Switzer Super Report

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Finding growth

Europe is sorting out its mess, but the markets still have some concerns. But I'm not stressing about it, as I tell you why today. Even so, it's likely that worries will hang about for some time, so we've got to be clever about where we look for growth.

Charlie Aitken noted last week that we won't find much growth in the top 10 stocks. He says we should look to selected small-caps as well as take advantage of a forming bubble - read his article this week to find out what's bubbling higher. JP Goldman also weighs in this week with some small-cap ETF recommendations. Plus, we look at why boards often like to report 'underlying profit' results, and tell you what to do if you, like so many others, breach your contributions cap. Enjoy the report!

Sincerely,

Peter Switzer

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Why I'm not stressing about the markets

by Peter Switzer

The Greeks have played ball, the European Union (EU) finance ministers have signed off, and the European Central Bank (ECB) is giving the EU liquidity, so what gives? In the parlance of an American movie: "Hey dude, where's my rally?"

Well, despite the most obvious advancement of the issues that were spooking the stock market in August and September last year, nagging doubts remain and these are being exploited by those who just can't get their heads around the fact that the Dow is now in all-time-high territory.

By the way, when interest rates are close to zero and governments are throwing money at economies to create demand as well as jobs, it's not surprising that companies are making profits, which in turn drives share prices.

However, there is a mentality (which can be understood) that says, how can all of this last with debt levels so high? This nagging doubt takes the steam out of rallies, but even the lagging Aussie stock market with its millstones of high interest rates and high dollar is up 11% since late September last year.

Worry warts?

Anyway, despite the obvious improvement in circumstances linked to Greece, the market again is worrying about credit-default swaps.

These are financial products which gained infamy when the world's biggest insurer was nearly rendered 'dead' in 2008 at the height, or maybe it was the low, of the GFC.

The New York Times pointed out that European policy makers "aimed for a voluntary debt exchange that would not initiate the default swaps, fearing that payments on the swaps might set off destabilising chain reactions through Europe's financial system."

But despite the €130 billion package to help Greece, it's now possible that swaps could be triggered. These are virtually insurances against someone not coughing up with their debt repayments.

There are suggestions that the Greeks could create a credit default swap crisis, which would jeopardise the banks that are exposed to bonds bought from Greece. However, there is some good news if we can believe it – European reports can have credibility question marks over them.

"A stress test of the region's banks last year did not reveal large, unhedged exposures on swaps written on government debt," The New York Times reported. "In nearly all cases, banks that sold insurance also bought a similar amount, which balances out their exposure."

The fear is that a bank, which is supposed to be underwriting a default swap, fails and this creates a snowball effect that leads to an avalanche of failures.

"Counterparty risk has been the great amplifier," said Walter Dolde, associate professor in the School of Business at the University of Connecticut to the Times. "Sometimes an avalanche starts with a snowball."

Don't stress

Right now this is the kind of alarmist story that emerges when a market looks like it is ahead of itself and, while it cannot be ignored, there are well-trained experts who dismiss these alarmist predictions.

"The fears about the market are small potatoes," Professor Duffie of Stanford said.

I don't have as much confidence as Duffie, but I also

don't have the same expertise as him. I cannot believe that the International Monetary Fund (IMF), the ECB and the EU – the so-called Troika – could have proceeded with the €130 billion debt deal without factoring in the debt swap challenges.

And given the ECB surprised many by lending cheap three-year money to European banks to the tune of €489 billion in December and another big round comes next week, I think that should be sufficient 'insurance' to allay market fears. We will see sell-offs ahead, but not crashes unless there is a real curve ball from left-field.

By the way, CommSec's Craig James thinks the worst of the EU nightmare is behind us. If he's right, the rally will return some time this year, but I suspect we will see some serious testing of the newfound optimism seen in stock markets since October last year, and particularly since January.

That's why I have my stress under control.

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There's a bubble forming and we can ride it higher

by Charlie Aitken

Tuesday was one of those days you remember in Australian equities. It was a day where OneSteel (OST +13%) said they were considering a 'name change', ANZ (+0.2%) hit all bidders in its hybrid issue (what is that telling you about funding?), yet a raft of mining services stocks issued results that beat expectations and led to upgrades. It was another day that absolutely confirmed Australia's two-speed economy and two-speed equity market.

Interestingly, large-caps again underperformed small and mid-caps as investors begin to work out the vast majority of our largest companies lack earnings growth.

The other reason large-caps, particularly banks, underperformed Tuesday was ANZ's massively upscaled hybrid issue. I suspect many people who bid for large amounts of ANZ hybrids were surprised by getting hit, leading them to either sell equities or take money from cash management trusts to pay for them. The market now suspects Westpac (WBC) to also upsize its issue. I continue to believe all these hybrid issues are competing with Australian large-cap equities for retail money.

