note that my portfolio tracked the index quite closely until the August reporting season started. Possibly as a result of using consensus recommendations to help me chose good high yield stocks, my Yield Portfolio has since beaten the index by a modest amount. Of course there is also an element of luck in any one experiment like this – or anybody else's portfolio.

Because I sold some Telstra in the recent buy-back, my actual performance is slightly better than that shown in Chart 2 which I assumed that I didn't sell into the buy-back. There are so many ways of measuring performance in such buy-backs, Chart 2 shows a clear comparison. Taking the buy-back into account, my actual capital loss was -3.3% compared to -3.1% without the buy-back. The ASX 200 was down -4.6% over the same period.

Four of my 16 stocks are yet to have produced a dividend as they all went ex-div a day or two before I started buying my Yield Portfolio. Nevertheless, with franking credits, my yield-to-date has been 2.6% with, of course, 20 more dividend payments to come by the time that the full annual dividend cycle is complete.

When I compare my holdings to what a new portfolio would now be using my methodology, I again conclude that my old stocks still pass the muster. From Table 1, no recommendation has slipped below a '3' (for a hold) and no share prices (price %) have, in my opinion, fallen out of line with the ASX 200. I do not get concerned until any of my stocks have fallen at least 10% more than the index. The target prices give some of my stocks plenty of upside. No share price is above the median (consensus) target price.

Chart 2: Relative capital gains performance of the yield portfolio and the ASX 200



Source: Thomson Reuters and Woodhall Investment Research

So given I produce a new portfolio each month, should I not have changed my portfolio by now? I stand firmly on this point. To me, it's like Windows updates. They keep coming round and the improvements are either marginal or negative. I am still on Windows 7 and I still largely write in FORTRAN 66 (ie the 1966 scientific programming language) because the messing around in changing stops me performing! But when I really have to, or the perceived benefits are so great, I change (like leaving Windows Vista behind as quickly as possible). So it is with my portfolios.

If I were to want to put a serious amount of money in a new Yield Portfolio, I would choose the next generation. With a few dividend dollars I will pump it back into this one or take a new stock from a more recent portfolio while I await the new portfolio. But, importantly, readers of my Weekly on my website www.woodhall.com.au would know that – although all sectors are cheap – the fear index is too high to warrant a buy. Each Saturday – usually before 11am – I update my views.

Table 1: Statistics on the yield portfolio

	Base price	Price %	New target	Base rec.	New rec.
SYDNEY AIRPORT	4.33	-4.4%	4.40	2.64	2.54
TRANSURBAN GROUP	7.72	0.1%	8.03	2.46	2.62
CARDNO	6.30	-9.5%	6.75	2.70	2.50
TATTS GROUP	2.99	2.0%	3.38	2.92	2.92
PRIMARY HEALTH CARE	4.57	-10.1%	4.99	2.47	2.53
SUNCORP GROUP	13.45	2.2%	14.25	2.40	2.73
IOOF HOLDINGS	8.44	-1.3%	9.60	2.77	2.46
BENDIGO & ADELAIDE BANK	12.23	-7.4%	12.70	2.33	2.82
BANK OF QLND.	12.23	-2.9%	12.95	2.65	2.41
MACQUARIE GROUP	59.80	-6.6%	60.00	2.27	2.27
FEDERATION CENTRES	2.57	-0.4%	2.74	2.23	2.62
STOCKLAND	4.00	-2.5%	4.37	2.18	2.21
DEXUS PROPERTY GROUP	1.14	-3.1%	1.18	2.64	2.93
TELSTRA	5.17	1.4%	5.60	2.80	2.94
DUET GROUP	2.49	-4.0%	2.49	2.62	2.92
SPARK INFRASTRUCTURE GP.	1.81	0.0%	2.01	2.62	2.39

Source: Thomson Reuters and Woodhall Investment Research
Note: data are to the close on 13th October 2014

Chapter 9: First Review of the Yield Portfolio

Written 9th September 2014

Version published in Switzer Super Report

In earlier postings on this site I described the process which I used to design my SMSF Yield-Conviction portfolio. I bought the portfolio over a three-day period June 25th – 27th, 2014 and detailed the results in a previous issue of this newsletter.

It is far too early for me to want to rebalance – or 'tweak' – my portfolio. I designed it to be relevant for at least three months and possibly 12 months. However, many stocks on the ASX 200 have just been through the August reporting season – one of two major periods each year when listed companies reveal their final or interim accounts and outlook statements – and so it is time for me to do a risk assessment of my portfolio.

I actually perform a light-touch review each day as I have automated links to the Thomson-Reuters database. It only takes me a few seconds to look out for any problems that may be arising. In this (my first) full review of my portfolio and its methodology I am looking for four things:

1) Is the *process* I use on track?
2) Have there been any deleterious changes in broker estimates and forecasts that warrant a stop-gap fix until I choose to do a full rebalance?
3) Have there been implicit changes to the 'optimal' model portfolio that might guide my thinking?
4) What shall I do with my dividends' payments which have started to arrive?

As I have often written, portfolio management is a very time consuming activity even if very few changes to the portfolio are actually made. My mantra as Chief Investment Officer at the Commonwealth Bank's Private Divisions was 'risk first, returns second'. I still live by that mantra as I know I have little influence over stock returns but I can play a major role in risk assessments and subsequent actions for my assets.

Following my return from a month long holiday visiting my brother in England (where I still did my risk assessments at the breakfast table each morning!) I performed a review on data up to Friday September 5th. Of course things change each day and subsequent changes must be added to any prior assessment.

Any readers who have been following my investment journey over the course of 2014 in the Switzer Super Report will know I took about six months to develop my methodology (based on my previous experience with real clients and their money) before I put my hard-earned into my approach. That is not to say that my prior offerings were wrong and needed correcting. It is more like James Bond drove an Aston Martin DB5 in the early films of the sixties but he presumably would now drive the Vanquish – times change, or at least evolve.

Since I have been keeping detailed records while I developed my software, I can track how each vintage of my portfolios has fared. At the earliest practical business day in each month I create three portfolios. The main one is my Hybrid Yield-Conviction portfolio (Yield for short) but I also produce a High Conviction and a High Octane portfolio. High Conviction is designed to focus on the big boys and not outperform by much in good times but be more robust in poor times. High Octane goes after high risk plays on top 200 stocks that might produce good outperformance. All three portfolios (Yield, Conviction, and Octane) use the same process but different sector 'tilts' and criteria for stock inclusion.

