Switzer Super Report

Issue 52, 27 January 2012

Can it last?

Stock markets are off to a good start this year, but can it last? In today's report I list the things I've seen in the market lately to show why I'm cautiously optimistic, and I take a look at one forecaster that says stocks will surge by 40%!

Also in the Switzer Super Report, Charlie Aitken brings you his weekly stock recommendations, and we tell you about a new fixed-income investment that's attractive for SMSFs and is on its way to Australia. Plus, we look at whether you should segregate your assets once you start paying a pension - your decision here can have a big impact on your account balance!

Have a great weekend.

Sincerely,

Peter Switzer

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Can our stocks surge 40%?

by Peter Switzer

Okay, the stock market has been nice to investors and my clients since October with Wall Street up over 20% and we have put on more than 10%, but the critical question is can it last?

An even more interesting question is: can Aussie stocks surge over 40% as one very credible expert predicts?

There is now no question that the United States is doing miles better than most so-called economic and market experts predicted, present analyst excepted, and this development in total provides a growing number of positives that will eventually turn the persistent 'go nowhere' stock market we have coped with for around two years.

Low rate pledge

Yesterday, the US Federal Reserve chairman, Ben Bernanke, gave stocks a future boost by saying interest rates won't be rising until 2014! In Australia, most experts are tipping a cut in February and some are going for a doubling up with another cut in March.

I doubt we'll get a double-down play from the Reserve Bank of Australia, though if the European Union plays its usual disappointing game and a financial meltdown threatens, we would see double downs alright and they could be 0.50 percentage point cuts as well!

I personally rule this outcome out based on what the EU knows is sensible, achievable and terrible. Working through the challenges of the possible debt defaulters of, say, Greece and Portugal is both sensible and achievable, but if they walk away from their debts, it could lead to a terrible contagion. This is unthinkable but still possible and that's why there has been a measured lift in stock prices lately rather than the boom that will eventually happen.

I hate guessing market moves based on what people in power do – I'd rather it be based on economic, financial and business trends, as I'm trained for those kinds of things. However, the unpredictable nature of the Portuguese, Italians, the Irish, Greeks and Spaniards – or the PIIGS – is more the domain of psychologists!

That said, if the EU and the eurozone can achieve a credible set of agreements from its members, and interest rates keep falling or remain low, then investors will drift back to stocks first and then eventually zoom back.

I reckon if nothing convincing happens, that the worst will be behind us by April, then the old market cliché 'sell in May and go away' will be a serious test for the market.

Is a 40% gain feasible?

However, I do think we will see the market bounce back this year. Current bear and fund manager, Geoff Wilson, thinks the bear market ends in 2013 and IBISWorld founder, Phil Ruthven, predicts a 40% rebound of Aussie stocks by at least 2013 as well! He says they are terribly undervalued and, by the way, Phil along with CommSec's Craig James were about the only two people who were publicly agreeing with me when I was predicting Australia could avoid a recession through the global financial crisis.

Lately, this is what I have seen that sustains my cautious optimism:

1. Yields on European sovereign bonds are falling.
2. US consumer sentiment is spiking to nine-month highs.

3. US unemployment is down to 8.5%.
4. The chartists say the 'technicals' point to a rising market with the so-called golden cross.
5. Durable goods orders were up way more than expected – 2% predicted, but 10% in reality – which points to a boost in business investment.
6. Unfilled orders in the US increased by 1.5% and this was the biggest jump since March 2008, which should help both production and jobs in the future.
7. Leading indicators in the States point to solid growth ahead.
8. Earnings of top US companies are largely better than expected.

Bloomberg says: "German and French consumers are growing more confident, suggesting household spending may temper the slowdown in Europe's two largest economies."

The evidence is clear; the US is making solid progress and Europe is showing some promise, but its history is holding share players back. However, when the lack of faith in the EU is replaced by confidence, then we will see stocks surge by 40% – or more!

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Four attractive stock buys

by Charlie Aitken

Here are four stocks that are currently attractive. I'll be returning to my full commentary next Thursday.

