Switzer Super Report

Issue 58, 16 February 2012

Getting tricky

It looks like that period of consolidation I've been telling you about has kicked in, with the S&P/ASX200 taking its biggest hit for some time in recent days. I talk about what this means for SMSF investors and why 2012 will be an OK year in my note today.

Charlie Aitken has also noticed some changes in the market. In today's Switzer Super Report, he talks about a lull in large-cap stocks and where to find growth. But if you read Charlie's note, make sure to also take a look at Ron Bewley's article on why large-cap stocks are still important for your portfolio. We also explain your options for passing on benefits when you die so that you can avoid the super capital gains tax death trap.

Enjoy the report and let's get those portfolios in order!

Sincerely,

Peter Switzer

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switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
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This will be an OK year for long-term investors

by Peter Switzer

With the market having the biggest down day for some time, it is timely to ask what the year ahead looks like. I know it's a big job trying to predict some of the hardest-to-forecast variables – such as the course of stock markets, the growth of volatile European Union (EU) economies facing recession, and the unpredictable fortunes of governments in these troubled times – but someone has to do it, so why not me?

My market outlook

Let's start with the easy, but most important bit: what will happen to stocks for 2012? I think the balance of historical, market and statistical evidence says it will be an up year. I think there will be the usual test of the market in May, but there could be bigger tests over February, as we are seeing now, and over March.

In March, we are expecting to see EU members and the European Central Bank (ECB) sign-off on the fiscal discipline commitment, and the other debt-rescue bodies are expected to add liquidity to the economic picture.

At the same time, local banks will be rolling over some pretty big debts and so the direction of interest rates ideally would be down.

Bears I know, such as Geoff Wilson of Wilson Asset Management, expect a big rebound when the worst is behind us, but Geoff's figuring tends to be that we might need to get to 2013 to see it happen. That could easily end up being late 2012 if all the ducks line up nicely over the year.

Early signs are pretty good with Europe's economic contraction for the December quarter coming in at 0.3% instead of the 0.4% expected. Helping this better-than-expected picture were the big economies of Europe – France and Germany – with the former actually growing rather than going backwards.

Thomson Reuters says these numbers have led to some positive revisions for 2012 growth. This is how the news agency saw it: "Economists at Credit Suisse raised their forecasts for eurozone GDP (gross domestic product) for 2012, and now predict that it will be flat rather than shrink by 0.5%."

But it wasn't all good news.

"Still, struggling Italy, the third largest economy in the euro region, fell into recession with worse-than-expected GDP shrinkage of 0.7% from the previous quarter," it reported.

Challenges remain

The big challenges for stocks again could be political with elections in France and Italy and these could have implications for debt repayments and sovereign bond yields. Fortunately, I expect to see Europe being thrown a liquidity lifeline and that could counter political negativity.

Also, China outlined a commitment yesterday to invest in EU debt and that was another positive sign. If you throw in the election year in the United States, which generally coincides with a good result for Wall Street, then it builds a case for optimism.

As you can see, the European challenge will create anxiety points that will hit share prices over the course of the year and probably build a better case for stocks in 2013, but for long-term investors in quality companies, I suspect 2012 will be an OK year at the worst.

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There's little growth in top 10 stocks this year

by Charlie Aitken

Global equity markets appear to have run out of short-term puff, with the S&P500 again baulking at 1,350 this week. It does appear we are in for some sort of consolidation of the huge moves from the October lows, which in the scheme of things would be quite healthy for markets.

All the sectors that led Wall Street's five-month rally have led the profit taking (banks, housing, transports, materials) and sectoral leadership changes often proceed periods of index consolidation.

Where's the growth in big-cap Australia?

The top 10 weightings in the benchmark S&P/ASX200 index account for 52% of the index itself. That level of index concentration is one of the reasons the Australian equity market, as measured by the ASX200, continues to underperform the world in raw terms.

The problem is, with a couple of exceptions (like the recovery in Wesfarmers' earnings per share), that the top 10 stocks in the ASX200 lack earnings growth relative to what is available in the region.

