Switzer Super Report

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Blue skies (almost)

The Dow Jones gave us a good sign this week by closing up over 13,000 for the first time in yonks, and while the market has pulled back a little since, it's clear that there's money out there that wants to take stocks higher once we're able to put our US economic and European debt fears to bed. I give you my outlook today.

Also in the *Switzer Super Report*, Charlie Aitken says there's only one stock on the ASX that is positioned to tap the rise of Asia's cashed-up consumer, and he tells you what that is today. Plus, Ron Bewley continues his portfolio-building series and explains how to design a 'core satellite' SMSF portfolio, and we look at the question of whether or not you should own life or disability insurance in your DIY super.

Enjoy today's report!

Sincerely,

Peter Switzer

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There's a blue sky behind those dark clouds

by Peter Switzer

If I wasn't well-trained, well read, experienced and in possession of the two qualities I like in a financial expert – grey hair or no hair! – I might courageously ring the bell on the bear market proclaiming it's time to go 'long' stocks.

Of course, for my part, I am already long stocks as I am a long-term investor and so I have been very happy since October, but I know some challenges lie ahead. However, while I think the worst is behind us, I have a nagging doubt and so I don't want to allay the fears of the nervous Nellies out there who have been hiding in cash in case there is one more big slide, which could really hurt those with limited funds in their nest egg.

For the young and well-heeled, time is on your side and stocks will come back. But you have to have the balance and the guts to stomach the things that come from left field in the investing caper.

On balance, good news is outpacing the bad and that's why the S&P 500 on Wall Street is up 8.7% since the start of the year!

The good

Let's just recap the better news coming out of the wider world:

- The Dow Jones index is testing the psychologically-important level of 13,000.
- US consumer confidence hit a 12-month high at 70.8 in February compared to 61.5 in January.
- Unemployment fell to 8.3% in January, which beat economists' expectations.
- Pending home sales in the States were up 2% to a reading of 97 and that's a two-year high! The experts had tipped a 1% rise.
- Warren Buffett says property investors should look at investing in housing, and it's a nice omen when this guy starts to see value in US housing.
- Another good sign is bond yields coming down in Europe.
- China easing monetary policy adds to my guarded optimism.
- US Stocks are up for February with the Dow rising 2.5%, the S&P 500 up 4.1% and the Nasdaq up 5.4%.
- The US Federal Reserve boss, Ben Bernanke, talked about a better labour market and he left an impression that there could be less QE3 (that is, monetary stimulation)!
- US gross domestic product (GDP) was up to a 3% pace and rising, which was better than expected and it means less QE3 is needed and the Yanks are closer to the day when interest rates start to rise.
- The Fed's Beige Book painted a US economy showing good growth.
- The European Central Bank (ECB) put another 530 billion euro into the European Union's banking system via low-cost loans to banks.

That's the good stuff, so what about the bad stuff?

The bad and the ugly

I am concerned about the unreliability of European politicians, especially with elections looming in places like Greece and France this year, and the Iranian threat to global oil supplies that has seen the oil price head over US$108 a barrel, which could hurt global economic growth rates and spook stock markets.

Of course, I think the Reserve Bank of Australia (RBA) has hurt local stocks with its over-careful rates policy forcing the dollar up as well, again hitting stocks in the slow lane of our twp-speed economy. But

that said, a sell-off breather is overdue, especially when the S&P 500 is up 8.7% since January. Meanwhile, our market is up 5.2%, which is a nice effort but it could have been higher with a less cautious central bank.

I think our economy will see some higher unemployment and the RBA will cut rates one or two more times. Also, if Europe improves, funding costs could come down for local banks, which should help the predictions of RBS Morgans' chief economist, Michael Knox, who says fair value for the S&P/ASX200 is 5,300!

Blue sky lies ahead as soon as we can wave goodbye to some of the lingering dark clouds coming from Europe.

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I'm very bullish on this Australian company

by Charlie Aitken

I think Monty Python summed up this week's events in Canberra very well in *The Life of Brian:*

Brian: *Excuse me. Are you the Judean People's Front?*

Reg: **#@* off! We're the People's Front of Judea.*

Anyhow, enough of Canberra for a few weeks; let's work out how to make money in Australian equities despite the ongoing political and policy risk that is inherent in Australia.

The key feature of all markets I'm watching is the accelerating outperformance of mid and small-cap growth stocks. I particularly favour larger Australian mid-cap growth stocks (with yield), and below I look at the positive investment case in Crown (CWN), which has a market capitalisation of $6 billion.

