Switzer Super Report

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Perpetually speaking

Have I been too bullish on stocks? I'm travelling around with the A-team from Perpetual this week and they're not as 'cautiously optimistic' as I have been this year. I tell you what they think in my column today.

Also in the *Switzer Super Report*, Charlie Aitken talks about BHP's stock price fall, IAG's hybrid issue and gives his outlook for the Aussie dollar, while Vas Kolesnikoff uses this week's news from David Jones, Kathmandu and Leighton to explain why timely disclosure is so important to investors. Plus, we have two ETFs for those looking for energy and oil exposure, and we look at how to maximise the tax-free component of your super using a re-contribution strategy. All the best on the market!

Sincerely,

Peter Switzer

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Perpetually into shares: my thoughts from the road

by Peter Switzer

I've been hanging out with the A-team from Perpetual this week because I'm the MC for their roadshow briefing with the country's financial advisers. And if these guys are right, I might have been a little too bullish being cautiously optimistic about stocks this year, but this is not to say that you won't have a good year with stocks!

"Que?" as Manuel from *Fawlty Towers* might have inquired.

Yep, Matt Williams, the Head of Equities at Perpetual thinks it is a "mug's game" trying to pick where the index might go, and he is not alone because there are many variables that can hit and hurt an index. However, he is still bullish on shares.

Get picky

Williams argues now is the time for stock picking, and that's his, as well as Perpetual's, long suit. On a 10-year basis, a number of their funds have been in the 'best of breed' category and while it doesn't mean the fund management team is faultless, it does mean you should take into account their learned, professional views.

Williams believes there are a number of structural challenges affecting the overall stock market, including the high dollar, infrastructure bottlenecks, credit problems, regulatory red tape and the dominance of mining companies powered by China, which in turn has created an accentuated two-speed economy. And this has created a Reserve-Bank policy approach that aims to kill future inflation linked to mining investment and exports, which means the rest of the economy simply has to adjust until the dollar along with China goes off the boil.

It is this structural change that explains why the US stock market is up over 100% since 9 March 2009 while we are lucky to be up 40%!

Okay, this might be a little too negative for me, but it could end up being realistic. That said, the A-team still has stocks it likes.

Good stocks

Williams says the stocks fall into two categories: dividend payers and growth stocks; but best of all there are companies he wants to keep, at least for now. The stock picker can be a buy-and-hold player, but they also can be in and out depending on their price targets for their chosen companies.

In the dividend-paying space Williams likes Telstra (who doesn't nowadays?), Tatts Group, Crown, IAG, Orica, ASX and Westpac.

On the latter, I asked his colleague, Charlie Lanchester why this bank was singled out and he basically admitted that all the big four banks are good dividend plays but Westpac is simply nicely priced at the moment.

Perpetual's energy analyst, Andy Blakely, is quietly confident that the China story is, and will be, HUGE and he likes the companies in the LNG space, which he argues has enormous growth projections. Here he likes Oil Search, QR National and Santos.

Two ways for SMSFs to invest

I have always argued that there are two standout ways to run an SMSF portfolio. The first is a buy, set and forget strategy where you get great dividend payers and only occasionally change when you think management is changing the game or where the game has actually changed – David Jones is a case in point.

On the other hand, you can adopt an active manager

stance and here you become an amateur copycat of a professional fund manager.

In such a case, you might be a buyer of David Jones, though you could wait for more declines in its share price. Or you might take the position that DJs will eventually get its online strategy right. They might close some stores, sell some real estate and buy some online rivals, which could do a lot for its share price. This kind of thing takes courage, but that's what fund managers have to do daily.

By the way, Matt Williams did admit he is not always right, so his call on the index might not be right – but I bet his calls on most of these stocks will be pretty good.

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BHP, IAG and hedging that US ski trip now

by Charlie Aitken

Invitation to give a keynote address at an iron ore conference: $0.

Cab fare to the iron ore conference: $20.

$5,000,000,000 in market capitalisation lost in your own stock after you speak: Priceless.

BHP moves the market

Resource stocks and commodities led global declines on Tuesday night as all the China bears cited BHP's comments on iron ore "flattening" as confirmation of everything they believe in.

But let me let you in on a little secret: neither BHP, Beijing nor the good Lord himself knows what Chinese steel production will be in 2020. Nobody has a crystal ball, particularly when it comes to commodity pricing.

The reason BHP ADRs (-3.3%) got hit harder than most is because global investors, reading a Bloomberg headline, correctly questioned, "Hey, if you are bearish on iron ore, why are you going ahead with record capex spend?"