In a world where most investors are looking for earnings leverage to a global economic recovery, consensus earnings growth estimates for this year for leading Australian equities are anaemic. Yes, there is yield support, but genuine double-digit earnings growth is hard to spot in the big end of our market. This is before consensus numbers are lowered again to reflect the reality of the two-speed economy and the structurally higher Australian dollar.

Earnings per share (EPS) growth for the top 10 ASX-listed stocks

Code	Company	EPS Growth 2012
BHP	BHP Billiton	-5.74%
CBA	Commonwealth Bank	-0.44%
WBC	Westpac	0.50%
ANZ	ANZ	3.01%
NAB	National Australia Bank	3.81%
TLS	Telstra	8.89%
WES	Wesfarmers	19.76%
RIO	Rio Tinto	-2.26%
WOW	Woolworths	5.63%
WPL	Woodside Petroleum	9.05%

Source: Bell Potter Securities

On that basis, you need price to earnings (P/E) expansion to get large-cap Australian equities up as the world becomes less risk averse, yet in that environment of rising risk tolerance small and mid-cap growth stocks will benefit more than mega-cap stocks. Similarly, with the mergers and acquisitions (M&A) cycle picking up, the mega-caps are far more likely to be predators then prey.

This lack of genuine earnings growth in Australian mega caps – which will get worse as the two-speed economy and high Aussie dollar kick-in this year – is one key reason I am strategically pushing a high conviction, high index tracking-error, concentrated portfolio with a real mid and small-cap structural growth stock tilt.

This year will be a highly divergent year of stock and sector performance. I would like to thank the billionaire who last week replied to my comment, "You will never overtake anyone by driving in the same lane," with "You'll never overtake anyone flying in the same plane". I suspect he was telling me he agreed with my strategy!

Mid and small-cap stocks

The point is, the more I sit here and attempt to pick the key themes of the year ahead, I think the key one is building as the outperformance of mid and small-cap stocks both globally and particularly locally. In the search for portfolio alpha, I think the early trends of this year, one being the outperformance of mid and small-cap stocks, will continue.

I have to say, the awful performance of the listed discretionary retail sector and their landlords this week was a clear signal that east-coast discretionary retail is getting worse. That agrees with all direct feedback I have had from unlisted retailers who continue to report very tough trading conditions. It really is only a matter of time before serious job shedding starts in the retail sector, which of course is like a virtuous circle for discretionary spending. There are 1.2 million people working in Australian retailing. Year-end unemployment is underestimated in Australia.

Money can still be made

Nobody wants to believe me, but I am strongly of the view that 2012 is the year when Australia realises it has all the symptoms of 'Dutch Disease' (the counter relationship between resource exploitation and manufacturing), and that is another of the reasons, perhaps the key one, why I downgraded our domestic equity strategy to 'selectively bullish' on Tuesday. The fact Australian politicians are asleep at the wheel is another factor in my decision to tone it down a notch.

This is going to be a very tricky economic and market adjustment period to negotiate successfully, so that's why I remain vigilant and highly aware of what price action and global trends are trying to tell me before the consensus-following analysts work it out.

We can still make money in Australian equities but we have to work a lot harder for it. The point is this gets trickier now.

Evolution Mining (EVN) – Buy

The corporate combination of Conquest, Catalpa and Newcrest's Mt Rawdon and Cracow mines has created a new mid-tier $1.3 billion gold stock in Evolution Mining. The transaction will prove to be of benefit to shareholders in the long run in being part of a stronger, larger, more diversified group. A rerating could occur similar to that of Alacer Gold (AQG) (which formed in February 2011) and was one of the best performing mid-cap gold stocks of the past year. Evolution stands out amongst its mid-cap rivals in consisting entirely of 100% owned Australian-based assets. The company is well funded after a recent capital raising ($152.5 million), while net cash stands at about $150 million.

- 12-month target price: $2.25
- Last closing price: $1.83

Consolidated Media Holdings (CMJ) – Buy

We view Consolidated Media as a cashbox – net cash coupled with strong associate free cash-flow as Foxtel's (it owns 25%) PVR and HD services near their peak take-up. While we remain cautious on the macro environment, Foxtel's result highlight the attractiveness of the STV model, including the levers it can pull to grow earnings relative to traditional media, which is skewed to cyclical dvertising. On a proportionate basis we estimate CMJ is trading on a 7.6-times EV/EBITDA multiple for fiscal 2012 in line with its peers, BSkyB and SKT.

