Switzer Super Report

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No fear

Today will be a test for Europe's Greek debt remedy and many experts out there say we're going to see a default. But why aren't the markets freaking out? I tell you why I'm not scared in my column today.

Also in the *Switzer Super Report*, Charlie Aitken names a stock that is a 'have' as opposed to a 'have not' in this two-speed economy, while we also take a look at an ETF that gives you exposure to the outperforming mining services sector. Plus, we explain why an audit could be the best thing to happen to your SMSF, and we tell you why it's important to understand the super definition of 'dependants'. Enjoy the report!

Sincerely,

Peter Switzer

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Why I'm not running from a Greek default

by Peter Switzer

Regular readers know I'm cautiously positive and I'm fully invested because I'm investing for the long-term; the potential unknown implications of the Greek 'default' have me concerned – but I'm not bailing out.

Today, European time, will be the first big test for the Greek bailout deal. There are a number reasons why I'm coping with the unknowns surrounding the Greek deal, and why those who insure against defaults on bonds via credit default swaps are not hopping mad that their insurance cover is not kicking in.

By the way, I'm a little confused why some experts say that a Greek default is imminent, but I'm comforted by the fact that the stock market is defying gravity, though that can't last forever considering the great two months we have seen this year. I expect a sell-off, but you have to be impressed at the market's reaction to China's revelation that it had cut its growth target from 8% to 7.5%.

Greek default

But back to the default. Nick Parsons, the head of research at National Australia Bank, thinks the markets have become desensitised to all things Greek and default-related.

"Technically the default is inevitable. There is another meeting at 11 March and we expect it will be a default," he said. "It might even ultimately lead to Greece's exiting from European Union itself."

"Many of the derivative contracts which had been written upon default have already expired. A year ago it might have proved a catastrophe. In two weeks very little will come of it. The market is prepared for this," Mr Parsons explained.

I have to say, there are plenty of people bellyaching on the internet pondering why the International Swap and Derivative Association (ISDA) has said no to coughing up on the insurance to private creditors who have copped a €100 billion haircut to make Greece's debt look manageable. Some say the ISDA thinks Greek bonds now have more credibility, but others says it has protected the banks who are supposed to pay up when a default happens. By not calling, the debt renegotiation saves the insurers but doesn't help the so-called insured!

No fear

I'm worried that as this evening's talks loom that maybe there is a derivatives storm that many have not seen on their market radar screens, but on the other hand, I do like the current market reaction, which is showing little panic. In recent weeks in the US, the VIX, or fear index, has been around 17-18, which is very low and indicates that the spook factor is not important right now.

One issue that has to be factored into your investment decisions is whether what goes on in Europe this week in relation to Greece could set up a 'me too' action where other PIIGS debtor countries – Portugal, Ireland, Italy and Spain – ask for easier debt terms and more bondholders end up with close-shave haircuts.

I'm relying on the smart guys of the world – the International Monetary Fund, the World Bank, the G20, the European Central Bank and possibly the European Union (though I have my doubts on the latter organisation after two years of stupidity) – to have already looked at the potential fallout from a derivatives problem linked to Greek sovereign debt, and that's why markets aren't very nervous.

But what about Lehman Brothers, you say? The smart guys missed that, including the ratings agencies, which are paid to rate financial organisations, so why

won't they miss it again?

My answer to this is that in 2008 the derivatives implications of the sub-prime mess were not front of mind, except for a few insiders who made money out of it. This time the whole financial and governmental world have to be focused on this.

If there was a risk, our own Reserve Bank of Australia (RBA) should be across it and interest rates should be 0.5% lower. The RBA's relaxed stance on Europe and the fact it held rates steady this week makes me less scared about the unknown.

Of course, if a financial meltdown does a re-run in 2012 then the key people at the RBA should be shown the door for being incompetent.

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A stock that is one of the 'haves'

by Charlie Aitken

While Treasurer Wayne Swan continues to bring unwanted negative attention to Australia with his personal attacks on Australian business people, perhaps he should be more focused on the rapidly deteriorating economic data on the east coast of Australia.

Treasurer Swan believes the right course of action for Australia is the largest fiscal contraction in Australian spending in over a decade – right at a time when east coast Australia is clearly suffering from Dutch Disease.

I realise Treasurer Swan believes he will achieve some sort of economic credibility by delivering a surplus, but not only will he be incapable of delivering that surplus as tax receipts collapse, but his brand of fiscal austerity will lead to growth in Australian gross domestic product (GDP) and company profits being lower than otherwise achievable. It will also lead to unemployment being higher than expected.

Tax change?

I just can't help but think some of Swan's recent jibber is softening us all up for a change to the Mining Resource Rent Tax (MRRT) to fill his growing budget revenue hole. The big miners should be sceptical of their agreement with Canberra and I believe some of BHP and RIO's recent heavy underperformance is based on valid fears of revisions to the MRRT deal.