The ASX Small Ordinaries Index (XSO) is breaking out versus the ASX20 Leaders Index (XTL). This technical breakout is fundamentally supported by the interim reporting season, which has confirmed stronger earnings and dividend growth in mid and small-caps stock compared with Australian mega caps. The vast bulk of growth ideas I am pushing in my notes are outside XTL.

Crown (CWN): Australia's luxury leverage – Buy

As regular readers know, one of my key macro themes is being overweight on luxury goods and services stocks as a play on rising Asian wealth. It's been arguably the best industrial way of playing the rise of the Asian consumer for many years now, but the hardest aspect is finding ways of playing the theme in Australian equities.

For some time I have thought Crown Limited was most likely the answer in Australia, but I wanted to wait to see confirmation of this at the interim earnings release. After Friday's stronger-than-expected first half-year earnings per share (EPS) and dividend per share (DPS) results, Crown in my view is the only liquid way to play this luxury Asian consumer theme in listed Australia.

Crown is the only ASX-listed company of any scale set up to capture the structural growth of Asian luxury spending. Not only does Crown own 30% of the City of Dreams Casino in Macau, which I recently visited and wrote bullishly about (gaming revenues are consistently beating all analyst forecasts), but their Crown Melbourne and Crown Perth Casinos are the only truly high-end complete offering in Australia.

On Friday, Crown increased its stake in Echo Entertainment (EGP), the owner of The Star in Sydney, to 10%. In the medium-term, it's not impossible that Crown would monopolise refurbished, casino assets in Melbourne, Sydney and Perth. Echo shares got excited by this development on Friday, but I suspect hopes of a full takeover offer are premature.

Crown has high-end accommodation, high-end restaurants, high-end shopping and high-end gaming. They are the only tourism properties in Australia aimed right at inbound, cash-rich, Asian tourists, and in the case of Perth, a few cashed-up miners as well – I'm convinced Crown Perth will become the *only* place to stay and play in Perth.

Very Bullish

I'm very bullish on Crown, feeling the stock is undervalued versus its strategic position and earnings growth. I have been doing some back-of-the-envelope calculations on Crown and I reckon you get the Macau exposure effectively for 'free'.

In my view, casino assets globally trade at around 12-times EV/EBITDA (enterprise value/ earnings before interest, taxes, depreciation, and amortisation), yet Crown as an entity trades at around 10.5-times. However, when you strip out the value of its Melco asset in Macau, the EV/EBITDA multiples drops below eight-times, which is ridiculously low for monopoly casino assets in growth jurisdictions. It's also worth noting that regulatory risk in terms of poker machine reforms in Australia have fallen sharply (Andrew who?).

The chart below shows that Crown shares have basically gone sideways for two years as they went through a high capex spend period, the ramp up of Macau, and perceptions of regulatory risk. But the capex spend is coming to a conclusion, Macau is going better than anyone predicted, regulatory risk has evaporated, and this stock will be re-rated to a global casino multiple, if not a global luxury brand multiple, through time.

Crown has tracked sideways on the ASX

You can also see that James Packer's Consolidated Press Holdings has increased its stake in Crown to 46%. I am very happy to co-invest alongside Consolidated Press and I think it increasing its holding is a very positive signal about the outlook for Crown.

Crown is cum-dividend of 18 cents and cum consensus upgrades to both earnings and valuation. If you believe in 'luxury', you need to own this company. It's also worth noting the quality and depth of its board, arguably one the strongest in Corporate Australia.

Crown directors

- Mr Christopher Corrigan
- Mr Ashok Jacob
- Mr Harold Mitchell
- Mr Geoff Dixon
- Mr James Packer
- Mr John Alexander
- Ms Rowena Danziger
- Mr Rowen Craigie
- Mr Michael Johnston
- Mr Benjamin Brazil
- Professor John Horvath
- Ms Helen Coonan

Go Australia, Charlie.

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How to design your own 'core-satellite' portfolio

by Ron Bewley

In my previous two columns, I demonstrated that there is a simple pair of rules that govern how many stocks should be in your portfolio. These are:

1. When market volatility is normal, about eight to 15 stocks might suffice to reduce portfolio volatility through diversification without needing to find too many potentially good stocks (read How many stocks should be in your SMSF portfolio?).
2. There are great potential gains in volatility to be had by selecting stocks from just the top 50 blue chip companies (read How market caps affect your portfolio's performance).