- 12-month target price: $3.15
- Last closing price: $2.69

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Avoid the CGT death trap

by Andrew Bloore

A recent draft tax ruling by the Australian Tax Office (affectionately known as TR 2011/D3) has led to quite a bit of discussion around a new superannuation capital gains tax death trap. But what exactly is it and how can it be avoided?

In essence, the trap relates to the way superannuation funds are taxed.

In short, when a fund's assets are in the pension phase, its investment earnings and capital gains are completely tax-free. However, when a fund's assets are not in pension phase, tax of up to 15% is payable.

Importantly though, according to TR 2011/D3, the ATO's longstanding view has been that in relation to a fund member, the fund will stop enjoying the benefits of being in the pension phase when that member dies – unless that pension automatically continues to a beneficiary.

Typically, in situations where a member is survived by a spouse or young child this is not so much of a problem because a death benefit pension can generally be commenced in favour of the beneficiary using the deceased member's benefits. As such, the fund can be returned to pension phase in a relatively short period of time.

The trap

However, not everyone is eligible to receive a pension. Consider a situation where the deceased member is only survived by an adult child. In this situation, according to laws governing superannuation, the fund is not allowed to pay a death benefit pension to the adult child and so a lump sum is the only option available.

Inevitably, in order to make this lump sum death benefit, the fund will need to either sell an asset to generate cash or physically transfer the asset out of the fund – in both cases this is a trigger for capital gains tax (CGT).

Now, if this trigger occurs while the fund is in the pension phase, CGT is not payable. However, given the ATO's clarified view – that is, that a pension generally ceases following the death of the member – this means the CGT trigger has occurred outside of the pension phase because the member has died!

Example

Mark has an SMSF that is in the pension phase. The main asset of the fund is a residential property the fund has owned for over 10 years. The property was purchased for $200,000 and is now worth $650,000.

If Mark's SMSF sells the property while he is alive and in the pension phase, there would be no CGT. But what if Mark passes away?

1. If he is survived by his spouse, Martha, their SMSF could elect to pay Martha a death benefit pension. And, if the fund were to then sell the property, the fund would still be in the pension phase resulting in no CGT.
2. If Mark is only survived by his adult son Jeremy, then the SMSF would have no choice but to pay Mark's death benefit to Jeremy as a lump sum. This would involve disposing of the property (either by selling it or by transferring it out of the fund). More significantly, this will result in a CGT liability to the fund of around $45,000!

Voila! There you have it – the CGT death trap!

How to avoid the trap

As our example highlights, and where it is

appropriate to do so, selling the property while in the pension phase (e.g. during Mark or Martha's lifetimes) would avoid this liability arising in the first place – although it must be said that this would be much easier if we were dealing with less bulky (and less emotion-charged) assets, such as shares.

If it's not appropriate to sell the property during the pension phase, then there are opportunities to maximise the tax deductions available to the SMSF.

Tax deductions

If Mark held insurance in his SMSF, the fund would be able to make an election not to claim a tax deduction for premiums paid in the year of his death, but instead claim a portion of the actual death benefit as a tax deduction.

Alternatively, Mark's SMSF could establish a plan to provide an anti-detriment payment, which in turn would create a tax deduction for the fund. However, as the ability to make an anti-detriment payment requires an appropriate funding mechanism (such as a reserve) this involves some forward-planning.

Both these tax deductions are relatively large and can be used to reduce the fund's CGT liability.

Another approach could be to retain the property within the fund itself – avoiding the CGT trigger occurring. The key to this approach is creating enough liquidity within the fund so that Mark's death benefit could be paid out using other assets – leaving the property untouched within the fund. This could be as simple as Jeremy joining the fund and growing his account balance, or it could involve the use of a specifically tailored insurance arrangement.