The chart of the ASX Twenty Leaders Index (XTL), while volatile, has broadly gone nowhere for two years. It's even worse on a six-year chart (I will be expelled from the Stockbrokers Union if I publish that one). Without earnings growth, you are betting on price-to-equity (P/E) expansion to drive capital gains. Unfortunately, right now, large cap Australian P/E's continue to contract to reflect a broad lack of growth.

Shovel or the hole?

Our two biggest overweight strategic bets in Australian equities are in resources and the resource service sectors.

Yesterday there were a plethora of results in the mining services sector that confirm that top-down growth is translating to earnings and dividend growth.

The question from many investors is now, 'should I own the shovel or the hole?' That's a very fair question with mining service stocks continuing to outperform their miner customers.

My answer is you should own both. In my view, the question isn't about miners versus mining services; it's really about miners and mining services versus the rest of the east coast industrial market and financials.

Be ready for the bubble

Our strategy is to hold "shovels and holes" – but I must warn you that I suspect a giant valuation bubble will form in the mining service sector over the next 18 months as investors capitalise the peak of the capex cycle.

As growth, particularly industrial earnings growth, gets harder and harder to find in Australia, you will see a wall of momentum money pile into mining services stocks. This is quite a narrow and illiquid road and I expect to see P/E expansion alongside consensus analyst upgrades. Remember, Australia has an 'industrial bias', so look for P/E's well above the miners to be commonplace. They are the 'have' sector of the Australian industrial market.

But it's as a bubble forms and everyone becomes a believer that you actually make your most money as an investor. Yes, I'm aware at some stage in the next 18 to 24 months I will need to press the sell button on this sector, but I believe it will be at substantially higher absolute and relative pricing.

I simply believe the big Australian capital expenditure

(capex) spenders – BHP Billiton, Rio Tinto, Fortescue, Hancock and Chevron – are going to keep the capex tap turned fully on. They learned from the GFC that you have to invest through the cycle to get the benefit of recovering prices. None of them blinked about (Greece etc.) and that is why I believe the capex spend forecasts are reliable, yet not yet capitalised into Australian mining services stocks.

Go Australia, Charlie.

Santos Ltd (STO) – Buy

Santos is financially strong and has a clear growth path through PNG liquefied natural gas (LNG) and Gladstone LNG. Rising gas prices and improving technology to extract hydrocarbons from low quality reservoirs creates exciting upside potential for the company through its Cooper basin position. This year we expect to see about 15 wells specifically evaluating the shale potential of the Cooper basin from several industry players. While the results may be mixed, some of the results are bound to be encouraging. Some of the smaller Cooper basin stocks with shale potential have run hard in the last year, which is not the case with STO. The shale theme is exciting and in our view, you get it for free in Santos.

- 12-month price target: $17.32 (up from $15.25)
- Last closing price: $14.31

Austin Engineering (ANG) – Buy

ANG is a heavy engineering business which manufactures, supplies and services mining products for the resource sector. Austin has proven capable of generating significant revenue and earnings growth with geographic and product expansion, recording organic revenue growth in excess of 20% per annum since 2004. This profile has been supported by an aggressive acquisition strategy where necessary ($67 million in two years), generating total compound revenue growth of 41% per annum over the period. Importantly recent investments in Latin America, Indonesia and Australia support further earnings growth through to fiscal 2013.

- 12-month price target: $5.60 (down from $5.73)
- Last closing price: $4.66

Emeco Holdings (EHL) – Buy

The turnaround at Emeco is now largely complete and the business is positioned to benefit from the growth in demand for rental equipment. Emeco has the scope to recycle $100-150mpa of surplus cash flow into the business for growth and there are clear signs this is occurring. The trajectory in Emeco is clear, with an improving return on equity, strong cash realisation, high levels of production-based revenues and further investment in fleet underwriting growth in net tangible assets.