In Table 1 I collect the performance stats for each generation of portfolio over the three styles. These stats are for a guide rather than a definitive assessment. For example, if a stock delisted during the period, I 'assume' that it was sold to cash at 0% interest for simplicity. Buy-backs and the like are ignored. All that takes too much time to deal with for this sort of check – unless my money is in it, and then I treat the portfolio differently!

Table 1: Performance statistics for portfolios of different vintages

Start	Capital gain to date				Outperformance		
date	Conviction	Yield	Octane	ASX 200	Conviction	Yield	Octane
Feb	6.1	14.6	16.3	7.9	-1.8	6.6	8.4
Mar	3.6	9.4	9.0	4.0	-0.4	5.4	5.1
Apr	2.9	9.0	8.5	3.4	-0.6	5.5	5.1
May	2.6	7.3	5.7	2.8	-0.2	4.6	2.9
Jun	1.7	5.1	4.9	1.5	0.2	3.7	3.4
Jul	3.9	6.0	8.9	4.1	-0.2	1.8	4.7
Aug	2.6	2.6	4.4	0.8	1.8	1.8	3.7
Ron (Jun 25)		4.8		3.6		1.2	

Source: Thomson Reuters and Woodhall Investment Research – as at 5th September

The first portfolio (Feb) has been going just over seven months. It was never envisaged that portfolio would be rolled over into the March but new money would have been put into that March portfolio had I been ready. Clearly each row in Table 1 refers to a different (overlapping) investment period from about seven months to about one month. The sector weights change over time and portfolios – and stocks leave and enter the portfolios over time.

All of the Octane portfolios have seriously outperformed the ASX 200. I am surprised (but delighted?) by that outcome. The Octane sector weights are tweaked towards growth and stock selection goes after the best of the broker recommendations. While the portfolios happen to have done well, some stocks in some portfolios tanked – which highlights the benefits of diversification.

The Conviction portfolios have jogged along as they might be expected to do in benign conditions such as 2014. The February portfolio suffered from its weighting to BHP and RIO and the lack of high yield stocks that became so popular during this year.

The Yield portfolios have done surprisingly well – but it has been the year of the yield play. Care must be taken to exit this strategy if it looks like it will go out of favour. My personal portfolio in the last row of Table 1 has done just fine in my opinion. A little bit of outperformance and 10 of the 16 stocks produced, or will produce, good dividends in the near future.

What I take away from this analysis is that the methodology has stacked up so far and I have no reason (yet?) to tweak it. But what about the component stocks in my portfolio? How did they perform and what are their prospects? I show certain relevant statistics in Table 2.

Table 2: Stock analysis

		Price			Recommendation			Target price			Expected gain	
Name	**Code**	**Start**	**Now**	**Gain**	**Start**	**Now**	**Change**	**Start**	**Now**	**Gain**	**Start**	**Now**
SYDNEY AIRPORT	SYD	4.33	4.50	4.0%	2.64	2.60	0.04	4.20	4.40	5%	-3%	-2%
TRANSURBAN GROUP	TCL	7.56	8.13	7.6%	2.46	2.50	-0.04	7.43	8.05	8%	-2%	-1%
CARDNO	CDD	6.48	6.88	6.2%	2.64	2.50	0.14	6.95	6.75	-3%	7%	-2%
TATTS GROUP	TTS	3.00	3.30	10.2%	2.92	3.00	-0.08	3.15	3.30	5%	5%	0%
PRIMARY HEALTH CARE	PRY	4.48	4.55	1.6%	2.47	2.53	-0.06	5.21	4.99	-4%	16%	10%
SUNCORP GROUP	SUN	13.43	14.72	9.6%	2.40	2.80	-0.40	13.40	14.25	6%	0%	-3%
IOOF HOLDINGS	IFL	8.43	9.30	10.3%	2.77	2.46	0.31	9.30	9.60	3%	10%	3%
BENDIGO & ADELAIDE BANK	BEN	12.42	12.66	1.9%	2.33	2.82	-0.49	12.20	12.70	4%	-2%	0%
BANK OF QLND.	BOQ	12.37	12.73	3.0%	2.65	2.71	-0.06	12.70	12.89	1%	3%	1%
MACQUARIE GROUP	MQG	60.88	57.75	-5.1%	2.27	2.27	0.00	60.00	60.00	0%	-1%	4%
FEDERATION CENTRES	FDC	2.54	2.70	6.3%	2.23	2.62	-0.39	2.52	2.74	9%	-1%	1%
STOCKLAND	SGP	3.95	4.22	7.0%	2.18	2.21	-0.03	4.16	4.33	4%	5%	2%
DEXUS PROPERTY GROUP	DXS	1.13	1.20	5.9%	2.64	3.00	-0.36	1.15	1.18	3%	1%	-2%
TELSTRA	TLS	5.21	5.64	8.3%	2.80	2.89	-0.09	5.14	5.53	7%	-1%	-2%
DUET GROUP	DUE	2.47	2.46	-0.2%	2.62	2.92	-0.30	2.23	2.49	12%	-10%	1%
SPARK INFRASTRUCTURE GP.	SKI	1.83	1.88	2.5%	2.62	2.54	0.08	1.91	2.01	5%	5%	7%

Source: Woodhall Investment Research

The first three numerical columns of Table 2 show the prices I actually paid at the end of June, the closing prices on September 5th and the unrealised capital gain over that period. Given that the index (from Table 1) did 3.6% over the period, any gain above that in Table 2 is reasonable. TTS, SUN, IFL and TLS have done quite well. Of course SUN came out with a very nice special dividend as well. TLS has a buy-back offer which I will subscribe to.

Only two stocks have so far gone backwards. MQG was quite disappointing at -5.1%. DUE at -0.2% is a result I can live with as I got the dividend before it went ex-div.

In the next three columns I show the broker consensus recommendations (1 is a buy, 2 is an outperform, 3 is a hold, 4 is an underperform and 5 is a sell). Given that these recommendations are averaged over 10 – 20 brokers with often very different opinions, it is very rare to get a recommendation between 1 and 2. There is also a bias against outright sells so I take 3.5 and bigger as a bad sign.

Most recommendations have not changed much. IFL did have a material improvement from 2.77 to 2.46 so that one is certainly a keeper. SUN, BEN, FDC and DXS have deteriorated in their recommendations by about the same amount. None has slipped above a 3 and so I am comfortable at this point especially as I am after yield. If SUN, FDC and DXS do not gain any more in the rest of the financial year, I would be happy to come away those gains listed in Table 2 that have already been achieved.

The median target price that is indicative of what share price brokers think might prevail in 12 months. However, I have found target prices to lag actual price movements so I treat targets with caution. Only two targets have gone backwards: CDD and PRY. The expected gains in the next two columns measure the growth from the initial share price to the target and then the latest share price to the new target.

