Switzer Super Report

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A time to buy?

Some prominent financial heads have cautioned superannuation investors against holding too many shares. But is this caution a good sign that now is a time to be buying? I look into this issue in my column today.

Also in the *Switzer Super Report*, as more companies issue profit warnings, Charlie Aitken names his top five stocks to own in this two-speed economy. Plus, Ron Bewley brings you the second part of his strategy on how to gradually build an SMSF stock portfolio, Andrew Bloore explains the three ways the mining tax will impact your super, and Jo Heighway looks at why costly valuations are worth every cent. Enjoy today's edition!

Sincerely,

Peter Switzer

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Do recent warnings signal a time to buy?

by Peter Switzer

At a time when luminaries, such as the Future Fund's ex-chairman David Murray and ex-Treasury boss Ken Henry, have warned Aussie investors and super funds about holding too many shares, the question is, is this a good sign that we should be buying?

To buy or not to buy?

Don't get me wrong, but I reckon Ken was one of the brightest Treasury Secretaries and you would be a mental lightweight to ignore the ex-Commonwealth Bank chief executive, Murray. He, in 2008 before Lehman Brothers collapsed, argued convincingly at a dinner party that fixed income was the smartest strategy at the time. He was proven right.

He also revealed on my *SWITZER* program that the Future Fund, which has to bankroll public servants' super payments, had only a 30% exposure to stocks.

When Ken and David's comments were reported in the press, a number of super fund managers questioned their comments pointing to how attractive stocks were, especially with the benefit of franking credits.

Dividend stocks

Regular readers know how I like dividend paying stocks as it means, with the franking credits, you can get a yield of about 7%. Then if your stocks put on some capital gain, life is all good.

Of course, if you have plenty of capital and you can sleep at nights with it going up and down with the cycle of a stock market, then the dividends become your friends. However, a lot of trustees can't stand capital depletion as they don't know how long it takes to comeback and during rough times, dividends can be cut.

Murray says Australia needs alternatives, such as a deep corporate bond market, and this would mean a lot of investors who are happy with 4-5% over the inflation rate could get that by risking their investments with brand names such as Telstra, Wesfarmers, Woolworths and the like.

Bonds sending signals

Over the past couple of weeks, I have travelled with some smart guys from a prominent funds management business and even their bond's guy thinks the big bond rally over the past 20 years or so, and with their current low yields, points to the relative appeal of shares.

The equities guy wouldn't say the index would necessarily make exchange-traded fund (ETF) players smile, and he would prefer investors to back his judgement, which history has shown has been better than the index.

Our S&P/ASX200 index is captured by Rio Tinto and BHP and the four banks and if you throw in Telstra, that's a lot of the driving force behind the index.

The banks could go higher on the recent positivity in the United States towards financials, but a US slowdown is now being tipped for the second-half of the year. Against that, if our Reserve Bank of Australia cuts rates this year, then maybe our banks will benefit.

The finance guys like stock picking and so do I, and that's why we get some of the best for this newsletter. That said, I am still punting on a solid end to the calendar year and I'm just hoping that we see a solid finish before June 30 but that could be a bigger challenge with Iran, oil prices, Spain and the EU's recession all bound to throw some curve balls over the next few months.

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My top five conviction stocks

by Charlie Aitken

The east coast Australian economy has claimed some more top-100 casualties, with **Leighton Holdings (LEI)** issuing a profit warning this morning and property major S**tockland Group (SGP)** issuing one on Tuesday. We have had five top-100 companies issue profit warnings in the past week, with the clear trend being stocks exposed heavily to Queensland having negative earnings issues.

Leighton and Stockland joined **QR National (QRN)**, **David Jones (DJS)** and **Bank of Queensland (BOQ)** in lowering profit guidance materially.

Stockland said, "A deterioration in the residential market has impacted its residential sales and in addition, prolonged wet weather has resulted in the deferral of a number of settlements into next financial year. Unfortunately the residential market has deteriorated since banks lifted interest rates independent of the RBA and March sales have been lower than expected. The revised guidance assumes sales will continue to be slow for the balance of the financial year."

You'd think Stockland were selling home and land packages in California, but no, this is Australia in a so-called 'mining boom'.

Stockland's profit warning came on the same day another two RBA operatives spoke and Fitch said Australian mortgage arrears were "unexpectedly" rising. Dow Chemical CEO Andrew Liveris also gave a downbeat assessment of Australia's economic prospects.

RBA softening the tone

But before I fire another shot at the RBA, in my understanding of how they attempt to communicate with markets, I think they are actually softening us up for a bad first quarter gross domestic product (GDP) print and a series of cash rate cuts. They tend to jawbone their changing intentions and I sense a genuine softening in their recent communications. There is at least now an acknowledgement that all is not good in Australia.

Bad news is now good news

We have this weird situation now, where in terms of the Australian equity market, domestic bad news, both macro and micro, is actually good news as it gets us one step closer to lower cash rates and a lower Australian dollar.

The other point worth noting is it seems no broker has downgraded Queensland coking coal export forecasts for the first quarter of 2012 despite the QR National profit warning citing coal volumes. These high-value coking coal exports are a big swing factor in Australian GDP and one of the key reasons I believe the first quarter Australian GDP print could be negative.