- 12-month price target: $1.39 (unchanged)
- Last closing price: $1.155

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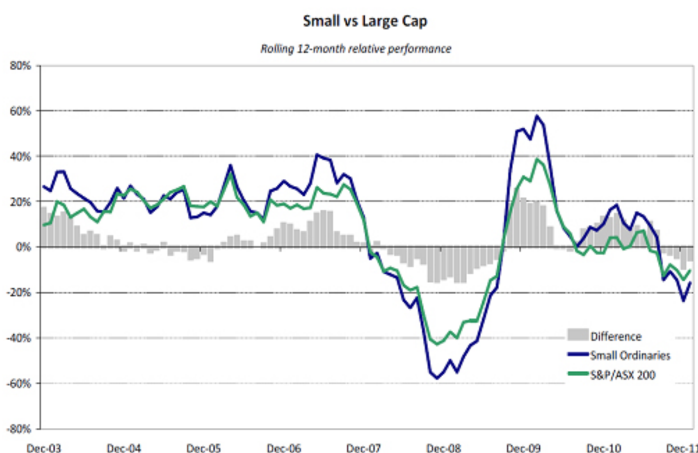
Finding growth with small-cap ETFs

by JP Goldman

The weakness in the share market over the past year has not spared the small-cap sector. In the twelve months to January, the S&P/ASX200 index was down 10.3% in price terms, whereas the S&P Small Ordinaries index was down 15.9%.

This should be no surprise. As small company shares are less liquid and their business models are generally perceived to be at greater risk during an economic downturn, it's often the case that small-cap stocks fall harder during market retreats. On the other hand, they also rise faster during rebounds.

At the height of the market's post-GFC rebound earlier last year, for example, annual performance in the small-cap index was also 15 percentage points better than for the large-cap index. Yet during the GFC, the largest year on year price decline for small-caps was 60%, compared with 40% for large-caps.



It stands to reason, therefore, that when – and if – the market eventually rebounds, small-caps are likely to shine again. Indeed, so far this year the small-cap index has raced ahead by 11%, more than doubling the 4.9% gain by the large-caps.

What to buy

Of course, that begs the question of which small-cap stocks to buy? If you're stumped for ideas and don't want to drown in too much paperwork, one easy way to gain exposure to the smaller end of town is through one of several recently listed small-cap exchange-traded funds or ETFs. In a single trade, investors can now gain market exposure to all the stocks in the ASX Small Ordinaries index (for ETFs provided by State Street and iShares) or the MSCI Australian Shares Small Cap index (for Vanguard's ETF).

In terms of long-run performance, the differences between these two underlying benchmarks is not great, so ETF selection come down to the cost, liquidity and the management experience behind what's on offer.

As seen in the table below, Vanguard (again) has the cheapest small-cap ETF offering, with a management expense ratio (MER) of only 0.3%. Vanguard's ETFs is the newest (less than a year old) and by the end of last month it had less than $10 million in funds under management (FUM). Yet despite this, liquidity was not bad, with an average bid-offer spread last month of only 0.37% and average bid depth of more than $2 million.

Vanguard's offering is a good option. That said, all the small-cap ETFs are provided by large, established and very experienced providers and would provide a useful vehicle for gaining small-cap exposure.

Comparing small-cap ETFs

ETF Provider	Listing date	ASX Code	MER [1] %	FUM [2] ($m)	Av. bid/ offer [3]	Bid depth ($m)†
iShares	Dec -10	ISO	0.55%	$23.5	0.53%	$1.50
State Street	Apr-11	SSO	0.50%	$7.5	0.58%	$1.90
Vanguard	May-11	VSO	0.30%	$6.3	0.37%	$2.50

[1] Management expense ratio; [2] funds under management in Australia; [3] average % difference between best bid and offer price; † average dollar value of five best bid offers.
Source: ASX ETF Monthly Report January 2012.

Not so small

Although these benchmark's track so-called 'small -cap' stocks, these stocks are far from the smallest on the market. Indeed, the S&P Small Ordinaries index is defined as those companies in the S&P/ASX300 index, but not in the S&P/ASX100 index. In other words, the small-caps are in fact the next 200 largest stocks on the market by market capitalisation after the top 100 stocks. Indeed, their average market cap is currently around $1.4 billion!

Compared to the S&P/ASX200 index, moreover, the small-cap index tends to have relatively more industrial firms and fewer financials. By late February, financials accounted for a mere 9% of the ASX Small Ordinaries index, while industrials accounted for 18%. In the S&P/ASX200 index, the respective sector shares were 37% and 7%. And you'll also get a bit more resource sector exposure, with materials accounting for 33% of the small-cap index and only 25% of the larger-cap index.

A final point to note is that while gaining small-cap exposure through ETFs is relatively cheap and easy, this tends to be one area of the market where good actively managed funds can more often beat the index – as information on small-cap stocks is relatively less well known across the market.

That suggests when, and if, the market finally turns higher, seeking out top performing small-cap funds and/or expert stocks pickers (as in the Switzer Super Report) can complement a small-cap ETF strategy in adding risk to your portfolio.

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Don't get fooled by 'underlying profit' results

by Vas Kolesnikoff

There is much uncertainty in the global financial market surrounding the eurozone sovereign debt crisis, and no one knows exactly how long it will take to fully resolve or what will happen. In the meantime, the investments that SMSF trustees select for their portfolios will be affected.

