Switzer Super Report

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Rate cut due

Wall street has had its best start to a year in 15 years, and Aussie stocks aren't doing too poorly either! And next week, the market is likely to get some more good news when the Reserve Bank announces their first interest rate decision for the year - I tell you why I think they will cut, and by how much, in today's Report.

Also in the Switzer Super Report, Charlie Aitken shows you which sectors of the market outperformed in January, and where he sees growth going forward, including three stock tips. Plus, we give you the rules on how many stocks you should hold in your SMSF portfolio, and take a look at whether now is a good time to transfer shares into your SMSF.

Have a great day!

Sincerely,

Peter Switzer

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A rate cut is coming, but will the banks follow?

by Peter Switzer

Last year the economy grew at a 2.6% pace, well below the 3%-plus rate expected by Treasury and the Reserve Bank. The end-result was an easing of interest rates – 25 percentage-point cuts in both November and December – as retail laboured and employment fell.

"Jobs growth is now going backwards, adding to data showing sluggish retail spending, a weak housing market and lacklustre activity in manufacturing, services and construction sectors," said CommSec's economist, Savanth Sebastian. "In fact, over 2011, there were no jobs created with a total of 100 jobs being lost – marking the weakest result for a calendar year since 1992."

Creating jobs should be a high priority of a Labor Government and so with employment going backwards – it isn't a good sign with the Gillard team's rating with voters around 30%.

So it's not surprising that a growing chorus of economists are singing from the same hymnbook that another rate cut is likely at the first meeting of the Reserve Bank of Australia (RBA) on Tuesday 7 February.

I suspect there is a good chance this will happen, but it's likely to be the last unless poor European decisions over debt and deficits lead to more stock market sell-offs.

Banking on a standoff

On the subject of interest rates both the Reserve Bank and the Federal Government look set to be on a collision course with the major banks, whose bosses are starting to plead poor mouth, which could see them refuse to pass on any future interest rate cut in full.

The seemingly endless weeks of poor decisions and inconclusive meetings coming out of the European Union have resulted in increasingly higher interest rates for sovereign bonds for most member countries and the pressure on bank balance sheets of customers who might default has pushed-up the cost of funds for banks, such as ours, which rely on external funding for about half of their local loans.

Leading the charge against the RBA and the home-loan borrowers of Australia, who have grown up expecting that banks play follow the leader with the central bank, is ANZ's chief executive, Mike Smith.

In January, his bank started setting and announcing what its home loan rate would be on a monthly basis. Smith says he is going it alone – independent of the RBA and his rivals.

"The change in the RBA's official cash rate is one factor we assess when looking at funding costs," Smith has argued. "However, the price we pay for customer deposits, and for the domestic and international wholesale funding that we rely on in order to continue to lend, are much more important considerations."

If and when the RBA next cuts – and it has to be on Tuesday – there will be an enormous focus on what Smith and ANZ do and it will put the focus on just how competitive our big four banks are. And while the Reserve Bank is unlikely to say anything publicly, you can bet the Prime Minister and her trusty world champion Treasurer, Wayne Swan, will be champing at the bit to get into some good old bank bashing to raise their popularity ratings.

I think the Aussie economy and the stock market will have a good year despite the expert negative types out there, but the second half of the year will be better

than the first and it will be two rate cuts early this year that will create a better economy and stock market.

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Strong gains, plus three stock buys

by Charlie Aitken

The year has started very positively, shocking all those who are defensively positioned after being warned of imminent 'corrections' late last year. With cash holdings at record levels, it only takes non-negative news to generate solid positive returns, with the only 'correction' being a basic melt-up led by basic materials. Unsurprisingly, the sky hasn't fallen.

January 2012 Returns

	30 Dec 2011	31 Jan 2012	% gains for Jan 2012
ASX 200 INDEX	4057	4263	5.08%
ASX 300 INDEX	4052	4260	5.13%
SMALL ORDINARIES INDEX	2209	2380	7.74%
ASX METALS & MINING INDEX	3722	4151	11.53%
ASX SMALL RESOURCES INDEX	4682	5215	11.38%
AUD/USD	1.0216	1.0599	3.75%

Source: Bell Potter Securities

While numerous people have pointed to the fact trading volumes this year have been very subdued, my view remains that low trading volumes are more of sign of sellers being exhausted than anything else. With self-managed super funds running average cash levels close to 30%, the question you have to ask yourself is who is the next marginal seller of equities, particularly small and mid-cap equities?