I think BHP need to clarify their position because I actually don't think their iron ore presentation was bearish at all (eg. a predicted iron ore floor price of $120 a tonne). The problem was the global financial press focused on one word and one word only – flattening – and that was the end of the story.

It's not structural

It looks like a bubble, smells like a bubble, but it's "structural" – really?

The biggest difference between my view and the Reserve Bank of Australia's view is they believe flows into Australian bonds and the Australian dollar are structural, while I believe they are nothing more than cyclical. Yes, they are massive and unprecedented cyclical flows, but to believe they are structural (ie. permanent) and then set policy based on this is a huge error in my view.

The RBA seems to believe global bond and currency investors are giving a huge vote of confidence to Australian fiscal and monetary policy settings. In my view, that is total rubbish.

We are the only G20 nation in the world not trying to lower our currency, which is in turn interpreted as a 'high dollar policy', while our cash rates are the highest in the G20. Demand for Aussie dollars and Aussie-dollar bonds is driven by nothing more than interest rate differentials and our unwillingness to intervene in our currency.

Rates are the key

I will guarantee you that on the day the US Federal Reserve (or European Central Bank for that matter) raises interest rates in 2013, the fallacy of this demand for Aussie dollars Aussie-dollar bonds being structural will be exposed. We are simply the global high-yield parking lot, but when those interest rate differentials start narrowing, all this money parked in Australia will head for the exit and the Aussie dollar will be down around US95 cents.

The other question the RBA can't answer, in fact they conveniently ignore it, is this: if the world is so bullish on Australia, why is our equity market one of the worst performing in the world?

Just so we are very clear, I believe the Australian dollar's price has NOTHING to do with commodity demand. It's got NOTHING to do with capex into WA. It is all about global interest rate differentials.

Rates and the Aussie will fall

But the good news is the central bank will be forced to cut cash rates shortly and they will disprove their own structural thesis. The consistently weak domestic data, combined with rising unemployment, low inflationary pressure, falling commodity prices, zero credit growth, falling property prices, weak retail sales and elevated wholesale bank funding costs, will force the RBA to start cutting cash rates again as soon as the April board meeting.

There is currently only a 22% chance of an April rate cut priced into debt markets, which means when the RBA does cut rates the very crowded long Aussie-dollar carry trade will get a surprise

My view remains that upside in Australian large-cap equities will be capped until we get physical confirmation of lower cash rates and a lower Australian dollar from the RBA. That day is not as far away as the consensus currently thinks.

Nothing about this is structural; nothing. It's time to short the Aussie dollar before it destroys its own demand.

My best advice is to hedge the 2013 Colorado ski trip now.

IAG Convertible Preference Shares (IAGPC) – At a 4% margin, the price is right

IAG has launched a new convertible preference share (CPS) issue primarily to fund the redemption of the $350 million fixed-rate IAG Reset Preference Shares (IAGPA) in June.

The security structure is similar to that adopted on the recent Westpac CPS (WBCPC) and ANZ CPS3 (ANZPC) issues. IAGPC has one new feature called a Non-Viability Trigger Event. This is a more subjective test whereby conversion of IAGPC into IAG shares is required if APRA determines that IAG would become non-viable in the absence of conversion, or a public sector injection of capital.

The most comparable security to IAGPC is the IAG Reset Exchangeable Security (IANG), both with issue margins of 4% (reflecting the grossed-up value of franking). While the duration of IAGPC is up to 2.5 years shorter than IANG converted at the first optional exchange date, this benefit is neutralised through the time value of money of paying half-yearly dividends and the Non-Viability Trigger Event.

Overall we assess a fair value margin of 3.85% (same as IANG). This provides a 0.6% premium to the 3.25% WBCPC issue margin, reflecting the more volatile nature of insurance earnings.

Issue overview

Issuer	IAG
Issue ASX code	IAGPC
Face value	$100
Estimated offer size	$350m
Bookbuild margin	4.00%
Franking	100%
Dividend payments	Half yearly
Minimum application	$5,000
First optional conversion	1 May 2017
Mandatory conversion	1 May 2019

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Why investors deserve to get timely disclosure

by Vas Kolesnikoff

With global markets having somewhat digested the solution for the Greek sovereign debt crisis, is there another eurozone problem sitting somewhere?

The markets will take time to restore themselves to some level of normality as the solutions work themselves though each of the troubled economies and globally. We should therefore become accustomed to living with uncertainty and volatility for quite a while yet. If one thing is certain, timely disclosure will help investors.