If I take all of these stats together, MQG looks fine for the future and so I am not itching to jettison it. While several stocks seem a little bland, the mix gives me confidence that my yield and growth expectations may both be met.

As a final diagnostic, I compare my June 25th portfolio to the one I would have rebalanced into at the start of September, had I been so inclined. The sector weights did not turn out to be that much different from those at the end of June. However, my algorithm struggled to find sufficient stocks that meet my criteria. As a result, it can be seen from Table 3 that the total number of stocks has fallen from 16 to 13. CDD, TTS, BEN, FDC, SGP and DXS would have been sold off in a rebalance. TAH, PPT and SCG would have entered.

SCG is an obvious candidate for inclusion. Westfield was going through its restructure at the end of June and SCG was not then available to buy. TAH is a straight substitute for TTS. I see no great difference between them and so I wouldn't swap but I might now have bought TAH instead of TTS. Similarly, changing BEN for PPT doesn't interest me (yet!).

Of course, some of the dollar values for sells and buys in the last column are too small to be efficient. In particular, for a $100,000 portfolio, the transactions for PRY, IFL, BOQ, DUE and SKI are too small to justify the brokerage, paperwork and effort.

Table 3: Rebalancing diagnostic

Name	Code	Portfolio Start	Now	New	Change
SYDNEY AIRPORT	SYD	4,190	4,360	6,909	2,549
TRANSURBAN GROUP	TCL	4,380	4,713	7,181	2,468
CARDNO	CDD	4,180	4,438	0	-4,438
TATTS GROUP	TTS	7,420	8,176	0	-8,176
PRIMARY HEALTH CARE	PRY	8,780	8,919	9,781	862
SUNCORP GROUP	SUN	9,610	10,532	9,079	-1,453
IOOF HOLDINGS	IFL	8,880	9,796	10,326	530
BENDIGO & ADELAIDE BANK	BEN	10,370	10,570	0	-10,570
BANK OF QLND.	BOQ	9,110	9,379	9,393	14
MACQUARIE GROUP	MQG	10,830	10,274	11,553	1,279
FEDERATION CENTRES	FDC	3,430	3,646	0	-3,646
STOCKLAND	SGP	3,670	3,926	0	-3,926
DEXUS PROPERTY GROUP	DXS	2,990	3,167	0	-3,167
TELSTRA	TLS	9,010	9,754	10,945	1,191
DUET GROUP	DUE	1,580	1,577	1,552	-25
SPARK INFRASTRUCTURE GP.	SKI	1,570	1,609	1,793	184
TABCORP HOLDINGS	TAH	0	0	5,672	5,672
PERPETUAL	PPT	0	0	11,867	11,867
SCENTRE GROUP	SCG	0	0	8,775	8,775

Source: Woodhall Investment Research

Note: Allocation is a dollar value for a nominal $100,000 portfolio for the 'start' portfolio but 'now' and 'new' also include the unrealised +4.8% capital gains.

To conclude, I am about to sell TLS in the buy-back and probably I will buy it back collecting franking credits along the way. Spare dividends after paying my pension might get parked in SCG while I wait for a rebalance. Since SCG's share price has climbed nicely since listing, a purchase now might turn out to be a good deal when I do get around to rebalancing. Of course such a move means that I am temporarily unbalanced – but this is how I operate. Since I have to wait about 12 months to collect my franking credits from my dividends, I am not in a position to reinvest much at this point.

Chapter 8: The Yield Portfolio III: Fine tuning

Written 15th July 2014

Version published in Switzer Super Report

In my two previous contributions, I outlined my portfolio construction methodology. In this piece I will discuss the actual portfolio I put a serious portion of my own SMSF savings into. In Table 1, I show the 'Top Ten' lists for each sector that I presented last fortnight. The first task is to choose the stocks. Rather than go just by yield, I also give credit for better consensus recommendations (from Thomson Reuters: 1 for a Buy down to 5 for a sell). And I also exclude stocks that worry me – for whatever reason.

Table 1: Sector top tens

Rank	Energy	Materials	Industrials	Discretionary	Health	Financials	Property	IT	Telcos	Utilities
1	WOR	ABC	SYD	MYR	PRY	SUN	FDC	IRE	TLS	DUE
2	-	ORI	MIN	TTS	-	NAB	SGP	-	MTU	SKI
3	-	ORA	DOW	TAH	-	IFL	DXS	-	SGT	APA
4	-	FBU	TCL	JBH	-	IAG	IOF	-	-	-
5	-	NST	CDD	SWM	-	BOQ	GPT	-	-	-
6	-	MGX	GWA	AAD	-	ANZ	MGR	-	-	-
7	-	PGH	MRM	SUL	-	BEN	CMW	-	-	-
8	-	AGO	SVW	AHE	-	PPT	CHC	-	-	-
9	-	MML	BKN	PMV	-	MQG	ABP	-	-	-
10	-	BCI	MMS	TME	-	CBA	-	-	-	-

Source: Thomson Reuters and Woodhall Investment Research – as at 25th July

I excluded from Table 1 for my portfolio:

1) WOR because it is more mining services than Energy.
2) MIN because it is very much in the mining business and has had some poor recent performance.
3) MYR because of the mergers, takeovers and retail woes.

That means I had no stocks – or weight – in four sectors: Energy, Materials, Staples, and IT. I redistributed the Energy and Staples allocations proportionately across the other sectors – noting that the sectoral split gave neither space for Materials nor IT.

Together with my decision rule for the number of stocks I allocate to each sector, I need to specify how much I invest in each stock. There are three obvious ways of doing this weighting:

1) Weight in proportion to market capitalisation of each stock
2) Equal weighting within each sector
3) Weight with regard to consensus recommendation

I think 1) misses the point for an SMSF. Because most sectors are dominated by one or two stocks, there is little point in going down the list as the size of the allocations falls off so quickly. Of course, by deviating more and more from market cap weights, tracking error (the variability of the fund's returns compared to those of the benchmark) increases but, to me, there is a good argument that stocks outside the top 20 are more likely to give my portfolio a kick in moderate to good times like now.

Equal weighting makes sense as it is simple and, apart from market cap weights, there is no other standard way of weighting. I prefer to weight stocks in each sector in relation to the consensus recommendations. If a stock gets a '1.5' that is a great recommendation. Such a stock seemingly has more chance of capital gains and yield as a stock with a 2.75 recommendation that scrapes through as a slight outperform.