There was a series of data released in Australia early this week that confirm my genuine concerns about East Coast Australia this year. The most concerning was the Australian Industry Group-Commonwealth Bank Performance of Services Index (PSI), which dropped 5.3 points to 46.7 in the month. The retreat below the 50-point level indicates services contracted in the month. New orders dropped to their lowest level in 12 months in February, down 8.5 points to 45.6.

But not only is the services sector physically going backwards, the data is showing Australia business is holding more inventory. Australian inventories rose by 1.4% in the fourth quarter of 2011 compared with an expected 0.3% rise, which saw Australian profits fall 6.5% in the quarter.

East coast struggling

That AI Group PSI reading for February is absolutely accurate in my view. The east coast economy is facing very serious headwinds that are translating to economic activity contraction. The mining and mining investment boom that is underpinning the Aussie dollar and high interest rates in Australia is damaging east coast Australia. It's that simple and that is why I continue to believe this is going to be a difficult year in east coast Australia, at least until the Reserve Bank of Australia works out that its implied 'high dollar policy' is an unmitigated disaster.

And this is all happening before Australian industry has to deal with the world's highest carbon tax from 1 July. You can see why I am running a 'selectively bullish' Australian equity strategy, focusing on the 'haves' and trying to avoid the 'have nots'.

Until I see a genuine change of policy from both the Federal Treasury and the Reserve Bank of Australia, which may come later this year after the damage is done, I will maintain our conservative approach to all this and I will keep using the term "Dutch Disease" because it's exactly what the east coast of Australia is suffering from. The first thing we all need to do is admit we have a problem.

So let's look at the 'haves'.

February was another strong month of iron ore export

shipments from the 'haves' across at Port Hedland. Normally February is the weakest month of the year given it has less shipping days and Chinese New Year. But this year, more ore was moved than in January. Clearly the cyclone would have impacted January's number, but good to see some catch-up is being made with similar volumes to what was going through in October and November last year. Keep in mind, 74.4% of Port Hedland iron ore exports went to China, reminding you that demand from China remains a record high.

Emeco Holdings (EHL) – Buy

Emeco is one of the 'haves'. It is trading on 10.3-times its fiscal 2012 offering, is plus-20% earnings per share (EPS) growth and has a 5% yield. The company is cheap and leveraged to the mining investment boom. This is one mid-cap growth industrial stock with yield support that I would be adding to portfolios.

Arguably the easy money is made in stocks like Emeco when utilisation rates in the existing fleet approaches 90-95% (effective capacity). In the case of this company, this has already been achieved in the Australian business and with global utilisation averaging 85% through to the first half of 2012 (currently 92%) the upside looks somewhat confined to further investment. However, we believe there is still some significant upside in the Indonesian and Canadian businesses, where we see the shift in fleet to core production as lagging the turnaround already visible in Australia.

We continue to see value in Emeco. The continued repositioning of the portfolio to production-based revenues (approaching 90%), increasing contract tenures, with higher minimum hours and capital investment support our forecast for 15% per annum compound EPS growth to fiscal 2014. We retain our Buy rating with our target unchanged.

- **12-month target price: at $1.39**
- **Wednesday's close: $1.06**

Go Australia, Charlie

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JP Goldman

An ETF that taps the growth in mining services

by JP Goldman

The Australian economy is often now described as travelling at 'two speeds'. In the fast lane is the booming mining sector; in the slow lane are the non-mining sectors, such as retailing, manufacturing and housing construction.

One would think given this outlook that the lead sector of the Australian share market would be the resources sector, and companies wallowing in such a seemingly trade exposed sector as 'industrials' would be doing it tough.

But the reality is far different.

Industrials take off

Since the overall S&P/ASX200 index bottomed in early October, industrials have been the strongest performing sector in the rebound. In the five months ending February, the industrials sector has lifted by a whopping 19.9% compared with a gain of only 7.2% in the overall market. The materials sector – which includes most of Australia's major mining companies – has only lifted by 5.7% over this period.

S&P/ASX200 Industrials vs. 30-day moving average

Relative price ratio to S&P/ASX200 index

Why is this so? Turns out that the mining boom is an important reason, as it's now benefiting sectors that might not at first glance seem obvious to many investors.

Not all industrials are strong

Of course, the industrials sector does include some transport and manufacturing firms that find themselves on the wrong side of the mining boom. But it also includes most of Australia's major engineering and construction firms that are enjoying good business due to the ramping up in mining exploration and development.

According to the Australian Bureau of Statistic's latest capital expenditure survey, the value of mining investment is expected to rise by over 70% this financial year, and by a further 60% next financial year.

Mining services strength

It's no surprise, therefore, that six of the top 10 performing industrial sector stocks over the past six month are engineering and construction firms, including NRW Holdings, Leighton Holdings, Macmahon Holdings, and Boart Longyear.

