



## Is greed good?

The big news this week, aside from the tragic events in Canada overnight and the S&P 500 index having the best day of the year, is the release of the Medibank Private prospectus. Paul Rickard today casts his watchful eye over the numbers and explains how a newly listed Medibank might be able to generate shareholder value. He thinks the pricing is a little on the expensive side.

And on the back of all the interest the float is sparking, Charlie suggests that other insurers that have been beaten down a bit – like IAG – might get a bit of a leg up. He says to expect more market volatility but not as much as we've seen in recent weeks.

Also in the *Switzer Super Report* today, we have Barrie Dunstan talking about what's best to do, when the only thing that's certain is uncertainty and in *Buy, Sell, Hold – what the brokers say*, Coca Cola and Myer got upgraded.

Tony Negline takes a look at how you can keep your Commonwealth Seniors Health Card and *Questions of the Week* examines the place for hybrids and what is meant by 'forward multiple'. *Short n' Sweet* re-examines some of our recent calls on Amcor and CSL.



Sincerely,

Peter Switzer

## Inside this Issue



Medibank is no bonanza – though I will be investing  
by Paul Rickard

02

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02 **Medibank is no bonanza – though I will be investing**  
by Paul Rickard

05 **Contrarian calls – BHP and IAG**  
by Charlie Aitken

08 **Buy, Sell, Hold – what the brokers say**  
by Staff Reporter

10 **Plan not to panic**  
by Barrie Dunstan

12 **Short n' Sweet – Amcor and CSL**  
by Penny Pryor

13 **How to keep your Commonwealth Seniors Health Card**  
by Tony Negline

15 **A place for hybrids and forward multiples**  
by Questions of the Week



## Medibank is no bonanza – though I will be investing

by Paul Rickard

### Key points

- *Medibank IPO is no bargain at 16.5 to 21.3 times earnings.*
- *Its success will depend on its ability to cut costs and reduce the management expense ratio.*
- *Risks include its reliance on investment income and government regulation.*

The Government has been a little greedy on the Medibank Private IPO. Pitched on a multiple of earnings of between 21.3 times at the top of the price range of \$2.00 per share, to 16.5 times at the bottom of the range of \$1.55, it is no bargain compared to listed NIB Holdings, which is trading on a FY15 multiple of 18.6.

At \$1.80, Medibank would be priced at a multiple of 19.1 times, and pay a normalised fully franked dividend yield of 3.9%. Interesting – but no bargain, so let's hope the institutions succeed in talking the price down.

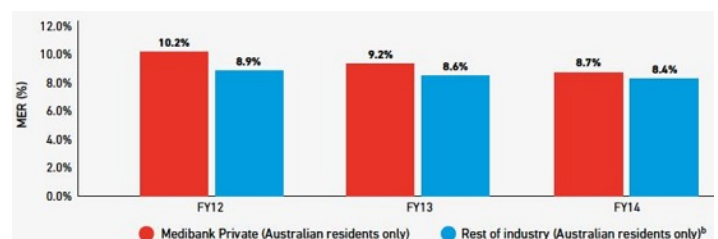
Comparing Medibank, the market leader in private health insurance with a share of 29.5% to the fourth placed nib, which has a share of 7.5%, is perhaps a little unfair because it doesn't highlight the opportunity. While there is execution risk, the opportunity with Medibank is to take considerable cost out.

And with Medibank Private, essentially what you are investing in is a company with a cost out story, in an industry where revenues are reasonably predictable and profits have annuity-style characteristics.

### A cost out story

In most industries, the market leader (with the scale) should have the lowest or near lowest cost base. That's not the case with Medibank. Management expenses, which comprise salaries, occupancy, IT expenses and sales and marketing costs, are higher than the rest of the industry. As the table below shows, Medibank's Management Expense Ratio (MER) in FY 14 was 8.7% (Australian residents only) compared to the rest of industry average of 8.4%. A 0.1% or 10 basis point decrease in the MER goes straight to the bottom line and is worth about \$4.2 million in NPAT.

### Management Expense Ratio – Medibank (Red) vs Industry (Blue)



The other part of the cost story is the management of claims expenses. This is a multi-faceted strategy that involves relationships with private hospitals, product design, supporting high claiming policyholders and reducing improper claims. While part of any claims expense reduction is shared with the industry, Medibank can also benefit by increasing margin, maintaining margin in the face of industry-wide cost pressures or making their policies more affordable in order to increase market share. In FY15, Medibank is forecasting that its gross margin will increase from 13.5% to 13.6%.