My actual initial allocation is given in Table 2. But there is more to buying the stocks it than dumping your cash into the market – in my opinion. I was in a hurry to get set because there were then only four days to go to the end of the financial year. I thought – and still do think – there was a good chance of a kick in July – and I've already made more than 3% capital gains in a few weeks. TTS was particularly kind to me but four other stocks have made more than 4% since I bought.

Table 2: Initial Allocation

Stock	Code	Company	Sector	Price	Dividend	Con. Rec.	Allocation
1	SYD	SYDNEY AIRPORT	INDUSTRIALS	4.36	5.7%	2.6	4,200
2	TCL	TRANSURBAN GROUP		7.68	5.0%	2.5	4,440
3	CDD	CARDNO		6.42	6.1%	2.6	4,140
4	TTS	TATTS GROUP	DISCRETIONARY	3.04	5.5%	2.9	7,530
5	PRY	PRIMARY HEALTH CARE	HEALTH	4.42	5.0%	2.5	8,700
6	SUN	SUNCORP GROUP	FINANCIALS	13.41	6.6%	2.5	9,620
7	IFL	IOOF HOLDINGS		8.35	6.2%	2.8	8,800
8	BEN	BENDIGO & ADELAIDE BANK		12.29	5.5%	2.4	10,260
9	BOQ	BANK OF QLND.		12.47	5.5%	2.7	9,190
10	MQG	MACQUARIE GROUP		60.20	5.1%	2.3	10,750
11	FDC	FEDERATION CENTRES	PROPERTY	2.59	6.2%	2.3	3,490
12	SGP	STOCKLAND		3.99	6.0%	2.2	3,700
13	DXS	DEXUS PROPERTY GROUP		1.16	5.6%	2.6	3,050
14	TLS	TELSTRA	TELCO	5.19	5.8%	2.8	9,000
15	DUE	DUET GROUP	UTILITIES	2.45	7.1%	2.6	1,570
16	SKI	SPARK INFRASTRUCTURE GP.		1.82	6.5%	2.6	1,570

Source: Woodhall Investment Research
Note Dividend is a forecast and allocation is a dollar value for a nominal $100,000 portfolio

I divided my notional '$100,000' total investment into four portions to take advantage of my estimates of sectoral mispricing, ex-dividend dates and general 'dollar-cost-averaging'. Because the end of financial year was looming large when I was committed on July 25th, I placed the trades much more quickly than I would otherwise have done. I was set by the close on Friday 27th July. I found that when I was placing clients money at CBA that it was possible to give a portfolio a kick-start!

Of course, the allocations at current prices are no longer the same as market prices have already changed over time. In the beginning, my expected yield was 5.7% against 4.6% for the ASX 200 index. My 'grossed-up' estimate of dividends (with estimated franking credits) was 7.5% against 6.0% for the index.

My capital gains forecast, using sector-averages, was 7.7%. I do not make forecasts at the stock level. I do use broker target forecasts as a rough guide. I think brokers tend to downplay these 12-month price targets so as not to get caught out. They can always inch these valuations up as they go along. My initial target-based capital-gains forecast was +2.7% but that has already been upgraded to +3.9% in less than a month! My High Conviction portfolio had a target forecast of +3.1% which, in theory, should be a fraction above the +7.7% sector-based forecast as High Conviction stocks are typically the big companies.

So I am thinking the bias in the 'target forecasts' is currently of the order of -4% points. In other words, I am expecting a grossed up yield of 7.5% with a capital gain of about +6.5% making a total return of around 14%. If I compare that to my index forecast of 6% with a dividend of 4.6% for a grossed-up total return of 12.0%. It may not seem worth all of this effort for an extra 2% (14% - 12%) but there is more to it than that:

1) Will I get the yield component without too many surprises? That is, will my companies deliver on expected dividends better than the rest, or fall short?

2) Will my flexibility to invest my dividends wherever over simply re-investing in the companies that generated them gain an advantage?

3) Will future rebalancing help my portfolio over the index?

I'll give you an update after my August holiday in the Motherland. In September, I will focus on how to judge how well you are travelling.

Chapter 7: The Yield Portfolio II: Stock selection

Written 15th July 2014

Version published in Switzer Super Report

Following on from a fortnight ago, I want to turn my attention to populating those sector allocations I presented with stocks. Of course sector weights and stock selection should evolve over time but I will fix on “Ron’s portfolio” with a June 25-27 start date in this pedagogic series to maintain clarity. When the series ends, I can then quickly refresh the whole process referring back to these postings.

The number of stocks I choose depends more on spreading risk across the portfolio in case one or more turn out to be duds – and even blue chips on occasions become duds – than following a more general rule! I published a series of reports on this site and elsewhere on how many stocks one needs in a portfolio. After extensive statistical simulations at different points in time I conclude that round 8 – 15 is a useful guide in normal times and that might rise to 15 – 25 in volatile times such a during the GFC. In all circumstances, one has to balance the difficulty of finding enough good stocks with the benefits to volatility.

When I construct a ‘real’ portfolio, I want to allow for not just ordinary volatility (measured by standard deviations) but a share price possibly imploding – almost to zero in rapid fire. Sadly it has happened to me so now I want to manage that risk even better! If I want 20 equally-weighted stocks, each gets 5% weight or $5,000 in a $100,000 portfolio. But when I introduce sector weights, clearer thinking is required. I have reproduced Table 1 with its sector weights from my previous column for convenience.

Table 1: Allocations of a $100,000 portfolio under two scenarios

	Sector	Allocations	
		Index	Tilts
Resource-related	Energy	6,029	9,044
	Materials	16,879	0
	Industrials	6,872	10,308
High yield	Financials	39,222	39,222
	Property	6,369	8,258
	Telco	5,278	7,259
	Utilities	1,692	2,539
Other	Discretionary	4,048	6,072
	Staples	8,204	10,281
	Health	4,678	7,016
	IT	729	0
	ASX 200	100,000	100,000

Source: Thomson Reuters and Woodhall Investment Research.
Note: These numbers were current on June 25th 2014.

If I approximately round the ‘Tilts’ weights to the nearest multiple of $5,000s I might have two stocks in each of Energy and Industrials but eight in Financials! That makes no sense to me – I don’t want 8 stocks in one sector – particularly the relatively safe Financials sector. Moreover, I wouldn’t want to choose ‘too many’ stocks in a weak sector. My rules tell me to put an extra stock in a strong sector (judged by risk-adjusted return – but more of that later) and subtract one from a weak sector. Not exactly a scientific process – but not far from it.