I believe that marginal equities seller is hard to identify, which could well lead to further gapping higher in the right small and mid-cap stocks. Risk was 'on' in January as investors snapped up stocks, with metals and mining stocks delivering twice the return of the benchmark index, and selected small resource stocks delivering more again. This has every chance of being the story for the entire year as cyclicals and Asia-facing stocks lead the index as Europe slowly fades from the daily news.

Where to invest

I had a nice lunch with two very proven Australian businessmen yesterday and our discussion simply reminded me that the way to generate the biggest returns is via high conviction, patient capital allocation to a high structural economic growth theme. Very, very few people are great short-term traders, and in markets still broadly obsessed with the next Greek or Portuguese headline, I am convinced it's time to be a 'set and forget' investor with a big focus on Asian growth equities and high sustainable dividend yield stocks. (Telstra (TLS) remains my 'enhanced cash' bet).

My number one contrarian view remains that Chinese growth (and therefore sentiment towards all things China) is going to surprise on the upside this year. Right now China bears are easier to find than the captain on a sinking Italian cruise ship, but all the data from China is now surprising on the upside ahead of the leadership handover to Xi Jinping later this year. Most investors are underestimating Xi, a new style leader for Beijing who is already in the US attempting to improve relationships.

Combine this with the fact the Fed continues to attempt to undermine the US dollar by ultra-easy monetary policy and potentially even a third quantitative easing play, and you can see why I believe the place to be invested most aggressively is Australian resource stocks and those who service them.

Under the scenario I believe in for 2012 and post the Fed's latest comments, I've updated my Australian dollar forecast and it now looks likely to test the highs around US$1.10, with a new trading range of US$1.05 to US$1.15 as global money floods into four of the world's AA-rated banks and one of the last AAA-rated sovereigns in the world.

Anyhow, just remember, the key to everything is

sentiment and in my view it's improving globally and locally. Sentiment drives momentum and January had both.

Challenger (CGF) – Buy

Given Challenger's leading position in the annuities space, and its growing reputation as a guaranteed income provider, it remains a top pick in the sector. We reiterate our favourable view on its highly successful annuity sales campaign, its strong retail annuity sales momentum, and it being a key beneficiary of market volatility and continued investor unease. We believe Challenger has appropriately repositioned its business to benefit from growth in superannuation and the shift of baby boomers into retirement with new products and a greater distribution reach.

- Wednesday's closing price: $4.49
- 12-month target price: $6.20 (previously $6.30)

iiNet Ltd (IIN) – Buy

IINet has agreed to acquire Internode for $105 million. We view the acquisition as compelling given the sound strategic rationale, complimentary nature of the businesses and solid yet conservative synergies expected (we foresee network synergies in excess of the $7 million). While the acquisition is not expected to be completed until 29 February, we don't expect any material hurdles and therefore have included Internode into our iiNet forecasts. Enhanced earnings growth prospects coupled with an improving regulatory settings support our Buy rating.

- Wednesday's closing price: $2.99
- 12-month target price: $3.75 (previously $3.25)

Mt Isa Metals (MET) – Speculative Buy

Mt Isa Metals started life as a Queensland gold and base metals explorer, but in the past 12-18 months it has shifted focus to gold in Burkina Faso, West Africa. Its first exploration campaign in Africa was very successful and led to the discovery of at least two significant gold deposits. An initial resource for the Nabanga Deposit is expected in March 2012. Mount Isa's activities are and will be subject to the usual risks of mineral exploration and development in Africa: these may or may not include inadequate infrastructure, difficult or remote terrain, inconvenient weather, inefficient bureaucratic processes, difficulty in sourcing staff and equipment, slow turnaround of assay results, and the possibilities that tenements may not be granted or contracts honoured. The biggest risk is attached to the results of exploration, which also bring the greatest potential rewards.

- Wednesday's closing price: $0.28
- 12-month target price: $0.42

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How many stocks should be in your SMSF portfolio?

by Ron Bewley

Before the global financial crisis (GFC) gripped our world of portfolio construction, I was happy to think in terms of a highly concentrated portfolio of eight to 15 blue-chip stocks. My basis were simple; it's easier to find a few good stocks than a large number, and the diversification benefits fall off rapidly when increasing the number of stocks. I based my conclusions on my 2005 simulation experiment of historical stock returns.