Retail stocks

We have just seen what this means in the Australian retail sector where David Jones went into a trading halt prior to an announcement. We knew then that it was not going to be pretty. On Wednesday, its stock took another 10% hit (down over 50% for the year) when it reported that earnings will be another 20% lower and that it had undergone a strategic review to look for new avenues in retail. Frankly, DJ's upmarket retail is just not relevant in these troubled times with cheaper products available elsewhere and over the internet.

Kathmandu also reported that earnings would be 40% lower in its extremely competitive space. Global forces are coming to bear on Australian stocks and this week's announcements clearly demonstrate our two-speed economy.

Leighton Holdings

We also heard that Leighton Holdings had agreed to a $300,000 penalty from the Australian Securities and Investments Commission (ASIC) over breaches of the company's continuous disclosure requirements one year ago. You may recall at the time that Leighton also went into a trading halt, after which it announced that upon a strategic review of its business, it had discovered it had lost $1 billion on three construction contracts. The company urgently raised capital to shore-up its balance sheet and the stock price took a big hit. You may ask how a company suddenly discovers that it lost that much money? Perhaps the answer is now clear.

Timely disclosure is key

What is also clear is that timely disclosure is everything. Investors need to be aware of all the facts immediately and delaying the inevitable is not a solution. The sooner companies announce where they are seeing problems in their businesses, the more informed investors and the market will be so as to avoid sudden and large stock price movements that correct the knowledge gap. In the meantime, investors need to watch the signs.

When I look at indicators of risk and how people manage it, I think about gold – a zero coupon bond. Investors park their money in gold knowing that there are no distributions, however, they bet on selling their investment at some point in the future to get their returns.

Gold is as thought of as a safe-harbour investment. The long-term trend for gold over the past 10 years confirms that the world was becoming a riskier place; however, now even the safe harbour is quite volatile.

Over the last 30-days, the price of spot gold has fluctuated US$145 within a range of US$1,643-$1,788 per ounce. An 8% swing in this period may not sound much; however, if we think back by precisely 10 years when the price of gold was at US$290, then we can appreciate the significance of this absolute dollar-value price movement, and the massive increase in the price of gold over this time.

Over the past six months, the All Ordinaries has also

fluctuated by about 10%. While some companies are experiencing material falls in their stock prices, some have their earnings and dividends remaining stable. Examples here include the Big Four banks and even retailers like JB Hi Fi and Super Retail Group. Total shareholder returns, however, are mixed where we see volatile or downward trending asset values, in spite of earnings and dividends being intact.

Have investors received their bonus?

In all the announcements, the big question for investors is whether executives and boards are doing their jobs when investors are not quite getting what they want, and some parts of the company's workforce are made redundant or experience pressure. Perhaps enough is enough; we may agree that in the short term, some executives and boards have done their jobs in part and are entitled to their very attractive salaries; however, indulgences through bonuses should be moderated for short-term results in an environment of falling or volatile assets values.

Theory after all states, that the value of the asset is the sum of the earnings expectations for that asset in the future as discounted for an appropriate level of risk. With the greater risk to earnings as we are seeing in corporate announcements, assets values fall in line with the potential for earnings to be lower in the future. Theory therefore also suggests that executive and board emoluments must be tempered in the current age of asset value and earnings uncertainty in the hands of investors.

Company insiders cannot be said to have achieved their requirements with an entitlement to a bonus unless investors have received their bonus; that is, their capital is intact and an appropriate return on that capital is achieved. Boards must bear this important point in mind when they are considering the company's results for the people whose interests they are there to represent.

At the Australian Shareholders' Association, our overriding interest is that appropriate returns are paid first to those taking the greatest risk, namely the investors.

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JP Goldman

ETFs with exposure to energy stocks and oil prices

by JP Goldman

Tensions with Iran and the gradual recovery in the global economy have refocused investor attention on the oil market in recent months. The West-Texas spot price for crude oil has leapt from about US$75 a barrel in early October last year to be now more than US$105 – a rise of 40%. There are fears that oil prices will move higher, which in turn could affect global energy prices more broadly.

So how can investors most easily gain exposure to rising energy costs?

With the introduction of an exchange-traded fund, or ETF, with oil exposure to the Australian market, these choices are becoming easier.