The next thing I need is my ‘Top Ten’ for each sector. It takes me back to 1997-1998 when I devised and programmed the first electronic sound recording charts for ARIA – a system they used for a decade or so! This top ten for stocks is much simpler. The list in Table 2 is simply based on expected yield with a cut-off requirement for market capitalisation, expected yield and consensus recommendations. I’ll show you my hybrid yield/conviction top ten’s next time.

Table 1: Sector top tens

Rank	Energy	Materials	Industrials	Discretionary	Health	Financials	Property	IT	Telcos	Utilities
1	WOR	ABC	SYD	MYR	PRY	SUN	FDC	IRE	TLS	DUE
2	-	ORI	MIN	TTS	-	NAB	SGP	-	MTU	SKI
3	-	ORA	DOW	TAH	-	IFL	DXS	-	SGT	APA
4	-	FBU	TCL	JBH	-	IAG	IOF	-	-	-
5	-	NST	CDD	SWM	-	BOQ	GPT	-	-	-
6	-	MGX	GWA	AAD	-	ANZ	MGR	-	-	-
7	-	PGH	MRM	SUL	-	BEN	CMW	-	-	-
8	-	AGO	SVW	AHE	-	PPT	CHC	-	-	-
9	-	MML	BKN	PMV	-	MQG	ABP	-	-	-
10	-	BCI	MMS	TME	-	CBA	-	-	-	-

Source: Thomson Reuters and Woodhall Investment Research.

Staples got no stocks (deleted from Table 2 for brevity) even though it was allocated $10,281 in Table 1. No stocks in that sector met my standards. Three sectors only get one stock. Moreover, as I will discuss next time, I wouldn’t want WOR (Worley Parsons) representing my Energy exposure as most people – including myself – think of WOR being better assigned as a mining services’ company. That means two sectors, Energy and Staples, do not get any allocation!

I now think I have given enough background to show next time how I chose my portfolio. Thereafter I will discuss some of the finer details.

I will be ‘off-line’ in August as I take a trip ‘back home’ to spend a month with my brother. I am really looking forward to that but also to posting the last bits of the jigsaw on this topic that is also so dear to me. If nothing else, I hope readers realise there is a lot more to building a portfolio than a choosing a list of stocks and a dartboard – but sometimes the dartboard will win. Winning in the long-run is what counts. I should also point out that I know that there is also more than one good way to build a portfolio – but the others are not for me.

Chapter 6: The Yield Portfolio: setting the scene

Written 1st July 2014

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Readers who have been following my column for some time will know I intended to design a new portfolio for July 1st. I can now report 'Mission accomplished'. On Wednesday, Thursday and Friday last week, I bought 16 stocks that I did not own – but I had previously owned three of them a few years ago. For those eager to cut to the chase I recommend that you go to the www.switzer.com.au site and look at the video of my interview from June 26th (with Marty Switzer) when I was part way through the process. The charts in a .pdf file are on my website under the tab 'In the Media'.

As will be obvious from what follows, it is an impossible task to do justice to the topic in an 11 minute interview. But, hopefully, the interview will give some insights and encouragement for investors to read on. I will be writing over the next few months about how I made various decisions. But, at the outset, I want to stress that it took me six months of hard work to come to this new framework after a lengthy career in markets.

Since most of the stocks were new to me, and I think resources stocks might have a good run over the next few months, I didn't sell down my whole portfolio to cash so as to buy the new one. Rather, I sold 25% (approx) a few weeks ago basing my selling decisions on those sectors I judged to be overpriced using my exuberance measure. As it turns out, I sold six of the eight parcels of shares at prices above today's prices and the other (AGK) did fall but is now a few cents higher following a recent regulatory decision. That means I did not lose by being in cash for about a month. I like to record all of these sorts of actions so I can learn when I make poor decisions!

About every three months I will sell down about 25% of the old portfolio and invest in the (possibly rebalanced) portfolio. Obviously the conditions at the time will have to be right for me and a lot can happen in a few months.

The first decision to make – in my book – is to articulate the objectives for the portfolio. I want to end up with a yield of about 8% (including franking credits) if that is possible. That means I can draw down my pension only from dividends rather than having to sell for capital gains. Under current rules that means 8% is above the minimum for the next 20 years (for me). By the time I am 85 (if I make it), I might be starting to look for some sort of aged care and my slowly growing capital should see me OK.

The classic way to build a vanilla portfolio is to buy the four big banks, Telstra, a property trust or two and weight them equally. I think I can do better than that – but there is nothing wrong with that approach for investors who are comfortable with it. This new portfolio of mine was designed only for me and it may not suit others. Nevertheless, the decisions that need to be made are common to many types of portfolios. It is just that different choices may be made at each step.

So I want some growth as well as yield. I do not see much growth in the classic portfolio of the previous paragraph as dividends have been compressed down to low– but sustainable – levels. My portfolio 'style' affects the sector weights or loadings I use, the number of stocks I choose, and the companies in which I invest – and the stock weights within sectors.

Let's start with the sector weights. For simplicity (and privacy) I am assuming that I have $100,000 to invest and that does not include brokerage and any other transaction costs. I have set out in Table 1 where that money would be invested if I wanted to hug the ASX 200 index – under the heading 'Index'. These amounts change over time as component stocks change in price and stocks enter or leave the index.

Table 1: Allocations of a $100,000 portfolio under two scenarios

	Sector	Allocations	
		Index	Tilts
Resource-related	Energy	6,029	9,044
	Materials	16,879	0
	Industrials	6,872	10,308
High yield	Financials	39,222	39,222
	Property	6,369	8,258
	Telco	5,278	7,259
	Utilities	1,692	2,539
Other	Discretionary	4,048	6,072
	Staples	8,204	10,281
	Health	4,678	7,016
	IT	729	0
	ASX 200	100,000	100,000

Source: Thomson Reuters and Woodhall Investment Research.
Note: These numbers were current on June 25th 2014.

So an index-hugger would buy $6,029 of stocks from the Energy sector, $39,222 worth of banks and related stocks, etc. Obviously allocations cannot be exact but one can usually get pretty close. I trade on CommSec and find their calculator useful in terms of deciding how many of each stock I want. But a word of caution, I nearly made a couple of silly mistakes when trying to by 16 stocks in three days. It is so important to write down the value, the number of stocks and the price by your calculations – and double check the stock codes! But as we are staying at sector level today – more of that later.

Since I want a yield portfolio it makes sense to invest more in the high-yielding sectors and less in the resources and others sectors. This process is called tilting. It can be done by just using common sense or highly sophisticated optimisation techniques can be used. The simplest solution would be to put zero dollars in the seven non-high yield sectors and scale up the others in proportion. That is one might place $74,622 in Financials, $12,117 in Property, $10,041 in Telcos and $3,220 in Utilities.