Adjusting for the recovery

During the 2008 market meltdown, I was asked if I had changed my rule. I didn't have the time during the GFC to do a proper analysis, so I had arbitrarily increased my range to 15 to 20 stocks. Even with supposedly quality stocks, some companies looked more likely to fall over – or at least take a massive hit in price – during a major bear market, but knowing which ones was tricky. With 15 to 20 stocks, there is less 'single stock dependence' on any one stock should it get suspended – or worse!

Now that we have bounced off pre-GFC levels of volatility (although we have experienced some major volatility clusters since) it's time to revisit the 'How many stocks should I have in my portfolio?' question using my previous analytical framework.

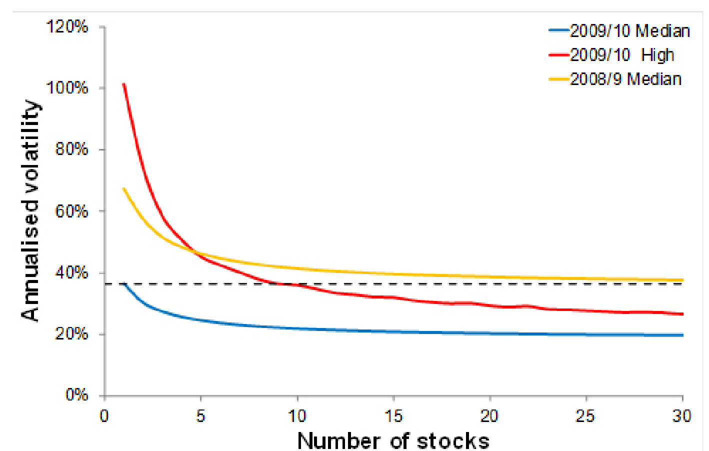
Determining which is more volatile

So let's work out the ideal number of stocks to hold by determining which number has the least volatility.

I took daily price returns data from the ASX 200 stocks for the two financial years 2008/9 and 2009/10 and simulated the volatility of the two portfolios, hypothetically weighted equally. Of course, using the stocks from the beginning of those financial years doesn't allow for those that exited the index during those turbulent times.

I constructed one million (yes, you read that right!) randomly drawn equally-weighted portfolios for each size of one through to fifty stocks and then calculated the historic volatility separately for the two financial years. In the chart, you can see the volatility of the median-volatility portfolio for the two years (the blue and the yellow lines) as well as the worst performing portfolio for 2009/10 (the red line). The black dashed line provides a visual guide for the median volatility of a one-stock portfolio (an average single stock).

Chart: Diversification benefits of increasing the number of stocks in a portfolio



Source: Woodhall Investment Research

The winning number

Unsurprisingly, the volatility of the median portfolio in 2008/9 is much higher than for 2009/10, no matter how many stocks there are in the portfolio. Indeed, I can see that a worst-case portfolio (allowing for the volatilities and correlations of the component stocks) of five-stock portfolios in 2009/10 has about the same volatility as an average portfolio of the same size in the previous year.

By following the black dotted line to the right from the one-stock average portfolio in 2009/10, I can see

that it crosses the red line (the worst performing portfolio) at about eight stocks. This was my basis (in 2005) for choosing a minimum of eight stocks in a portfolio – somewhat arbitrary – but my minimum requirement is that I want my portfolio to have no more volatility than an average stock.

The blue line (the 2009/10 median) flattens out quickly by about 15 stocks. In a chart not shown here, a similar analysis on the 2008/9 data produces a minimum number of stocks of 13. The old rules-of-thumb appear to be back on track!

Care must be taken when interpreting these results; the thrust of the analysis is about an average portfolio. It is easy to construct 'bad' portfolios by biasing the stock selection to small stocks in a single sector.

How to use this information

So what are the rules? The number of stocks you hold in your portfolio should match your risk profile, but a few simple rules-of-thumb flow from my analysis – and a modicum of common sense:

1. Eight (equally-weighted) stocks seems a reasonable minimum in 'good times' and this should be increased in bad times – say to 13 or 15 – providing the stocks are chosen without putting too much emphasis on a sector or Small Caps.
2. No matter what your choice set is, there is little to gain in a volatility sense by holding many more than 20 to 25 stocks from the ASX 200.
3. Using unequal weights has advantages when the weighting is in tune with volatility and correlation.
4. Having regard to sector weights helps when those sector returns are less correlated than the returns within a sector.
5. The 'old rules' seem to still be working and didn't need too much modification during the GFC.
6. Good portfolio construction isn't for amateurs.