National Australia Bank (NAB) – Buy

NAB remains our top major bank pick. While we expect the bank to maintain a minimum 15% return in equity (ROE), despite higher liquidity and elevated funding costs, the upside is even more significant once capital is returned from the eventual sale of its UK business (estimated 1% ROE and 3% earnings per share (EPS). Regardless, NAB's competitive advantage lies within its domestic retail and business banks and particularly on the revenue side.

We have lowered NAB's price target by around 2% to $27.40 (previously $28.00) as a result of changes to our net interest margin (NIM) forecast. The market remains uneasy about NAB's NIM outlook given its dependence on offshore wholesale funding and higher rollover requirements in 2013. We expect NAB's NIM to remain reasonably resilient and decline by only four basis points in 2012 and by six to seven basis points in 2013. Factoring in these outcomes, we have reduced cash earnings by 2% across the forecast horizon.

We continue to rate NAB a Buy on the strength of its core Australian banking operations and with management delivering on all the key strategic objectives to date including de-risking the business model. We continue to rank NAB ahead of its peers given a better earnings growth profile.

- 12-month target price: $27.40
- Wednesday's close: $24.20

Gindalbie Metals (GBG) – Buy

Gindalbie's December quarter report suggests its Karara magnetite project remains on track to make its first trial shipment in the September quarter. The infrastructure is well progressed and should be available in the first half this year. Karara provides the attractions of a large-scale operation, economies of scale and long mine life. The project remains underfunded by $150-200 million at current exchange rates, but this should be covered by additional debt if required and the report suggests discussions have been held with China Development Bank on the matter. Following the recent rights issue, the project's debt to equity ratio is now 54:46 compared to the originally approved 70:30 ratio, leaving additional debt capacity to cover both this shortfall, and some further capex over-run.

Gindalbie is trading below the recent rights issue price of $0.67, presumably due to concerns that a further delay pushes out first production another quarter, and could eventually result in another capex over-run. Our 12-month price target is $1.33 a share, which gives an 80% weighting to the Stage two expansion to 15Mtpa, although there is the potential to get to 16Mtpa. That price target has decreased from $1.35 to $1.33 because we have lowered our expected contribution from hematite in fiscal 2012 and 2013.

- 12-month target price: $1.33
- Wednesday's close: $0.63

Grange Resources (GRR) – Buy

Grange Resources produces iron ore pellets at its Savage River operation, in north-western Tasmania. There is potential to increase production through debottlenecking. The company is also planning to develop a 10Mtpa magnetite concentrate project at Southdown near Albany in Western Australia and an associated pellet plant in Malaysia, both in a joint venture with Sojitz (70% GRR:30% Sojitz). Construction is due to commence in 2012 and production in 2014.

Our valuation is already diluted for an anticipated raising of $500 million at 50¢ in 2012 to fund the Southdown project, with the balance of funds expected to come from cash and debt. We have assumed that Grange raises equity to cover its share of the capex not already covered by cash. However other funding options include selling a stake of Savage or Southdown. Despite the dilution we assume, there is still upside to our risk-weighted valuation and we maintain our Buy rating. In addition, the stock now offers 7.2% yield, making it one of the highest yielding resource stocks.

- 12-month target price: $0.91
- Wednesday's close: $0.595

Paladin Energy Ltd (PDN) – Buy

Paladin's performance in the market this year has been disappointing. Fukushima accounted for a large part of the downfall, which was exacerbated by the debt funding of projects and acquisitions, slow production ramp-up at Kayelekera and continued net cash outflows leading to a weakened balance sheet. However, Paladin is guiding for a 33% increase in production in fiscal 2012 and is very well positioned for growth over the long-term with large uranium resources across its projects.

Production in the last quarter of 2011 was up 47% from the previous quarter, which is a solid result, and provides investors with much-needed relief. Our production guidance for fiscal 2012 has been downgraded to 7.1 to 7.4mlb (prev. 7.4 to 7.9mlb), following unscheduled shutdowns at its Kayelekera Mine due to localised ground movement, and scheduled ramp-up of Stage three at Langer Heinrich Mine. In order to meet our estimate, Paladin will need to average 2.2mlb per quarter for the next two quarters. This is possible, provided it continues to ramp-up and operate at nameplate. Paladin represents good value.