The first 'rule' is adjusted for more volatile times by increasing the minimum number of stocks to between 13 and 15 with a maximum of, say, 25 stocks.

Using ETFs in your portfolio

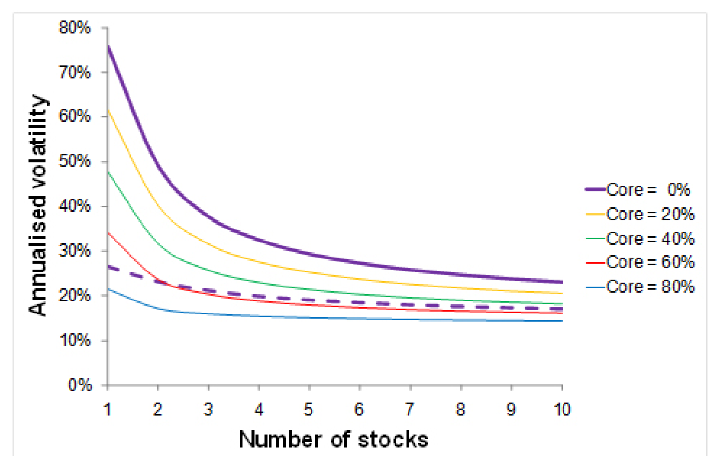
Investors who are new to portfolio construction might find it hard to find sufficient good stocks to get going. With the increase of interest in exchange-traded funds (ETFs) some investors are opting out of stock selection altogether by looking towards investing in the index rather than individual stocks. But what about a compromise? Say, a few stocks and an ETF? There are a number of ETFs designed to mimic the ASX200.

So, to reflect an ETF in a portfolio, let's revisit the 'number of stocks' question, but this time, let's assume one of those stocks is forced to be the ASX200 index – and not necessarily equally weighted with the stocks.

I used data from 2010/11 this time to construct simulations of a number of equally-weighted portfolios of randomly chosen top-200 stocks, plus 'core' holdings in the ASX200 ranging in size between 0% and 80% of the total portfolio and measured in 20 percentage-point increments. For example, a portfolio with an 80% 'core' plus five stocks has 80% invested in the ASX200 and the additional five stocks each get 4% of the total portfolio value – making 100% in total.

Rather than just estimating the average volatility of each of these hypothetical portfolios, I computed the median volatility and the 99th percentile, which is the maximum volatility of the one million simulations after eliminating the worst 1% of portfolios in terms of volatility. I summarise the key results in the chart below.

Chart: Volatility and number of stocks



Source: Woodhall Investment Research

Note: the dotted line denotes the median of the 0%-core portfolios.

Understanding the chart

The solid purple line (0% core) represents the 99th percentile of the portfolios – an almost worst-case random choice of stocks – with no index, or core, included. The dotted purple line represents the median volatilities from the same 0%-core portfolios. This median result is directly comparable to those I presented in my previous columns, the only

difference being the year from which the data have been taken. Both purple lines flatten out by the time 10 stocks have been included in the portfolio – in line with the eight to 15-stock rule.

In the chart, the yellow line represents the 99th percentile of portfolios that includes 20% invested in the ASX200 index. As you can see, in the one-stock portfolio along the yellow line, there is 20% invested in the index and 80% in the single stock, and accordingly, volatility is high. In the two-stock portfolio along the same line, there is 20% invested in the index and 40% in each of the two stocks, etc.

Core size

There is no dramatic improvement by including a 20% core in your portfolio. However, as the size of the core increases, important gains are made. For a 40% core (represented by the green line), the 99th percentile 'worst-case' gets close to the average portfolio with no core by the time five or six stocks accompany the 40% core.

When the core is 60%, the red line for the 99th percentile is lower than the median 0%-core line for two or more stocks. An 80% core brings the 99th percentile below the median 0% core for all numbers of stocks. In other words, an almost worst-case scenario for an 80%-core is better than an average 0%-core portfolio with any number of stocks.

The bottom line

The conclusions are straightforward. An investor who can tolerate the typical volatility of an equity market need only find two or three stocks to combine with a core of 60% or 80% in the index. While this combination reduces volatility over 0%-core strategies, it does make it harder to get much outperformance or 'alpha'. But then again, investors new to equity markets should perhaps start slowly. Next time, I will combine the results of my entire series on 'How many stocks to own' to suggest a strategy for an SMSF share portfolio.

Ron Bewley, Executive Director, Woodhall Investment Research.

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Should I take out insurance using my SMSF?

by Andrew Bloore

It's possible to hold various forms of life insurance in a self-managed super fund (SMSF), but should you?