Another industrial firm benefiting from the mining boom – though this time in the transportation sub-sector – is QR National.

Of course, with a lot of due diligence, investors could probably pick a few stocks in the industrials sector in order to gain exposure to this engineering and construction boom. But there's an even easier and perhaps less riskier way for those simply seeking broad exposure to the sector – through an exchange-traded fund, or ETF.

An Industrials ETF

ETF provider Australian Indexed Investments currently has six sector-based ETFs trading on the ASX, one of which (IDD) tracks the S&P/ASX200 industrial sector. The annual management fee is 0.43%, and in exchange investors can gain broad exposure to the sector by holding only one investment.

IDD Top Stock Holdings

Company	Weight
Brambles Limited	14.10%
Transurban Group	10.84%
QR National	8.24%
Asciano Ltd	6.32%
Leighton Holdings	5.61%
Qantas Airways	5.23%
Campbell Brothers	5.20%
Toll Holdings	4.94%
Sydney Airport	4.83%
Seek Limited	2.89%

Source: Australian Indexed Investments

At this stage, however, this is still a relatively new ETF and is not that actively traded. Last month, only $1.6 million in funds under management and an average daily bid-offer spread of 0.71% according to ASX's monthly ETF report.

The bottom line

That said, IDD is still a good way to seek broad exposure to the sector, provided investors buy carefully – such as, for example, using limit orders rather than market orders, and haggling for better prices when volumes seem small and/or the best bid and offer spreads seem too wide (read more about how to trade ETFs during times of low liquidity).

Due to the ASX requirement of active market making in ETFs, investors should always find modest quantities of this ETF for sale or purchase on the market at around the net-asset-value of the underlying stocks that it holds. And as market makers can generate new ETFs as needed, they will always make more supply available at prices near the net asset value (NAV) as long as there is demand.

News Flash

In January, JP Goldman told you about the introduction of bond ETFs to the Australian market. Well, the first fixed-interest ETFs have now been announced. Russell Investments is launching three bond ETFs: the Russell Australian Government Bond ETF (ASX:RGB), the Russell Australian Semi-Government Bond ETF (ASX:RSM) and Russell Australian Select Corporate Bond ETF (ASX:RCB). Stay tuned for more on these products in an upcoming edition of the *Switzer Super Report*.

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Why an audit could be the best thing for your SMSF

by Jo Heighway

Naturally, when you hear the word 'audit' your first reaction is likely to turn around and run the other way – fast – not because you have anything to hide, of course, but let's be honest; being audited doesn't sound like the most fun way to spend a day.

The annual audit of your self-managed super fund (SMSF) is very different though. It's not like being audited by the Australian Tax Office (ATO), and in fact, it has many benefits to you as a trustee.

Wise investment

A good quality audit can be one of the smartest investments your SMSF ever makes. This is because your auditor is your safety net and can deliver some significant savings by:

- Checking the allocation of contributions before they are reported to the ATO so you don't cop an unexpected extra tax bill.
- Revaluing your super fund's investments so you know exactly what your super is worth.
- Identifying investments held in wrong names that are at risk to creditors and others.
- Finding mortgages over assets that shouldn't be there!
- Ensuring your investments are performing in line with your investment strategy.
- Maximising the tax effectiveness of your superannuation balances.
- Reviewing legal documents to ensure they have been properly prepared and your rights are protected.
- Giving you comfort in your advisors and yourself as a trustee.

These are my secrets for how to have a positive audit experience each year.

Your auditor works for you

It's very important to understand that your auditor works for you, not against you.

Your auditor is engaged by you to provide an opinion on how your fund has fared over the past 12 months. What you should get is an independent report card as to whether your fund is complying with the rules, and comfort that your accountant has prepared the financial statements and annual return correctly for you.

Understanding that a good quality independent auditor has your best interests at heart is the first step to a positive audit experience.

Be proactive

Most auditors have pre-audit checklists that set out the types of records they will need to audit your SMSF each year. Ask for a copy!

If you know what sort of paperwork your auditor needs up front, you can be proactive about keeping good records. This will save you so much time and effort when audit time rolls around.

There's nothing worse than being told the auditor needs something and you threw it out because no one ever told you to keep it.

As a heads up, any transactions between an SMSF and its members (or related parties) will always attract more attention from the auditor, so pay extra special attention to documenting these transactions.

Prevention is better than the cure

Building a relationship with your auditor that enables you to 'ask before you act' is vital. Before you proceed

with a significant transaction, you should feel free to talk to your auditor about it. A good auditor can really help you avoid problems before they happen.

Consider asking your auditor questions such as:

- What are the key rules I need to consider, both in setting up the investment arrangement initially and in the ongoing maintenance of the investment?
- What could go wrong?
- What sort of documents should I keep?
- What common mistakes should I avoid?