- 12-month target price: $3.10
- Wednesday's close: $1.78

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New fixed-income investment coming to Australia

by JP Goldman

Don't look now but there's a new financial product on the horizon that will further threaten the cosy world of our highly-paid fund managers – and this time it's fixed income managers under the spotlight.

But this new competitive threat offers benefits for investors, especially those grappling with their own self-managed superannuation fund.

So what's this hot new product? None other than fixed-income exchange-traded funds or ETFs!

The Australian market now has over fifty different equity-based ETFs to choose from, but even today there's not one bond market ETF. Up until now, the quirky rules of the Australian Securities Exchange haven't allowed it.

Times are changing

The good news for investors is that late last year the ASX finally changed its rules to allow bond market ETFs to be listed on the exchange. Pretty soon, investors will be able to choose from a suite of fixed-income ETFs offering relatively stable returns and at very cheap rates.

Unlike those paid to pick stocks, fixed-income managers are paid to choose the best bond market investments – be it government or corporate bonds in either Australia or overseas. To that end, they try to be adept at guessing the direction in interest rates, yield curves and corporate risk premiums. A key part of the game is buying up long-term bonds when interest rates are falling because their capital values will appreciate the most.

Fixed-income funds are an important cornerstone of most balanced investment portfolios and while they generally provide lower returns than equity funds, they come with significantly less volatility.

Another benefit is that bond funds tend to do best when equity funds are at their worst, such as in periods of weak economic growth when interest rates and inflation are falling. As a result, the returns from bonds and equities tend to have low correlation, meaning a combination of the two can reduce portfolio volatility without great sacrifices in expected return.

Last year, for example, the UBS Australian Government bond index – a standard benchmark for local fixed-income managers – returned 12.6%, while the S&P/ASX 200 equity total return index fell by 10.5%. In 2008, this bond fund returned 17.4% while the Australian equity market total returns fell by 38.4%.

Equities vs bonds

And in what may be a surprise to some investors, over the past ten years the average annualised return from this bond index (6.6%) has in fact been a little greater than that of the S&P/ASX 200 (6.2%). Some suggest that means investors should own a lot more bonds and a lot less equities.

I'm not so sure. The past decade has been an exceptional period with two recessions in the United States and the global financial crisis (GFC). When currently low global interest rates start to increase, it will reduce bond returns back to their low single digit rates. And as the global economy eventually recovers from the GFC, it will boost equity returns given price-to-earnings valuations are now at quite cheap levels.

I reckon equity returns will handily beat those from bonds over the next ten years.

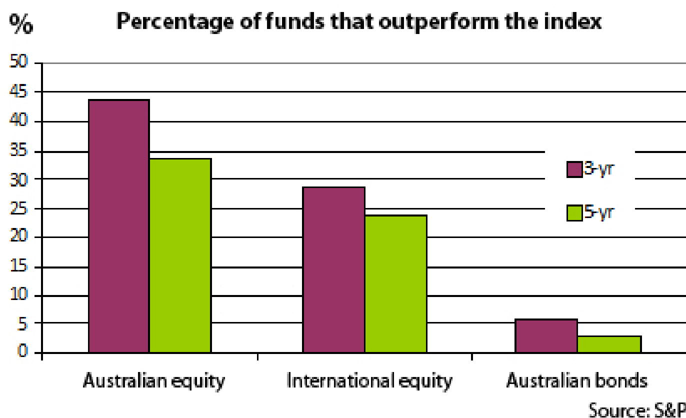
Risk reduction

Either way, bonds remain a useful source of portfolio diversification and risk reduction – especially for those either in or approaching retirement.

That's why the introduction of bond ETFs is such great news.

Like ETFs in general, bond market ETFs usually don't aim to 'beat the market' like active managers, but simply track established bond market indices. In exchange, they charge a relatively low annual management fee. Bond ETFs already flourish in markets such as the United States.

What's more, the case for bond market ETFs is even stronger than that for equity market ETFs, as surveys suggest active fixed-income managers have even more difficultly consistently beating their benchmarks than equity managers. According to a recent survey by Standard & Poor, for example, fewer than one in 10 Australian fixed-income managers were able to beat their benchmark over a three- and five-year time horizon.