Health insurance premiums account for 90% of Medibank's revenue – the other 10% is earned from 'complementary services', such as contracted health management services and the distribution of other lines of insurance. With a little over 3.8 million



customers, there is clearly a revenue opportunity to develop this further.

## Risks

Taking the costs out will be the existing management team, and while they have been making progress, you could be entitled to ask why they haven't made more progress.

One reason is that the cost reduction program depends in part on an 'IT Renewal Program' – a \$150 million program touching its core mainframe systems. As anyone who has been involved in IT knows, these types of programs involving heavyweights like IBM and SAP carry their own risks. As the prospectus warns on page 95: "A failure to complete the IT Renewal Program on time, within budget and with the required level of functionality...may result in a write-off of the costs and have an adverse impact on customer service, financial performance, regulatory compliance and future competitiveness"

On the revenue front, Medibank is not growing its primary brand.

Policyholders have been static in the main Medibank Private health insurance brand, while the simpler 'ahm' brand has been gaining customers, leaving the group largely unchanged on a market share basis. This highlights one of the key business risks – maintaining market share – which is always harder when you start as the leader. Moreover, the health insurance industry is undergoing considerable change, particularly around how it is distributed, and if online comparison websites like iSelect continue to expand share, this could place Medibank under pressure.

There are two other material risks worth noting. Firstly, as an insurance company, Medibank relies on investment income from the investment of its capital and premium revenue to boost its bottom line. With interest rates expected to stay low, the company is forecasting a decline in investment income from \$113.9 million in FY14 to \$89.7 million in FY15. The other risk is, of course, regulatory – the health insurance industry is highly dependent on government policy. For example, a change to the

private health insurance rebate or the medicare levy surcharge could have a major impact on Medibank.

## Dividend "dress up"

Before moving on to the details of the float, let me clarify one important point – Medibank's initial dividend has arguably been dressed up. While the company is forecast to pay a final dividend of 4.9c per share for FY15 (which on a simple arithmetic basis for seven months translates to a yield of 5.4% pa (at a share price of \$1.55) to 4.2% pa (at a share price of \$2.00), Medibank is subject to some seasonality in its monthly profit. December and January are high profit months as hospitals/doctors wind back for Christmas/summer. On a normalised basis, the forecast dividend yield is only 4.5% at \$1.55 or 3.5% at \$2.00. No dividend gold mine here – although they are expected to be fully franked.

## Float details

The timetable for the IPO is set out below. The Retail Offer opens next Tuesday and closes on Friday 14 November. The institutional book build will set the final price, which will be paid by all applicants except that retail investors won't pay any more than \$2.00 per share. The basis of allocation and the final price will be announced on the morning of Tuesday 25 November, with trading to commence later that day on the ASX under the stock code MPL.

<b>Shares on offer</b>	2,754 million
<b>Indicative price range</b>	\$1.55 to \$2.00 per share
<b>Market capitalisation</b>	\$4,269m to \$5,508m
<b>FY15 PE Multiple</b>	16.5x – 21.3x
<b>Dividend for seven months to 30/6/15</b>	4.9c per share (fully franked)
<b>Normalised FY 15 dividend yield</b>	3.5%pa to 4.5%pa
<b>Retail offer opens</b>	Tuesday 28 October
<b>Retail offer closes</b>	Friday 14 November
<b>Institutional book build</b>	Tues 18 Nov to Thurs 20 Nov
<b>Final Price, Allocation, ASX Trading</b>	Tuesday 25 November
<b>Minimum Application</b>	\$2,000 and then in multiples of \$100

The Retail Offer comprises a broker firm offer, employee offer, policyholder offer and general public offer. Policyholders (under either the Medibank or ahm brands) will receive a priority in the event of oversubscription – up to 30% more shares than an applicant under the general public offer, if they pre-registered, or up to 15% more shares if they

didn't pre-register. Pre-registrants, who aren't policyholders, will receive up to 15% more shares than someone who didn't.

## Bottom line

Despite this IPO being overpriced at the top end of the range, this is still a government privatisation and the first from the Abbott government. It is hard to imagine the government wanting to disappoint circa 1,000,000 shareholders (voters). And while it is not necessarily a "must have" stock for the institutions or for that matter, most retail stock portfolios, it is a relatively low risk share investment with annuity-style characteristics. If 500,000 retail investors put in \$10,000 each – the offer is more than covered by retail alone. So, if the lead managers do their job, there should be some post-listing demand.