Careful consideration should be given whether to hold it within an SMSF or in the member's personal name outside super because this decision will determine who the policyholder is and the benefits that follow.

While there are benefits to holding life insurance policies in your SMSF, superannuation legislation and taxation considerations may curtail its appropriateness in specific circumstances.

Benefits of insurance in your SMSF

The most obvious benefits of using SMSFs to pay insurance premiums are:

Tax effectiveness: Salary sacrificing into an SMSF effectively enables premiums to be paid from a person's before-tax income. The higher the person's marginal tax rate, the greater the saving. Similarly, if a member is able to claim a tax deduction for their personal contributions – for example, someone who is self-employed – they are ultimately claiming a tax deduction for the premiums. These tax outcomes are generally not achievable where insurance is held outside super.

Personal cash flow benefits: If a member chooses not to make super contributions to fund the insurance premiums, then premiums can be paid using amounts already accumulated in the SMSF, including compulsory employer contributions and fund earnings. This way, the member doesn't pay for the premiums personally; their personal cash flow remains intact.

SMSF Deductions: With the exclusion of trauma insurance, premiums are generally tax-deductible to the fund. Additionally, where an SMSF holds a policy for a member who passes away or becomes disabled, the SMSF may claim a deduction in that year for the 'future service' element of the death or 'total permanent disability' (TPD) benefit paid. This deduction could be quite substantial depending on the member's circumstances.

Restricted access to payouts

So, an SMSF may seem like an obvious choice for holding insurance, but remember, if the SMSF is the policy owner and is paying premiums, then any insurance proceeds must be paid into the SMSF. As such, a condition of release must be met before the money can be released to the member.

The dilemma this creates is whether the SMSF can legitimately release the proceeds as, and when, they are required. This is relatively straightforward for life cover because the insurance policy is paid in the event of death or terminal illness, both of which are specified conditions of release. However, some cases can be less transparent.

Things to think about

Some key considerations when deciding whether to hold insurance inside an SMSF include:

Trauma insurance: Trauma cover inside SMSFs, whilst permitted, has largely been rendered ineffective. Most trauma events would not alone be sufficient to meet a condition of release, resulting in the insurance payout being trapped inside the SMSF at the time of need.

TPD insurance: The way TPD is defined in the insurance policy will be critical in determining whether a claim is paid and if the proceeds can be released to the member. TPD cover can be provided under 'own occupation' or 'any occupation'. The terms

of TPD 'own occupation' are likely to be narrower than the permanent incapacity definition under the super laws.

So while this may be considered more appropriate for a member, it may result in the insurance proceeds being retained in the SMSF until an effective condition of release is met.

Conversely, the more general 'any occupation' definition could be harder to successfully claim against, but is better aligned with the super laws' permanent incapacity definition.

Split policies: There may be scope to split certain insurance policies by retaining the portion matching the super law definitions within the SMSF, and the remaining portion outside. This structure can help to maximise tax benefits without entirely jeopardising accessibility of insurance proceeds.

Further, premiums for TPD 'own occupation' definition will only be partially deductible. The super laws prescribe a percentage of TPD insurance costs that can be claimed as a deduction.

Payment restrictions: Similar payment restrictions may exist where income protection policies are held in an SMSF. This can occur where cover is provided on an agreed value basis but the claim value (that is 75% of the member's income at the time the policy was taken out) exceeds the member's income at the time the claim is made. This excess amount would be trapped in the SMSF until a further condition of release is met.

Taxation: Life insurance proceeds are taxed if paid to non-dependents for tax purposes, which include independent adult children over the age of 18. The tax amount could be up to 31.5% which would significantly deplete the death benefit.

Fund balance: Insurance premiums paid from SMSFs will reduce the balance of your fund. This is especially relevant for members who are not working – such as members on parental leave or long service leave – if contributions are not made to the SMSF to replenish the outgoing value of the premiums.

And remember, premiums may only be paid by an SMSF where the fund is the owner of the policy. If the SMSF pays the premiums for a policy owned by the member, this could break the rules concerning the early release of superannuation.

Life insurance premiums paid by the SMSF have definite benefits, but careful consideration should be given to a number of potential pitfalls.

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Did you know?

We've just updated our share market sector allocation recommendations in the 'Investments' section of our website. Click here to see our latest allocations.

Don't miss this!

Charlie Aitken is on SuperTV talking to Peter Switzer about why the Australian stock market is underperforming Wall Street. Watch the video here.