The simple four-sector approach does not have much in the way of diversification or growth benefits. I use a very complex method based on my massaging of broker forecasts of dividends and earnings, and risk forecasts from daily index price changes. Rather than trying to just achieve the highest 'risk-adjusted return' – or the so-called Sharpe ratio – I put limits on the tilts to achieve my hybrid yield-growth goals. For example, I do not allow the four high-yielding sectors to be 'underweight'. That is I must have at least $39,222 in Financials, etc – but the optimiser might choose more.

I show the weights I used as a base in my trades under the column headed 'Tilts'. These weights do change from month to month as expected risk and returns evolve – and sometimes they evolve quickly – so beware! Although these weights were my base, I changed them for reasons I will give in the next few weeks.

So, under the 'tilt' heading in Table 1, one can note Materials and IT each got no allocation because of the poor expected returns and high risk. Financials got index-weight but the other three high-yield sectors are overweight. Next time I will discuss how many stocks to choose in each sector and the stocks that passed my 'filters'

Chapter 5: Exit plan – how should you approach the end of the road?

Written 17th June 2014

Version published in Switzer Super Report

I planned to submit this piece (with this title) several months ago as the final in my latest series on contributions for this website. I didn't realise at the time I would be writing it the day after my 65th birthday – so it is unusually relevant! Even more of a coincidence is that yesterday (16th June) an article in the *Financial Review* by Sally Patten on a new super product from Equisuper to stretch out savings in retirement. I have not studied the Equisuper product and so I will not comment on it but the *AFR* version makes it sounds exactly the same as the concept I proposed in a series of papers I published around July 2012 on Switzer Super Report – and the name 'three buckets' of the strategy matches my writings! I will be commenting on my strategy and not Equisuper's in this present article. Interested readers might like to go through the archives of the Switzer Super Report to find those relevant papers of mine. In fact many of my earlier contributions were strategies for super funds.

A problem I have always grappled with is that various commentators talk or write about it being unfortunate when someone retires just as the market has turned bad. It was no surprise to me that I turned 65 yesterday so I have been planning my investment strategy in its growth and its exit for at least a decade. Of course I could have passed away before the date but, sensibly, I had that base covered through my will.

The essence of my bucket strategy is that it hurts a fund when the investor sells down some asset for a pension payment at a low point. Therefore, I have always advocated having two to three years cash (or a closely related safe asset) at hand, or a virtually guaranteed distribution that will exceed the anticipated pension payment.

In bad times, the pension is taken from the cash bucket until either there is less than one year's cash left or the market is doing 'well' and some profits can be taken from the equities bucket to top the cash bucket back up to the desired two or three years level. In my more advanced analysis I have a number of buckets ordered by expected return and risk. I cascade funds down the bucket line as conditions warrant.

So rule one is to start doing something at least two or three years before the desired retirement date. Of course illness can put the plan into disarray but perhaps, at the onset of illness if there is time, a potential retiree could bring forward plans.

My personal situation is a little unusual. I do have a modest defined benefits pension from my early retirement from university. That, with the money I earn from my part-time business and dividends from my equity portfolio in superannuation is more than I currently wish to spend. Therefore I do not yet need my cash bucket. However, when I stop working and I might want some big holidays, or healthcare payments, or retirement home expenses, etc I will need that cash bucket close at hand.

Nevertheless, as I flagged in this column many months ago, I intend to transition to a yield-conviction hybrid portfolio very soon. I am pretty sure I have nailed the software specification that will help me set and monitor my yield portfolio. Perhaps one more iteration will get me there!

One thing I have noted since I started building these portfolios each month from the 1st February 2014 is that my yield portfolios have done particularly well compared to the index while the conviction portfolios have slightly underperformed. I cannot stress too strongly that different types of portfolios do relatively well at different times and this relative performance should be monitored. Yield has done particularly well in the first half of this year in terms of unrealised capital gains so it is pretty easy to have a winning yield strategy at the moment.

I had lunch with a prominent Australian Equities fund manager last week and we discussed this relative performance. They seem to be expecting yield's advantage may soon dissipate (but not collapse – just market perform). I am not sure when the switch will start. I think it might take a little longer – until rates here and overseas start to rise – perhaps mid next year. My yield portfolio (as it is a hybrid of yield and conviction) should automatically navigate the switch but I will be watching performance carefully during that phase.

As I wrote over recent weeks I sold a material portion of my SMSF portfolio towards the end of May and the beginning of June – including AGK, BHP, CBA, WBC and WPL. I did not think any of these stocks were bad. In fact I may even buy some back if there is a mini correction. Rather I wanted to go to cash first so I could buy the stocks from my yield portfolio when the time was right – in my opinion. I chose the stocks to sell using my sector mispricing measures and consensus recommendations. I obviously avoided selling stocks that I thought were cheap at the time.

I went to cash early because 'funny things' can happen at the end of the financial year due to fund managers' window dressing. I did not obviously predict the Iraq situation but I did believe the market was unlikely to rise much before July. Please see my weekly on woodhall.com.au (including old copies that are on the archived page) to see my commentary leading up to my expected rebalancing.

I could start buying any day if the 'price is right' but it is unlikely that I will before July 1st when I generate my next yield portfolio. That is about the time of my next contribution to this site when I will present those stocks that pass my current filters for inclusion in my portfolios. It will take quite a few issues for me to get my whole point across. I know some of our readers have been waiting for this new series. I hope it does not disappoint!

Chapter 4: Investment rules still rule!

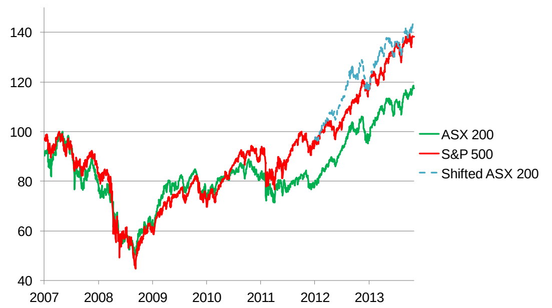
Written 1st May 2014

Version published in Professional Planner

With the GFC fading into a distant memory, it is time to reflect on how we went during the crisis and whether we need to change the investment rules most of us used to use! Rather than just looking at the price index for our market – because our dividends overshadow those of the S&P 500 and also contribute about one half of the total returns for an Australian investor on the ASX 200 – it is appropriate to assess performances using accumulation indexes that assume dividends are re-invested.