Previously, I commented that Australia's Big Four Banks are as good a bet as any because they have a strong position in the Australian economy to ensure a consistent level of profitability, ensuring dividends to investors and a relatively strong level of security in regards to their capital.

When a business sees its costs rising, it seeks to pass on those costs to the consumer. We can see recently that the banks have been raising their rates, in spite of the Reserve Bank of Australia indicating that there is downward pressure on domestic rates as it seeks to stimulate weakness in segments in the domestic economy.

Banks recovering costs

In the current reporting season, the Big Four Banks have continued to report strong profits, with Commonwealth (CBA) reporting a statutory profit of $3.6 billion for the half-year, representing a 19% increase over the prior period. In their quarterly results, Westpac, ANZ and National Australia Bank (NAB) reported statutory profits of $1.4 billion, $1.7 billion and $1.6 billion, respectively. In each case, they cited headwinds from rising borrowing costs and contraction in their net interest margins, but profitability was still strong.

When we compare these statutory results with companies such as Qantas, Billabong and Pacific Brands, to name a few, we see that profitability is heavily impacted by increasing costs and weaker demand, yet these companies do not have the same ability as the banks to increase prices to the consumer. Instead, we hear about significant declines in their profits, closures and job cuts.

Qantas struggling

If we examine the results of Qantas, for example, we can appreciate why the Australian Securities & Investments Commission (ASIC) requires companies to disclose their 'true profit' – or statutory profit – so as not to mislead investors.

The half yearly results for Qantas in 2012 can be summarised as follows:

	Underlying Profit (Management Determined)	Adjustment	Statutory Profit (Under the Australian Accounting Standards)
1st Half 2011	$417m	($95m)	$322m
1st Half 2012	$202m	($144m)	$58m
Decline	$215m		$264m
Decline	-52%		-82%

Source: Qantas; Australian Shareholders' Association

Qantas's issues have been widely publicised. It has historically had, and continues to have, material industrial relations problems impacting its business and its costs. Furthermore, rising fuel costs and the high Australian dollar have contributed to its escalating cost structure. Qantas also competes with other global airlines, such as Emirates, which receives significant concessions from the United Arab Emirates' government that allow it to improve its competitiveness relative to Qantas.

In light of Qantas's issues of competitiveness and profitability, shareholders have not received a dividend for the last two years and its stock price has dropped significantly from $6.06 in October 2007 to

as low as $1.35 in October 2011, and is currently trading at $1.65. In the meantime, the chief executive, Alan Joyce, has received a 72% increase to his salary and incentive package to exceed $5 million.

The role of executives

When we look at the performance of the board and executives and their entitlements to bonuses and salary increases, the shareholders and risk-takers in the business require a return on their investments. Qantas's recent announcement that it suffered a 52% decline in underlying profit from $417 million to $202 million is bad enough; however, the true result is much worse.

The statutory profit, which is determined in accordance with the Australian Accounting Standards, actually shows a decline of 82% in the profit to shareholders from $322 million to $58 million. So what is 'underlying profit' and why is this figure so heavily publicised?

Underlying profit

Underlying profit is the profit determined by management and the board after excluding certain 'one-offs' that are deemed to be non-recurring or not part of the normal course of business. Unfortunately, for Qantas shareholders, our table also shows that adjustments for such 'one-offs' appear to be quite a regular occurrence. The 'one-offs' may not be of the same nature, but nevertheless, they account for hundreds of millions of dollars subtracted from profits to shareholders for which management and the board must be accountable.

ASIC requires that companies do not give undue prominence to underlying profit in order not to mislead investors. However, investors must delve carefully to understand the performance of management and boards in their investments and hold them fully accountable for producing results.

It's important to remember that statutory profits are the ultimate result for investors, out of which dividends are paid, and these will impact the share price, especially if we regularly see adjustments for 'one-offs'.

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What to do if you exceeded your contribution cap

by Andrew Bloore

Since 1 July 2007, the superannuation system has been graced with contribution limits restricting the amount that can be put into super without penalty. Since their arrival, these limits have been repeatedly discussed and debated, changed and amended – and they continue to create pain and confusion for DIY super trustees.

Knowing your limits

It's critical that you are aware of your contribution limits to make sure they are not breached, because to breach them results in a tax liability of effectively 46.5%, but easily up to 93%!

There are two broad types of contributions:

1. Concessional contributions: Typically made by an employer but also includes tax deductible personal contributions; and
2. Non-concessional contributions: Typically personal or spouse contributions for which a tax deduction is not claimed.