Hedged oil ETF

It's now possible, for example, to buy direct exposure to the US dollar oil price through the BetaShares Crude Oil Index ETF (ASX:OOO), which is also hedged against movements in the Australian dollar. That means investors won't lose out if the Aussie dollar continues to rise – negating oil price returns in US-dollar terms – and allows pure risk exposure to oil prices alone.

Since this ETF's inception on 11 November last year, it has increased by 7.8%, which is close to the 8.2% rise in oil prices over this time.

Note, however, that this index gains exposure to oil prices through the purchase of futures contracts, and there can be some divergence in performance against that of the spot oil price where there are large price premiums or discounts built into the futures curve.

In general, the ETF will tend to underperform movements in the spot oil price when future prices are above it, though outperform when future prices are below the price. The broad movements in both oil prices and the ETF overtime, however, should be similar.

Energy sector ETF

Another option is to buy exposure to the Australian S&P/ASX200 energy sector (ASX:ENY), which includes Australia's leading blue chip energy stocks. This includes companies engaged in the exploration, production and distribution of energy, such as oil, gas, coal and uranium. It includes major oil and gas producers, energy related mining service companies, and petrol refiners and distributors.

However, it excludes some of Australia's major diversified mining companies – such as BHP Billiton – due to their broader exposure to minerals and metals.

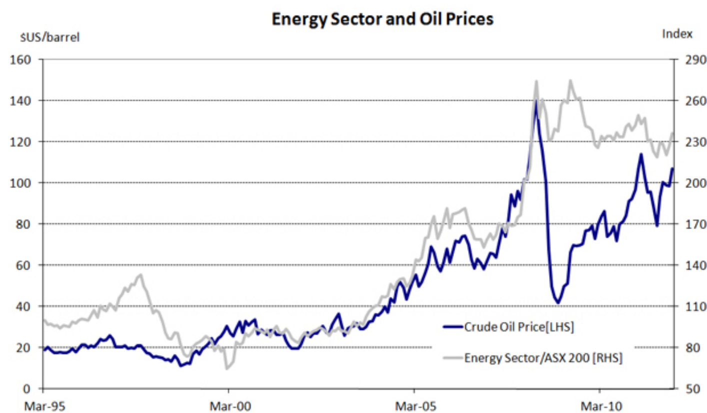
Tops Holdings in the S&P/ASX200 Energy Sector ETF as of 20 March 2012.

Company	Holding (%)
Woodside Petroleum	27.67%
Origin Energy Limited	18.01%
Santos Limited	17.56%
Oil Search Limited	9.69%
Worley Parsons Limited	7.89%
Caltex Australia Limited	2.45%
Beach Energy Ltd	2.15%
Aurora Oil & Gas	1.99%
Whitehaven Coal Limited	1.91%
Paladin Energy	1.9%

Source: Australian Index Investments

As seen in the chart below, there has been a broad

correlation between relative performance of the energy sector and oil prices over recent years, especially during the strong run-up in prices prior to the global financial crisis. The energy sector has been among the strongest sectors in recent months, which is line with the recovery in oil prices.



The outlook for oil

With the United States economy in clear recovery mode, China still posting reasonable growth and Europe shaking off its sovereign debt concerns, the outlook for the global economy – and hence global energy demand – is firming.

At the same time, the United States is still not completely satisfied with Iran's protestations that it is not enriching uranium for the purposes of building its own nuclear bomb. Eventual, military strikes again Iran – by the United States or possibly Israel – still can't be ruled out, which could inflame passions across the critical oil producing Middle East region. Indeed, one scenario still deeply troubling energy analysts is a possible retaliatory move by Iran to block or sabotage the Strait of Hormuz, through which around one-third of the global oil trade passes each year.

That said, geo-political tension aside, the global economy should remains reasonably well supplied with oil for at least the next year or so – with spare production capacity in countries such as Saudi Arabia at reasonable comfortable levels. In recent days, for example, the Saudis have indicated that they could and would pump more oil to supply global markets if needs be in order to keep a cap on prices.

And even if energy prices don't rise, some exposure to oil prices and/or energy companies could provide a handy source of portfolio diversifications, and provide some insurance should the energy outlook turn nasty.

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Making super re-contributions work for you

by Andrew Bloore

Retirees over the age of 60 can receive their superannuation benefits tax free, either as a lump sum or as an income stream. However, should the individual meet a condition of release and withdraw their benefits before 60, there could be tax consequences.

Paying a benefit to a non-tax dependant upon an individual's death may also have tax implications. With these factors in mind, it is beneficial to ensure that any tax-free component of your super is maximised. An effective way to achieve this is by employing a re-contribution strategy. Here's how to do it.