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How market cap impacts portfolio performance

by Ron Bewley

In my last column, I outlined how many stocks you should own in your SMSF portfolio. As we discovered, eight to 15 stocks seems a reasonable number to hold to receive diversification benefits during normal times. In more volatile times, we found that perhaps 13 to 25 is a more relevant range. The increase in the number of stocks in part allows for the increased chance of one or more stocks really tanking in particularly volatile times.

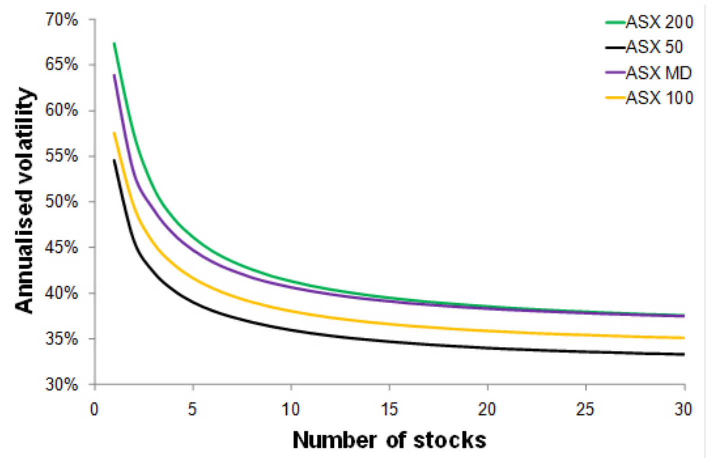
I was a guest on *SWITZER* on Sky Business recently (you can watch me here) and I argued that we are now enjoying pre-GFC levels of market volatility. While eight to 15 stocks per portfolio might be the current way to go, an eye should always be kept on volatility levels to check whether there would be benefits from further diversification in the event of a renewed bout of disturbances – particularly from Europe.

This week I'll demonstrate how the market capitalisation on stocks in the ASX200 can impact returns.

Let's take a look at what happens to returns if the set of stocks is restricted to just the ASX50, the ASX100, or the mid-caps (stocks 51-100 in the ASX100). Clearly, there is no overlap between the ASX50 and mid-caps.

Using the same methodology as in my last column, I've shown the median volatility of randomly produced, equally-weighted portfolios in the Chart for 2008/9, which was the height of the GFC. The comparable chart for 2009/10 (not shown) looks similar except all volatilities are much, much lower.

Chart: Median volatility benefits of focusing on blue-chip stocks in 2008/9



Source: Woodhall Investment Research

Nothing beats the top 50

The chart shows that each curve has the same characteristic drop-off in volatility as more stocks are added to the equally-weighted portfolios. The ASX50 curve – which is basically top 50 ASX-listed companies ranked by the total value of their shares, and are predominately blue-chip companies – is below the ASX100 everywhere – but more so in a relative sense for a larger portfolio. The difference between mid-caps and the ASX200 is very small. That is, the random selection of stocks for these equally-weighted portfolios falls off rapidly when the selection happens to include stocks outside the top 50.

For instance, the median volatility of a seven-stock (or more) portfolio selected only from the ASX50 is lower than the median of any sized portfolio from the ASX200. As you can see, adding more small-cap stocks does little to reduce portfolio volatility.

This confirms what I have argued in previous columns: size matters when choosing the universe of stocks to follow.

While it may seem boring to just own stocks with household names from the top 50, the cost in terms of risk of delving into the small cap space is immense – even in a 13 to 25 stock portfolio. Before buying a small-cap stock – even within the top 200 – you should be convinced that its expected gains are so high that the extra risk is worth it.

In the next few columns, I will further develop the number-of-stock question by considering the impact of including a 'core' of the ASX200 index in a so-called core-satellite portfolio. This type of strategy gives the investor a little more wiggle room in choosing one or two small-cap stocks!

Ron Bewley, Executive Director of Woodhall Investment Research.

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Don't miss this!

Our newest Switzer Super Report expert, George Boubouras from UBS, will be chatting about the markets with Peter on SWITZER on the Sky Business channel tonight from 1900 AEST. Also, one of our regular experts, Alistair Bailey from Art Equity, will make an appearance on Tuesday to talk about buying art investments for your self-managed super fund. Tune in live, or catch the videos the next day on SuperTV.