So, I will be investing – but I'm not moving other stocks out to make room for Medibank.

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## Contrarian calls – BHP and IAG

by Charlie Aitken

### Key points

- Expect more volatility but not as much as recent weeks.
- Iron ore price could have bottomed for the year and BHP offers good exposure.
- IAG could also benefit from Medibank IPO hype.

### What's catching my eye?

1. The awful events in Ottawa ?
2. AT&T downgrading revenue forecasts ?
3. US oil inventories rising ?
4. The EURO ?
5. US dollar index ?
6. VIX ?
7. Gold ?
8. Boeing ?
9. Interest in the Medibank Private IPO ?
10. The lack of inflation in the world ?

There's certainly no lack of volatility with the combination of strong bellwether US earnings and hopes of European Central Bank action driving the biggest percentage gain for the S&P500 all year, earlier this week. It was actually the biggest daily points gain since 2011. What a difference a week makes since the Dow's – 460 point intraday swoon, which actually was *the knife sticking*.

### Ebb and flow

While the VIX has pulled back to 16.2 from a panicky peak last week of 31, it remains elevated versus averages of the last few years and I believe we should position for further volatility, but volatility that is lesser than the wild swings we have seen in the last few weeks.

Markets are still going to ebb and flow in the short term between worrying about global economic growth and what central banks can and will do about it. Liquidity is not great in terms of risk asset markets as evidenced by the wild swings of the last two weeks.

In terms of Australia, I think the Aussie dollar/US dollar will consolidate the new lower trading range of 86.50 to 88.50, while the ASX200 is also consolidating in a lower range of 5100 to around 5450. With three of the major banks about to go cum final dividends, it's fair to say the index, due to those bank weightings, will be supported on dips.

Importantly also for Australia, and I may well be on my own saying this, but I think the iron ore price has bottomed for the year and will track higher (\$95t target) on seasonal restocking from China. It also appears spot oil prices have bottomed and will also edge higher. If I am right and our key commodity prices have stopped falling, and in fact start edging a little higher, you will see buying coming into the beaten up Australian resources sector.

You can ONLY make money in resources if the underlying commodities are rising, probably more accurately *"not falling"*, if the company in question has production growth. That is coming in Q4 for the Australian resource sector and I suspect we all need to be a touch braver and buy a beaten up resource name or two.

### The options

For private investors, the best risk/reward/quality/diversity option remains BHP Billiton (BHP), which is effectively an ETF over iron ore, oil, copper and coal. BHP has fallen sharply due to a lack of capital management at the FY14 result,



UK pension funds agitated that they won't get a UK listing of spin-off co, and general weakness in commodity prices. However, those sentiment drives are now stabilizing, or reversing, and you can see in the chart below that the knife has stuck in BHP. After an -18.5% peak to trough fall since August, it's time to buy a few more BHP.

### BHP: knife sticks



For those wanting pure iron ore exposure, the answer is Fortescue Metals Group (FMG). Again, this doesn't require over-analysis. FMG trades like a listed spot iron ore ETF. The 12-month correlation below confirms that. I think both spot iron ore and FMG have bottomed. If I am right and iron ore recovers to \$95t, then if this correlation holds, FMG would bounce back to \$4.50 a share.

### FMG vs. spot iron ore



Another aspect of my constructive and opportunist Australian equity strategy is to identify large cap industrial names that now appear solid risk/adjusted value and offer solid potential total returns (inc franking credits).

### For the brave

Clearly, it seems interest in the Medibank Private IPO from private investors is strong. Fair enough, I can fully understand that and I suspect Medibank is headed towards a very successful listing on the 25 November.

In the interim, I am looking for stocks that may be re-rated a little by Medibank's successful listing.

While Medibank effectively creates its own private health insurance sector once listed, I have a feeling its successful listing and solid rating will make investors also look at the general insurance sector and consider whether there is relative value in that space.

No doubt general insurance is higher risk, less predictable, and doesn't have the structural growth of the private health insurance sector. But there is a price for general insurance and I think general insurers are now looking cheap after the market correction.

I want to reiterate our BUY recommendation on ASX top 20 member IAG. IAG has just experienced a -10% correction and on our estimates now look compelling value.

Mike Wilkins is a high class CEO with a track record of successfully growing companies by acquisition and organically. The issue with IAG in the short-term is due to an acquisition, EPS goes backwards -14% this year. That is well known and consensus, but that is why you are getting a chance to buy IAG cheaply before double-digit EPS growth returns in FY16.