How re-contributions work

A re-contribution strategy, like Transition to Retirement, requires the individual to withdraw benefits from their super (provided they have met a condition of release) and re-contribute those amounts back into their super fund as non-concessional contributions, subject to the contribution caps.

In order to understand how a re-contribution strategy might be effective, it is important to identify the taxable and tax-free components of your super. The super laws define the taxable component of a superannuation interest to be equal to the value of the total interest less the tax-free component. Therefore by enlarging your tax-free component, you can reduce your taxable component.

The tax-free component consists of a crystallised segment and a contributions segment. For the majority of superannuation interests, the crystallised segment was calculated and set at 1 July 2007 and will remain unchanged. (Note: where the individual was under age 60 with an existing income stream at 1 July 2007, the crystallised segment will be triggered by specified events in accordance with section 307-125 of the Income Tax (Transitional Provisions) Act 1997). Therefore, in order to maximise a tax-free component, an individual can increase the contributions segment by increasing their non-concessional contributions.

Example

Sam is 57 in 2011-12, retired and would like to start a pension. Currently, his super balance is $500,000. If he were to start a pension today, his tax-free component would be $200,000 and his taxable component would be $300,000.

Instead, he withdraws a lump sum of $150,000, being $60,000 tax-free and $90,000 taxable – the proportion being the same as the components in the superannuation interest. The tax-free component is tax-free, but the taxable component for super lump sums will need to be included in his personal income tax return as part of his assessable income.

However, as he is aged between 55 and 59 and the taxable component of $60,000 is below the low rate cap (currently $165,000), he will receive a tax offset to ensure that he pays no tax (or Medicare levy) on this amount.

Sam then re-contributes the full $150,000 back into his super fund as a non-concessional contribution. As he is under the age of 65, the non-concessional cap is $150,000 and he does not need to meet a work test in order to contribute.

The re-contribution strategy:

	Tax-free	Taxable	Total
Initial Superannuation Interest	$200,000 (40%)	$300,000 (60%)	$500,000
Lump Sum benefit	($60,000) (40%)	($90,000) (60%)	($150,000)
Tax paid on benefit	$0	$0*	$0
Re-contribution (non-concessional contribution)	$150,000	$0	$15,000
New Superannuation Interest	$290,000 (58%)	$210,000 (42%)	$500,000

** The net rate of tax is 0% on any amount up to the low-rate cap for super lump sum benefits received by individuals aged between age 55 and 60.*

Sam's super balance remains at $500,000, however he has now increased his tax-free component. The re-contribution now forms part of his tax-free component, thereby increasing it from $200,000 originally to $290,000. The taxable component has decreased from $300,000 to $210,000.

If Sam now decides to start a pension, he will have reduced the taxable component, which is assessable at his marginal tax rate less a 15% tax offset.

Further, if he dies and a death benefit is paid to non-tax dependants, they will be subject to tax only on the taxable component. By implementing the re-contribution strategy, he will have reduced the taxable component and thus the tax payable.

Think of these factors first

Importantly, the following issues should be considered before undertaking a re-contribution strategy:

- **You must meet a condition of release to withdraw benefits.**
- **Ensure you are eligible to re-contribute the money back into the super fund.**

Restrictions include individuals aged between 65 and 74 who must meet the work test before contributing. An individual meets the work test if they have been gainfully employed for at least 40 hours in a period of not more than 30 consecutive days in the financial year. No contributions can be accepted if the individual is aged 75 and above with the exception of mandated employer contributions, such as industrial awards. Currently employer super guarantee obligations cease when the employee reaches age 70, but the government has proposed the abolition of the age limit from 1 July 2013. This legislation is currently pending.

- **Watch out for contribution caps.**

Ensure the re-contribution is below the non-concessional cap to avoid excess contributions tax. For those aged 65 and over, the non-concessional cap is $150,000 for 2011-12. For those aged below 65 at any time during 2011-12, the non-concessional cap is $150,000 and the 'bring forward' rule can also be used. This effectively enables the individual to bring forward two years' worth of non-concessional contributions, with a maximum of $450,000 of non-concessional contributions for the income year, without exceeding the cap and triggering excess contributions tax. However if maximum contributions are brought forward to the current financial year, no further non-concessional contributions will be permitted in the following two financial years.

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Don't miss this!

George Boubouras, head of investment strategy at UBS Wealth Management, talks to Peter Switzer about the outlook for small-cap stocks and those that pay dividends. Watch it on Super TV.

Did you know?

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