Moreover, many stocks on the ASX 200 come with franking credits for certain investors but those on the S&P 500 do not. There is no published series for the proportion of dividends that are franked. Most estimates I have seen put that figure as varying over time but ranging between about 70% and 80% for the ASX 200. I have shown the S&P 500 accumulation index alongside an equivalent series for the ASX 200 that I have 'grossed up' for franking credits assuming a conservative, constant 70% franking proportion. In other words, the two series are equivalent to pre-tax investment returns when dividends – and franking credits in the case of Australia – have been reinvested.

Chart: An accumulation index comparison



Source: Thomson Reuters and Woodhall Investment Research; data to end April
2014; the ASX 200 accumulation index has been 'grossed up' for franking credits at 70%.

Since an index can be 'based' at any point in time, I have scaled each series to be 100 at the respective 2007 peaks. From the Chart, I note that the red and green lines moved very closely together for four years (2007-2011). After a period of a year or so when the ASX 200 was left behind, our market again took off at a comparable rate to the S&P 500. It is easier to see this new co-movement when I rebase the ASX 200 series to have the same value as the S&P 500 from July 1st 2012 – to give the blue dashed line. There was an apparent repricing of our index during FY2012 as the impact of the China boom was re-assessed. That repricing could account for the structural break in the co-movement.

So if I look at pre-tax investments (or after-tax for a super fund in pension mode – but without draw-downs), $100 invested at the peak of 2007 would now be valued at about $120 on the ASX 200 or $140 on the S&P 500. Of course the S&P 500 is priced in US dollars but the exchange rate happens to have finished up much the same as it started in this 6-7 year period. Since the ASX 200 price index is still well short of the 6,829 peak – but the S&P 500 has made record highs during 2014 – some investors may undeservedly feel negative about their investment records.

On reflection, many of us who stayed in equities throughout the period took a beating during 2008 and 2009 but the old maxim of making at least five-year investment decisions worked. Indeed, even the ASX 200 (grossed-up accumulation index) surpassed its 2007 peak at November 2007 by Valentine's Day, 2013 – or a 5¼ year investment period! Naturally, any investor who added to his or her (indexed) equity portfolio could have gained much more in the common dollar-cost-averaging strategy.

Let us assume an investor starts with $100,000 or $500,000 (in super?) at the end of October 2007 – the worst time to start a fund – and then adds $2,000 per month (super contributions?) in a tax free environment (but does not draw down as would be required in a pension mode super fund). The $100,000 initial investment plus regular additions at the end of each month would have produced a return (internal rate of return, or 'irr') of 6.9% pa over the period. The $500,000 initial investment would have earned less because it benefits less from the *relatively* smaller regular payments at the lows of 2008/9. It would still have returned an irr of 4% pa. Not bad for a 100% equities fund starting at the worst time and passing through the worst financial crisis in at least 75 years. Investment rules still rule!

Chapter 3: The full price of yield-seeking

Written March 1st 2014

Version published in Professional planner

Continuing with my yield theme from last month, I asked myself the question of whether higher yielding stocks lose out to those from other parts of the market in terms of some capital gains offset. I took all of the available published S&P / ASX 200 sector data on price and accumulation indexes, and market valuations to derive returns for each calendar year from 2003 to 2013. I grouped the 11 sectors into three using the beginning-of-the-year market valuations as weights. The sector groups are:

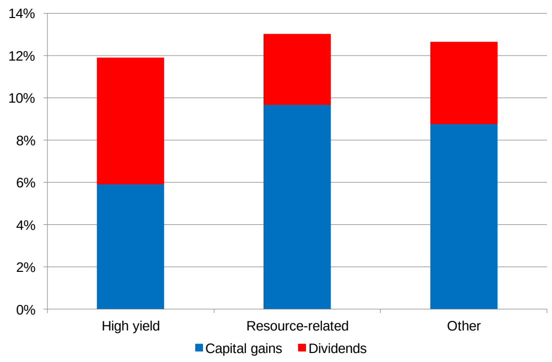
a) High yield (Financials-x-REITS, REITS, Telecommunications and Utilities)

b) Resource-related (Energy, Materials and Industrials)

c) Other (Consumer Discretionary, Consumer Staples, Healthcare and IT)

To my surprise, the average total returns (that is including dividends) over these 11 years shown in the Chart were very close indeed (11.9%, 13.0% and 12.6%, respectively). Clearly the dividend streams are quite unequal meaning that going for yield was done at the expense of capital gains. Presumably companies that make larger distributions have less capital to re-invest and grow. Of course, the timing and rate of taxation on yields and gains are quite different – possibly lifting the after-tax total returns for the high yield sectors to at least that of the other two groupings.

Chart: Total sector returns disaggregated by yield and capital gains



Source: Thomson Reuters and Woodhall Investment Research

Dividend yields have been far less variable than capital gains. Indeed, the dividend on the high-yield group was more than 1% point more than the yield in either of the other two groups in any of the 11 years.

Of course, the differences in total returns vary greatly across these three groups over time. The standard deviation of the difference between Resource-related and High-Yield total returns was 17% while between Other and High Yield was 7%.

The volatilities of the three total returns series are much the same. They are all between 20% and 25% so an investor doesn't reduce risk in this traditional measure by going for yield – indeed the High Yield returns have an estimated volatility between those of the other two! However, he does potentially lock in significantly higher regular payments – if that is what is desired. Naturally, if the yields are extracted each period from a fund characterised by each sector grouping, the much lower capital gains for the high-yield group means that funds will accumulate much more slowly from that style.

Chapter 2: Yield Rules OK!

Written 1st February 2014

Version published in Professional Planner

In my past I declined to design 'Yield' portfolios because all that then mattered to me were total returns. Capital gains can always be harvested for income, as I argued. As I slip into the seniors club, I realise that it is sometimes too tiring and time wasteful to do all of the buying and selling to keep up a steady income stream from capital gains! So during this January, I designed a framework for building a yield portfolio – for me! After trialling it for the next few months I might 'buy' myself one in June for my 65th birthday and a pension stream!

I don't want a straw man for comparison so I will use my notion of a 'High Conviction' fund as a basis that I have depended on for a decade or more. In my view, I only consider ASX 100 stocks for my flagship portfolio. Stocks must meet a certain (Thomson-Reuters) consensus recommendation of at least '3' (or hold) and, in good times, a '2.5' (mild outperform). I use my broker forecasts of dividends and earnings to get sector total forecast returns, and my method for forecasting volatility, to optimise sector weights. I then populate the sectors with the biggest stocks in the sector that meet my current consensus recommendation cut-off.