Annual limit on concessional and non-concessional contributions

Concessional cap – below age 50	Concessional cap – age 50 or over	Non-concessional Cap – all ages
$25,000	$50,000 †	$150,000

† This may change in 2013 to be $50,000 for account balances less than $500,000 and $25,000 for account balances greater than $500,000, pending approval.

Note that if you're aged under age 65, you can bring forward two years' worth of non-concessional contributions, up to the value of $450,000, and generally make this contribution in one year. You can read more about the bring forward rule here.

Importantly, when a person's concessional contribution limit is exceeded, the amount of the excess will also spill over into the non-concessional limit – which could provide a nasty sting.

The tax sting

Rosemary is 55 years old and has an agreement in place ensuring she receives annual employer contributions of $50,000, including the 9% compulsory superannuation guarantee.

To assist with her retirement planning, in the 2010/11 financial year she made a $450,000 non-concessional contribution to her super following her husband's retirement (read more about this strategy in How to move large sums of money into super).

However, in July 2010 her employer had made an unexpected additional concessional contribution of $1,000 – a back payment from the previous year.

Due to this $1,000 contribution, Rosemary breached her concessional contribution cap by $1,000. As a result, she will effectively pay tax at 46.5% on the $1,000, a tax impost of $465.

Unfortunately, this $1,000 excess contribution will also need to be added to Rosemary's non-concessional limit for 2010/11. And, as she had already used up this limit, she has now breached her non-concessional limit – attracting an additional 46.5% penalty.

So, this $1,000 contribution has attracted $930 in tax!

While this example simply highlights the mechanics

of the contribution limits, excess contributions tax notices of around $70,000 are often created by similarly small oversights.

How to avoid breaching your cap

Avoiding the creation of an excess contributions tax liability is always the best way to deal with the problem. Some simple tips to avoid breaching your cap include:

- Keep track of your super contributions by regularly reviewing statements;
- Remember that compulsory super contributions count towards the concessional contribution limit – in addition to salary sacrifice contributions and personal contributions where a tax deduction is claimed (eg. by a self-employed person);
- Before finalising salary sacrifice arrangements, consider the total to be contributed as well as the timing of these payments (eg. late payments from earlier years) – perhaps consider leaving a small buffer; and
- Watch out for additional superannuation contributions made by your employer as a result of a bonus.

What can be done?

On a positive note, if you exceed your contribution limit, there may be ways to manage the problem.

A simple yet important step is to check that contributions have not been made by mistake, or reported incorrectly to the ATO. For example, a rental payment intended to be made to a landlord can easily be made to a super fund in error when using online banking systems. Or alternatively, an employer may have made a super contribution rather than paying directly onto a credit card.

Where such errors have been made, the contribution may be refunded as the intention to make a super contribution did not exist.

If this is not the case and a breach has occurred, it is important to consider whether the offending contribution(s) is one that rightly belongs to the financial year in question.

When someone exceeds their cap, they will be advised in writing by the Australian Taxation Office (ATO) alerting them to this fact before an assessment notice is issued – unfortunately, this is often the earliest that people discover the breach.

It is also important to understand that the ATO does have some limited discretion to either disregard a particular contribution or to allocate it to another financial year.

Looking back at Rosemary's case, the $1,000 contribution that caused the 93% tax penalty is one that related to a different financial year. As such, Rosemary may consider applying to the ATO to have the $1,000 contribution allocated to the relevant financial year – a successful application may solve the problem.

Where all avenues have been exhausted, there may be nothing left to do other than to pay the penalty. At least some comfort can be taken from the fact that the money to pay this penalty can come from the fund rather than directly impacting your hip-pocket.

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Did you know?

The latest SMSF quarterly statistics were released by the Australian Tax Office today, and the data shows that total SMSF assets rose 1.4% to $399.8 billion in the fourth quarter of 2011 compared with a year earlier. The gain comes despite stock market declines that pulled the value of total assets down 2% from a peak of $407.6 billion in the second quarter of last year.

The annual increase was also fairly muted given the number of SMSFs rose 7% over the period to a new high of 873,903.

The uncertainty at the end of last year caused a 10% increase in the amount invested in cash and term deposits, which accounted for 29% of total SMSF assets at $114.9 billion in the quarter, while listed shares made up 31% of the mix at $122 billion, down 7.2% from a year earlier.

These trends will likely reverse as confidence returns to the stock market.

Don't miss this!

Gary Stone, the managing director of Share Wealth Systems, spoke to Peter Switzer earlier this week about a small-cap stock investment strategy. He also named the top 10 small-cap stocks to watch this year. See what he had to say on Super TV.