If the development of bond market ETFs in the US is any guide, these products should also prove popular with Australian investors. Indeed, local investors already have around $5 billion invested in equity market ETFs, representing a still tiny, but rapidly growing share of the managed-funds industry.

Some in the industry are working to get the first bond market ETF listed ASAP, and this could be as soon as one to two months if there are no delays. Watch this space!

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Should I segregate my pension assets?

by Andrew Bloore

When an SMSF buys and holds assets on behalf of its members, the trustees need to decide how to structure and invest these assets. Effectively, you need to decide between either 'segregating' assets, or keeping the assets 'pooled' (or unsegregated).

Segregating fund assets generally involves the identification and physical separation of certain assets. On the other hand, the pooled approach is the opposite; that is, all assets are held and invested together as the name suggests.

Segregated vs pooled

While there could be a number of reasons why one approach may be more attractive than another, when dealing with pension assets, the approach you choose can lead to vastly different outcomes for the fund.

Given our ageing population, coupled with the advent of Transition to Retirement strategies (TtR), it is growing increasingly common to see SMSFs paying pensions. Also, the prevalence of these funds having both a pension and an accumulation (or savings) account within the same fund (indeed for the same member) has also increased.

This is in part because one of the benefits of commencing a pension within an SMSF is the tax exemption (regardless of the member's age) given to pension asset investment earnings.

Where the fund is entirely in pension mode, the identification of these pension assets is rather simple – all of the fund's investment earnings will be exempt from tax.

However, where the fund has pension and accumulation assets, like in a TtR, the assets must be segregated to obtain the pension income exemption.

Segregated approach

As noted earlier, the segregated approach requires a physical separation of assets. That is, pension assets will need to be identified, invested, and accounted for separately from assets that are in the accumulation mode.

Under this approach, for example, separate bank accounts would be maintained for the pension and for accumulation assets. Similarly, separate term deposits and share holdings would be held.

The ATO has also indicated its discomfort with only partially segregating an asset. This can be particularly troublesome if a bulky asset such as a property is held inside the fund and a pension is to be commenced.

The benefits:

- All income and capital gains derived by the pension assets will be automatically exempt from tax – including capital gains triggered in pension phase but accrued in accumulation phase;
- No actuarial certificate is required – reducing associated costs/delays;
- Individual investment strategies are more easily catered for – e.g. income-producing assets can be specifically identified and held in pension phase.

The disadvantages:

- Capital losses are disregarded, that is, they can't be used nor carried forward;
- Bulky assets such as property can't be partially segregated;
- Separate bank accounts and investment holdings are required;
- Two or more separate sets of accounts will

- need to be produced each year, potentially increasing costs and complexity.

Pooled approach

The pooled (or unsegregated) approach is quite the opposite. Effectively, all assets are invested and accounted for together, regardless of whether they are pension or accumulation assets.

However, because the pension assets haven't been specifically identified under this approach, in order to determine the level of exempt income the fund is entitled to, the trustees will need to obtain an actuarial certificate each year.

The benefits:

- Capital losses can be applied and/or carried forward;
- Easily caters for bulky assets such as property;
- As assets are not held separately, only one set of annual accounts is required – making the administration of the fund simpler.

The disadvantages:

- Only a proportion of income and capital gains are exempt from tax – creating a potential trap if selling an asset which has accrued capital gains, even if sold in pension phase;
- An actuarial certificate is required each year, which may result in additional costs and/or time delays;
- Difficult to cater for differing individual investment strategies.

Selecting your approach

Deciding on a method of asset segregation will have a number of impacts, from simple differences in costs and the way that assets are invested, to the creation of a potential tax trap when selling certain assets. However, the method used is also one that can be changed from year to year.

So, as both approaches have a range of benefits, it is a case of selecting which one is best suited to your fund and its assets at a particular point in time – a case of horses for courses!

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The week ahead

All self-managed super funds should have a written investment strategy. If you haven't got one, read our resources on Creating a DIY super investment strategy and A sample investment strategy.

Did you know?

If you're an employer, tomorrow is the last day to lodge your superannuation guarantee contributions for the second quarter. If you miss this deadline, you'll have to lodge a Superannuation Guarantee Charge Statement with the tax office by February 28, and this can't be deducted from tax.