On 11.8x FY15 earnings and offering a 6.4% fully-franked yield, generated from an return on equity of 18.2% and insurance margin of 15.8%, IAG is buy.

*100% of Charlie Aitken's fees for writing for the Switzer Super Report are donated to The Sydney Children's Hospital Foundation.*



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## Buy, Sell, Hold – what the brokers say

by Staff Reporter

Brokers were a lot more active this week but are still finding bargains in the reduced share prices that volatility has brought. At least one broker is also a lot more optimistic about the retail outlook too.

### In the good books

**Macquarie upgraded Coca Cola Amatil (CCL) to Neutral from Underperform.** The broker remains cautious on Coke, given the ongoing trend of lower local fizzy drink consumption and sugar pricing pressures. However longer term, the broker sees earnings forecasts as no longer demanding, given Coca Cola's cost-cutting efforts and the upside potential in Indonesia.

**Downer EDI (DOW) got three upgrades this week, from Neutral to Buy by Citi and UBS, and from Neutral to Underperform by Credit Suisse.** Citi sees positives from Downer EDI's intention to acquire Tenix, which specialises in the provision of operations and maintenance services to the utilities sector. The analysts see the deal as EPS accretive in FY15, plus it also improves the quality of earnings, expands DOW's range of capabilities and comes with further attractive growth prospects. Credit Suisse considers the acquisition of Tenix Australia for \$300 million shows financial discipline has been relaxed to allow for an offensive move to capitalise on the privatisation of state-owned power distribution assets. UBS estimates the acquisition to be 6-9% accretive in FY15-16, largely attributable to the low cost of debt from Downer EDI's new committed bank facility.

**Morgan Stanley upgraded Fortescue Metals Group (FMG) to Overweight from Equal-Weight.** Morgan Stanley now suspects too much conservatism is priced into Fortescue Metals. The broker expects iron ore prices to stabilise above US\$85/t and forecasts debt reduction and increased dividends on this basis.

**Citi upgraded Myer (MYR) to Neutral from Sell, Orotan Group (ORL) to Buy from Neutral and Premier Investments (PMV) to Neutral from Sell on an improved overall environment for retails in Australia.** Analysts say this seems to be happening at a time when most retailers are suffering weak share prices. On Citi's estimates, lower oil and tax burdens that haven't gone through parliament should improve overall retail spending by some 1.7% annualised. This is seen as sufficient to lift ratings for retail stocks under coverage.

**Macquarie upgraded NewsCorp to Neutral from Underperform.** Foxtel will turn defence into attack from next month as it introduces a big pricing shake-up to head off competition, resulting in anticipated subscriber increases at much lower margins. The broker has downgraded its Foxtel valuation but this is more than offset by increases to News Corp's core businesses.

**UBS upgraded Southern Cross Media (SXL) to Buy from Neutral.** The company issued a profit warning at its AGM, downgrading first half guidance because of weaker share and ad markets. First half earnings will now be down 18-20% against prior guidance of down 10-15%. UBS believes the stock is inexpensive and upgrades to Buy from Neutral, given a 28% fall since its results in August.

### In the not-so-good books

**Deutsche Bank downgraded Ausdrill (ASL) to Hold from Buy.** The company's profit warning and subdued FY15 outlook reveals the challenges facing the business and the broker has materially reduced near-term forecasts as a result. Ausdrill has flagged potential asset impairments but Deutsche Bank expects it to remain in compliance with debt covenants.



**UBS downgraded WorleyParsons (WOR) to Sell from Neutral.** UBS has lowered FY15-17 profit forecasts by 4-19%, largely because of a slower capex environment from major oil customers but also to reflect increasing risks around the gas and oil outlook on the back of lower prices. The broker remains attracted to WorleyParsons track record, balance sheet strength and exposure to global hydrocarbons spending but has downgraded to Sell from Neutral as the stock is trading at a premium to revised valuation and to peers.

*The above was compiled from reports on FNArena, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.*

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## Plan not to panic

by Barrie Dunstan

### Key points

- *The Reserve Bank still has some worries about property market.*
- *Any fallout in the property market won't mimic the US.*
- *Best way to minimise losses is to diversify across asset classes.*

Investors may have to resign themselves to continue to invest under a cloud of uncertainty, whether in shares or property. Even though pressures may remain to keep interest rates low and supportive, investors continue to get warnings from authorities and thought bubbles from market commentators – whether the markets are rising or falling. The important thing is to plan not to panic.