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Should I move my shares into my SMSF now?

by Andrew Bloore

Many people would have enjoyed the thrills, sounds, and smells of the various carnivals to pop up during the recent summer holiday period. But, as the carnivals pack up and move out of town, it seems that someone forgot to tell global share markets to get off the roller coaster!

With global uncertainty seemingly set to continue throughout 2012, now might be an opportune time for investors to consider what to do with existing shareholdings.

Two of the options likely to be going through an investor's mind are:

1. Do I continue to hold?

2. Do I sell?

However, a third option effectively provides a combination of these. That is:

3. Do I transfer them into my self-managed super fund (SMSF)?

A better tax outcome

Ultimately, a decision will be made based largely on the investor's beliefs about the future of share markets and their continued willingness to ride the highs and lows that are part and parcel of investing in shares.

However, where an investor is prepared to retain their exposure to shares, transferring those shares into an SMSF is likely to provide a better tax outcome when the market upswing kicks in.

It is widely accepted that super is an extremely tax-effective way to save for retirement. Some of the key reasons for this are that investment earnings (including dividends) received by an SMSF are taxed at a maximum rate of 15%, capital gains tax (CGT) is generally capped at 10%, and once a pension commences at or near retirement, the tax rate on both income and capital gains within the fund reduces to 0% – compare that to paying tax at one's marginal tax rate (typically 30% – 45%)!

When you add to this the fact that once a person reaches age 60, any superannuation withdrawals are received completely tax-free to them personally, it's not hard to see why super provides a tax effective environment for retirement savings.

The strategy

However, the Government places limits on how much someone can put into their super fund each year. For example, for people under 65, these limits generally allow $150,000 in contributions a year as well as an ability to bring forward the next two years' contribution limits – allowing $450,000 in the one year.

So, with investment markets and asset values having fallen, now might be a good time to transfer a share portfolio into the tax-effective superannuation environment while remaining within the contribution caps.

Example 1

Jim is 52 and has a share portfolio that is in his own name. He would like to retain this portfolio because he expects markets to bounce back.

This time last year the portfolio was valued at $510,000 and he was unable to transfer the entire portfolio into his SMSF because this was above the allowable limit of $450,000 over three years. However, his portfolio is now valued at around

$440,000, so Jim can now transfer it into his SMSF without breaching his limit.

By transferring the portfolio into his SMSF, Jim has ensured that any future dividends and capital gains are concessionally taxed at super tax rates as opposed to tax at his personal rate.

It should be noted that CGT may be personally payable by Jim if an overall capital gain has been made on this portfolio. However, in many cases, this tax liability can be reduced by claiming a tax deduction for the contribution.

Example 2

Let's assume that the cost base (for tax purposes) of Jim's share portfolio was $390,000 and that he is self-employed.

Following his $440,000 transfer (or contribution) of the portfolio into his SMSF, Jim could elect to claim $50,000 of the contribution as a personal tax deduction, effectively wiping out his personal CGT liability.

Alternatively, if an overall capital loss had been triggered, this loss would be available to Jim to be used to reduce any realised capital gains, or carried forward to be used against a future capital gain on other investments such as an investment property.

Game changers

Also, there are a number of important changes due to kick in from 1 July this year that Jim will need to consider.

Firstly, available tax deductions for those aged 50 or older will be reduced to $25,000 – or at least an additional limit introduced.

Secondly, there is likely to be a change requiring future transfers of shares be done 'on-market'. This change is likely to result in increased brokerage costs and complexity with a risk of being out of the market.

So, for investors who are thinking of moving assets into the tax effective SMSF environment, the lead-up to the end of the financial year might prove a crucial time.

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Don't miss this!

The Reserve Bank of Australia will hold its first monetary policy meeting for 2012 on Tuesday 7 February and most economists expect the board to cut the benchmark interest rate by 25 percentage points to 4.00%. We'll put the results up on the Switzer Super Report website when the decision in announced at 1430 AEST, and, if applicable, we'll also keep track of which banks do and don't pass the rate cut on to customers.

Did you know?

Are you thinking of locking in a term deposit before the upcoming rates decision? You may be interested to know that some banks have already lowered their term deposit rates in recent weeks. Take a look at our list of term deposit rates, which we update every week to make it easy for you to compare your options.