Be up front

The majority of breaches are caused by genuine mistakes. We're all human; it's OK to make mistakes!

Don't try to be clever trying to cover these things up. The more open and honest you are, the easier it is for your auditor to give you the most accurate opinion and recommend a solution.

Your best asset when things go wrong

If your auditor finds issues, ask them what they recommend you do to fix it. If you have an experienced auditor they will have seen just about everything, so let them help you make it right again.

It surprises me how often I come across trustees who don't even know who their auditor is, what their qualification is, or what relationship the auditor has with their advisor or accountant.

You should never under-value the relationship between you and your auditor. Quite often they can be your greatest asset.

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It all depends on the dependants

by Andrew Bloore

The dictionary may be your first port of call when identifying the meaning of words, but this could lead you astray when defining a 'dependant' when it comes to super.

This is because the dictionary, the Australian Tax Office (ATO) and the super laws each have their own take on who is and isn't a dependant. But why does this definition matter?

The definition of 'dependant' becomes highly relevant when a member of your self-managed super fund (SMSF) dies and a super death benefit is paid; not only does the definition determine who gets paid, but also how the benefit is taxed in the hands of a beneficiary.

Super dependants

This definition of 'dependant' in the Superannuation Industry Supervision (SIS) Act determines who can receive a super death benefit. This definition includes the spouse and any child of the person, and from 1 July 2004, any person with whom the person has an 'interdependency relationship' with. The inclusive definition means that a dependant under common law principles (generally a person who is financially dependent on the deceased) is also covered.

Tax dependants

The Income Tax Assessment Act (ITAA) 1997 contains the definition of 'death benefits dependant', which is used for the purposes of the taxation of super death benefits once paid, as a dependant or non-dependant.

Dependant	Super	Tax
Spouse		
Married	Yes	Yes
De facto	Yes	Yes
Former	No	Yes
Same sex	Yes	Yes
Child (birth, step, ex-nuptial or adopted)		
Under age 18	Yes	Yes
Over age 18	Yes	No
Financial dependant (full or partial)	Yes	Yes
Interdependency relationship	Yes	Yes

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Spouse

A spouse is a dependant regardless of whether the spouse was financially dependent on the deceased. A spouse includes to whom, at the time of death, the deceased was married to or with whom they were in a de facto relationship with or in a relationship that was registered under a law of a State or Territory (whether of the same sex or a different sex).

Important: Former spouses are dependants for tax purposes only – not for super.

Child

This includes any person, regardless of age, who at the member's death was the member's natural, step, adopted, ex-nuptial or current spouse's child, including a child who was born through artificial conception procedures or under surrogacy arrangements with the member's current spouse

Important: A child for tax purposes does not include a child age 18 or over.

Financial dependant and interdependency relationships have the following definitions for the purposes of both a super and tax dependant:

Financial dependant

A person who was financially dependent on the member at the time of the member's death is considered a dependant. This means that the person could have been either wholly or partially financially dependent on the member to maintain their normal standard of living.

It is the trustee's responsibility to decide whether a person was financially dependent on the member at the time of death.

Interdependency relationship

A dependant includes a person who was in an interdependency relationship with the deceased at the time of death. A person will have had an interdependency relationship with the deceased if they had a close personal relationship, they lived together, and one or each of them provided financial support, domestic support and personal care for the other at the time of the member's death.

Examples include adult children who lived with elderly parents to care for them, or any person who resided with and significantly cared for the member just before the member's death, that would be more substantial than that from a mere friend or flatmate.

If a person had a close personal relationship with the member, but did not satisfy the other criteria due to either person having had a physical, intellectual or psychiatric disability, or they are temporarily living apart due to one or both temporarily working overseas or in gaol, an interdependency relationship will still prevail.

Other circumstances taken into account include duration of the relationship, care and support of children, degree of commitment to a shared life and emotional support.

Importantly, interdependency relationships may have existed whether or not the person and the member were related. However, this is not the case if the care and support is provided by a person under an employment contract, contract for services or through another organisation.

Next step

Once a beneficiary is identified as a super dependant, the form and taxation of the super death benefit can then be determined. Understanding the different definitions of dependants is imperative in understanding how the super and tax acts apply to super death benefits. The final outcomes all depend on the dependants!

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Did you know?

You can listen in to Peter Switzer's *The Super Show*, broadcast at 21:00-22:00 AEST on Sydney's 2GB and Melbourne's 3MTR radio stations, Monday to Thursday. Or, tune in on the internet from anywhere in the world! Just go to the 2GB website and click on "Listen Live".

Don't miss this!

The market will be closely watching the US non-farm payrolls figures out Friday evening, our time, for confirmation that the US economy really is strengthening. About 200,000 jobs are expected to have been created in February, so a number well above or below this mark will move stocks – one way or the other!