Because I don't want to rely too heavily on the broker forecasts and possibly get lop-sided portfolios I cannot rationalise, I put constraints on sector weights (like most managers). I allow a reasonable upside on all weights and a low of a 0% sector weight – except for Materials and Financials – as it would be embarrassing to have no stocks at all in either or both of these major sectors – no matter what. I limit Materials and Financials to be at least 75% of their index weights. My January version of my High Conviction portfolio is given in the Table – alongside the current index weights. It so happens that Materials has been allocated index weight and Financials the lower bound.

My starting point for building a Yield portfolio was the same risk-return sector optimisation as for my Conviction portfolio but I deviate on the allowable limits for the weights. There are four 'High-Yield' sectors (Financials, Property, Telcos and Utilities). I limited the downside to be index (or Market Capitalisation) weights. In other words, I cannot be underweight in so-called High-Yield sectors that contribute more than 50% to the index. I also allow a bigger upside than in my Conviction Portfolio to allow for the index weights limit of those four High-Yield sectors. So a key necessary (twofold) point of differentiation is that Conviction can have only 75% index weight in Financials but Yield must have at least 100% index weight – and Materials can have 0% weight in Yield but must have at least 75% index weight in Conviction mode.

Table: Comparing weights (%) for Conviction and Yield

	Portfolio weights		
Sector	**Index**	**Conviction**	**Yield**
Energy	5.90	7.37	8.85
Materials	17.83	17.26	0.76
Industrials	6.47	8.08	9.70
Discretionary	4.66	5.82	6.98
Staples	8.20	10.25	12.30
Health	4.71	5.88	7.06
Financials	38.50	28.88	38.50
Property	6.05	6.83	6.05
IT	0.81	1.01	1.21
Telco	5.30	6.62	6.20
Utilities	1.59	1.98	2.38
Expected:			
Yield	4.70	4.49	5.88
Cap. gain	8.45	9.53	9.77
Tot. return	13.55	14.44	16.23
G-U yield	6.20	5.91	7.83

Source: Thomson Reuters and Woodhall Investment Research; G-U stands for grossed up (including estimated franking credits)

As it turns out in the table, Materials gets less than 1% weight in the Yield portfolio and Financials again gets the lower limit of index weight under the Yield 'rules'. I choose to only have top 100 stocks in my Yield portfolio as I want to try to limit risk from holding Small Cap. stocks. I choose the best (expected) yielding stocks that pass albeit a weaker consensus recommendations. In both Yield and Conviction portfolios, I choose the number of stocks per sector using a rule that spreads risk and I choose intra-sector weights that depend on the strength of the recommendations.

The summary results in the lower panel of the table are dramatic. The Yield portfolio is expected to produce more than 1% yield more than even the index with a good helping of franking credits. Indeed, reasonable expectations for a portfolio in pension mode in an SMSF is that this Yield portfolio might yield (with franking credits) 7.8% with capital gains of near 10% in an otherwise 'ordinary year'. The capital gains forecasts for the portfolios are based on my sector forecasts as I know of no *reliable* way for forecasting the returns on individual stocks.

Space precludes my going into too much detail here but I am writing a paper for my website (www.woodhall.com.au) that may be helpful to interested people. Please check it out in a few weeks.

Chapter 1: Rethinking market forecasting

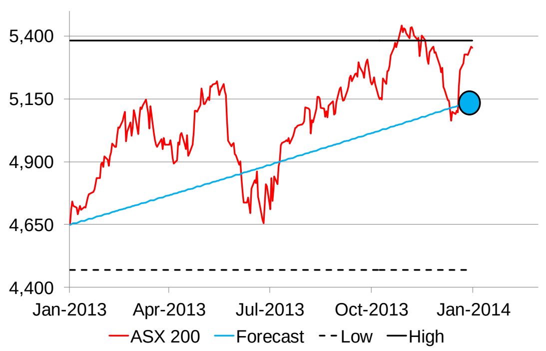
Written 10th January 2014

Version published in Professional Planner

I have always been uncomfortable with answering the question, “What is you end-of-year forecast?” My discomfort stems from my knowledge that market volatility relative to trend is such that any sensible confidence interval for a specific day in December is so wide. On rethinking the problem, I think the wrong question is being asked!

Take 2013 for example. My January 1 forecast was 5,150 as I show in the Chart and that got revised upwards as the year progressed to reach 5,350 with a couple of months to go. Were my forecasts any good? It would be easy to argue either way. But I think no one is interested in the December 31st figure per se. I wonder if most people want to know just the high or the low? I recalculated what would have been my high and low forecasts using the same January 1 data and they too are shown in the Chart. Of course I am not estimating when the high or low might occur. That chart seems far more interesting and informative to me now.

Chart: ASX 200 and Woodhall’s forecasts



Source: Thomson Reuters and Woodhall Investment Research

Most analysts believe in a so-called random walk process to describe market behaviour. That is, positive and negative shocks are added each day to the index. These daily changes dwarf the trend in the short run. After a run of positively-dominated shocks, as happened in January and February 2013, the nature of the randomness makes it then harder to get down to the original low forecast. The converse is also true. So, while the high forecast has a 50% chance of being exceeded (it is a median of possible high values) and the low has a 50% chance of being too high, there is a much smaller chance of both high and low forecasts being reached in any year – about one chance in ten in the current climate. Of course, at the start of the year we do not know which forecast, low or high, is more likely to be breached.

My broker-based method of forecasting means that my e-o-y forecast typically evolves very slowly during the year – as in 2013. However, these high-low bounds will alter far more so because a new ‘local’ level will have been ‘locked in’ and the time to the e-o-y is reduced – thus reducing the possible range for the remaining period. So from now on I will always give my updated range when asked the perennial question!

So, starting with 2014, my e-o-y is about 5,850. But to get the range, I must forecast (or assume) a level of volatility. My current forecast in the near term is 10% but the long-run average for volatility is 12.5%. I have given ranges in the Table for both volatilities as well as a 20% level to show how a high volatility regime would affect the outcomes.

Chart: 2014 Forecasts for the ASX 200

Volatility	Low	High	e-o-y
10.0%	5,200	6,050	5,850
12.5%	5,100	6,150	5,850
20.0%	4,900	6,450	5,850

Source: Thomson Reuters and Woodhall Investment Research (forecasts rounded to nearest 50 points)

I assume 12.5% is a reasonable volatility for the whole of 2014. That gives a low and high of 5,100 and 6,150, respectively. Changing the volatility forecast to 20% substantially widens the range. If the market gets comfortably above 6,000, I will consider some profit taking. If the market dips below 5,100 I would hold – unless my returns’ forecast has substantially fallen. As I wrote for the previous issue of Professional Planner, I do not estimate that 6,000 will be *sustainable* until 2015.