Clearly, the Reserve Bank of Australia still has some worries about risks posed by the rise in housing borrowings. In the latest warning, deputy governor Philip Lowe said “these events [a slowing in the growth of rents and a high ratio of housing prices to income] . . . are leading to some increase in overall risk.”

While there isn't much inflation in consumer prices, there is plenty of heat in house prices. The property market isn't any different to the stock market: when prices rise and prospective rent yields decline, this produces lower prospective returns.

Studies have shown, time and time again, that the biggest factor driving future returns is whether or not investors have bought at reasonable or low prices and high yields. The property market isn't immune from this rule.

This penny clearly hasn't dropped in the housing market. While there is still debate on the extent of participation of SMSFs in the housing boom, it is clear that there is an unprecedented amount of speculative money going into housing.

Now everyone hopes that any setback in the housing market won't turn out like the US collapse; but the linkages through to security markets simply aren't the same here. However, any fallout from the clouds of uncertainty is likely to fall on both property speculators and homeowners alike.

Combine this with the near certainty that the next move in bank lending rates (whenever it comes) will be a rise in rates, plus the danger that prudential changes might cause banks to tighten lending, and there is cause for concern. Some commentators worry this could put a dampener on bank shares – but before that happens, housing speculators may suffer.

Not that share investors can breathe easier. The bears can preach doom from either a rising market (“this makes the inevitable adjustment for over-pricing nearer”) or from a falling market (“this is the start of a correction, or worse.”)

If things turn bearish, share investors need to determine how they will react: what are the odds of a big fall?; should they lighten off or sell, or can they wait out any paper capital losses? It's better to do this in relatively calm times, rather than be panicked into rash action in a downturn.

After the GFC scare, big investors want to manage for risk rather than for return. They realise that in a low return market, there are dangers in chasing riskier, high yielding returns. Not only are markets potentially more risky but it is harder to know where risks are coming from. And when risks are unpredictable, it is very hard to know how to protect portfolios.

At least share investors usually have a more liquid market in which to trade their investments. A bear market in housing (with easing prices, few buyers and potential pressure from bank lenders to sell) is not a pretty prospect, but if the Reserve Bank and APRA are telling the banks to do stress tests, housing investors should be doing the same.

With share portfolios, no one wants to lose money, especially if the fund is in pension mode. But, unless investors have perfect foresight on markets, the only known way to minimise capital losses (hopefully temporary ones) is to invest across a range of diversified assets – and then hope not all assets are hit at once.

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## Short n' Sweet – Amcor and CSL

by Penny Pryor

Volatility might be the new normal but thankfully we've had a reprieve during the last few days. No one's expecting it to be over just yet and as Barrie Dunstan points out today, perhaps we all just need to get used to it.

But while we do have a bit of a breather, it's a good time to go back and have a look at a few calls we've made over the past weeks and how they've fared.

You might be a bit tired of us going on about a lower Aussie dollar, and how that will benefit a certain group of stocks, but this play of ours is stating to pay off.

One of Peter's favourites for a long time has been packaging company Amcor. In [Switzer on Saturday a month ago he said](#): "I've been anticipating a fall in the dollar, despite the fact that I'm taking my TV show to Wall Street in early December."

"I've been arguing that a lower dollar would come and help a whole pile of companies and we've named them, including CSL, Computershare, Amcor, Resmed, BHP, Rio, Macquarie and even QBE (I have expressed concerns about that company's ability to disappoint).

And look at how it has fared over the past month compared to the ASX/S&P 200.

### Amcor (AMC)



CSL is another company that benefits from a lower dollar and was a favourite of Platypus Asset Management's Don Williams in late August when he said he liked "everything really" about it.

"Since it listed in 1994, CSL has grown its earnings per share by on a compound basis by 23.3% p.a. (26.2% p.a. in US dollars). The company has managed to successfully expand offshore and become the leading player in plasma-derived therapies globally," [he said in his Fundie's Favourite](#) report.

He put a 12-month price tag on it of \$82 so there is plenty of upside left there too.

As the chart below shows, it has done very well against the index after a big spike up in August following a healthy result and a jump in full year net profit after tax of 7.8%.

### CSL (CSL)



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## How to keep your Commonwealth Seniors Health Card

by Tony Negline

### Key points

- *The income test for the Commonwealth Seniors Health Card will be changed next year.*
- *It will include deemed income on an account-based pension.*
- *If you start your account-based pension before the end of the year, it will be grandfathered.*

There are some major changes that will be made to government benefits available to retirees from next year. The second of these (we discussed the first one [last week](#)) will affect eligibility for the Commonwealth Seniors Health Card (CSHC).

To be eligible for the CSHC, you have to be of pension age, with an adjusted taxable income under \$51,500 for singles, or \$82,400 for couples. The definition of adjusted taxable income is pretty straightforward – it is your taxable income, plus any reportable fringe benefits or reportable super contributions, plus any net investment losses. Income from an account-based pension (ABP) is effectively excluded from this definition – it doesn't impact your taxable income if you are over 60.

With the change that comes in from 1 January 15, the income test will be expanded to include "deemed" income on any non-grandfathered account-based pension.

### The changes

Any account-based pension that commences after December will be deemed.

Those that commence before January next year will remain exempt from the CSHC income test. However, if you lose access to the CSHC after 2014 but subsequently are able to receive it again, then when you apply, your pre-2015 account-based pension will be subject to deeming.

The following table summarises the rule changes:

	Pre- 2015	Post-2014
Income Test	Fully Exempt	Deemed income

It's pretty clear what happens here. At present, any account-based pension income you receive from pre-January 2015 pensions is exempt. That is, nothing is counted. After that date, they're deemed.

For 2014/15, the deeming thresholds are \$48,000 for a single and \$79,600 for couples. Up to these thresholds, you're deemed to earn 2% each year. Above these thresholds, your investments are assumed to earn 3.5% per annum.

Assume the \$300,000 purchase price is assumed to earn 3.5% per annum. That is, \$10,500. Depending on your income from other sources, this might see your income higher than the CSHC thresholds mentioned above.

### Need to do before 2015

By starting a pension before the end of the year, you will be grandfathered, which means:

- You get the income test exemption, which will mean no pension income is counted, thereby potentially enabling you to access the CSHC; *and*
- You're not exposed to potentially higher future deeming rates (which will go up when the interest rate cycle finally turns)

## Some further CSHC opportunities

- You might be tempted to take some of your pension money and move it back to the accumulation phase of your super fund – this is called a partial commutation. Your objective might be to reduce the account-based pension income you're paid. The downside for aged pension purposes is that once you reach age pension age, any money in the accumulation phase is deemed. However, this doesn't apply to the CSHC income test. If necessary, you could take lump sum withdrawals from this accumulation money.
- Money you give away is subject to the gifting rules for the aged pension only. That is, gifting doesn't apply to the CSHC.

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## A place for hybrids and forward multiples

by Questions of the Week

**Question:** Thanks for your comments in the Switzer program on Sky on Monday evening regarding the Medibank IPO. You mentioned the term “forward multiple” a couple of times in arriving at your estimate that the \$2 top range price is a bit on the high side. Can you elaborate please?

**Answer (By Paul Rickard):** It is the price/earnings multiple. I use the word ‘forward’, because it applies to FY15.

Take Medicare as an example:

Share price: \$2.00

Number of shares: 2,754 million

Forecast net profit after tax (NPAT) for FY 15: \$258.2 million

Earnings per share  $(258.2/2,754) = 9.38c$

Multiple (PE ratio)  $= 200/9.38 = 21.3$

At \$1.55:  $155/9.38 = 16.5$ .

**Question 2:** Your [latest article](#) indicates you are a bit of a fan of the hybrid securities market. However, any hint of ASX-listed credit is absent from your income model portfolio. I appreciate everyone’s circumstances differ but do you see a place for hybrids in an SMSF in pension mode for over 60’s and if so, at what levels?

**Answer 2 (By Paul Rickard):** The ‘income’ and ‘growth’ portfolios we publish are quite deliberately equities only. Further, I consider hybrid securities to be part of my ‘fixed income/bond’ weighting.

Because they are a crossover security, some commentators make the case that hybrid securities should be considered part of your equities weighting. I don’t subscribe to this argument, because while they potentially have equity downside risk, they don’t have equity upside gain potential. Furthermore, most

of these securities will have reasonably stable capital prices – the downside risk is possible, but in most cases, unlikely.

And yes – I do see a place for hybrids within an asset allocation – as part of a weighting to bonds/fixed interest – however it would be relatively small.

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## Did you know?

This week Paul Rickard interviewed me about what's going on with the markets. Is volatility the new norm?

[Watch the video to find out.](#)