Top stocks

My top-five high conviction large-cap Australian recommendations are all immune to east coast pressures and remain in earnings and dividend upgrade cycles. They are:

1. **AMP (AMP)**
2. **Crown (CWN)**
3. **Fortescue (FMG)**
4. **Santos (STO)**
5. **Telstra (TLS)**

Our Australian equity strategy remains only selectively bullish (ie. picking stocks), but I hope to upgrade that next Tuesday to 'bullish' (ie. recommending the asset class) when the RBA lowers

cash rates. If I am wrong and they don't cut rates, we will remain only selectively bullish, focused on the 'haves', the vast bulk of whom face Asia or are in structural growth sectors.

The Australian equity market is at a big decision zone again, yet large cap earnings and GDP growth forecasts are being downgraded. The only way to truly crack through technical resistance is via monetary policy change and a lower Australian dollar.

Go Australia, Charlie

Other recommendations:

Bank of Queensland (BOQ) – Sell

Bank of Queensland is raising $450 million as a result of massive write-downs in its commercial property portfolio. The offer price for the new 74 million new shares to be issued is $6.05 – a 17.1% discount to the prior closing price. Looking at the gloomy prospects painted by management, it is difficult to see things improving in the short to medium term. While there is always the possibility of an approach by a larger player, we discount this as long as the bank's business model remains shaky. We have lowered earnings by 87% for 2012 and by 3-4% subsequently having assumed the bank is now adequately provisioned for future commercial property stresses.

- Target price: $5.50 (formerly $7.20)
- Last closing price: $7.65

Commonwealth Bank (CBA) – Hold

Commonwealth Bank remains a lower risk bank with: (1) value upside from further productivity gains to sustain current return on equity (ROE) levels; and (2) strong capital generation to support a higher payout ratio. The bank continues to exhibit the qualities of a utility in the current environment and remains a Hold with a share price trading at close to our price target. While ANZ (price target $24, Buy) and National Australia Bank (price target $26.30, Buy) remain our preferred major banks, we see an opportunity for those seeking exposure to domestic retail/business banking to switch into Commonwealth Bank from Westpac given the latter's higher profit and loss volatility from mark-to-market and reliance on internal Residential mortgage-backed securities for liquidity purposes.

- Target price: $50.80
- Previous close: $50.38

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Watch Charlie's appearance on SWITZER **on the Sky Business Channel on** SuperTV**. He sat down with Peter Switzer to talk about his outlook for the market and the stocks he likes and doesn't like.**

Three ways the mining tax impacts your super

by Andrew Bloore

Super is set to benefit from the Minerals Resource Rent Tax (MRRT), which has passed the Senate and will come into effect on 1 July 2012 after it receives Royal Assent.

The MRRT is part of the government's mining tax package consisting of 11 bills, two of which relate to super. The amendments to the super legislation proposed in the bills were dependent on the passing of the MRRT package because the proceeds of the tax will be used to fund a number of government tax initiatives, including policies to build super savings.

1. Superannuation Guarantee Increase

As part of the package, the compulsory employer-paid Superannuation Guarantee (SG) will gradually increase from the current 9% of an employee's salary, paid quarterly, to 12% by 2019-2020, where it will subsequently remain. This increase intends to boost future retirement incomes.

The schedule for the increase is set out below.

Income year	Charge (%)
2012-13	9
2013-14	9.25
2014-15	9.5
2015-16	10
2016-17	10.5
2017-18	11
2018-19	11.5
2019-20	12

2. Abolishing the Superannuation Guarantee age limit

Amendments will include the removal of the maximum age at which an employer no longer needs to pay an employee super. Currently, employers are not required to make SG contributions for employees who are aged 70 or over. Effective 1 July 2013, employers will have an SG liability for eligible employees regardless of their age.

Also included in the package are amendments to the Income Tax Assessment Act 1997 (ITAA 1997) to allow employers to claim an income tax deduction for SG contributions in the year in which the contribution is made for employees aged 75 and over.

Currently, employers are only able to claim a full deduction for SG contributions made on behalf of their employees up to age 75. The deduction is limited to the amount of the contribution that reduces the employer's SG charge percentage in respect of an employee. The SG charge percentage is the minimum level of employer superannuation contributions applied to each eligible employee's ordinary time earnings.

Example

For example, if in 2013/14, when the SG charge percentage is 9.25%, an employer contributes more than this amount, they will only be allowed a deduction for the amount equal to 9.25%. The amendments, effective 1 July 2013, aim to match the deductibility of SG contributions with the removal of the SG maximum age limit.

3. Introduction of a low income superannuation contribution of up to $500

The package also amends the Superannuation

(Government Co-contribution for Low Income Earners) Act 2003 to enable eligible low-income earners to receive the low income super contribution from 1 July 2012.

The low-income super contribution effectively returns the tax paid on concessional contributions by their super fund. It will also remove the 15% tax penalty that exists for individuals with a 0% personal marginal tax rate in relation to their SG contributions. The amount will be paid into a super account of an individual to directly boost their retirement savings.

Low-income earners are defined as individuals with an adjusted taxable income (being taxable income, adjusted fringe benefits, target foreign income, total net investment losses, tax-free pension or benefit, reportable super contributions less any deductible child maintenance expenditure for that year) not exceeding $37,000. The individual must have concessional contributions for the year (which include SG contributions, salary sacrifice and personal deductible contributions), must not hold a temporary resident visa, and satisfy an income test in which 10% or more of their total income is derived from business or employment.

The amount of the low-income super contribution is calculated at a rate of 15% of the total eligible concessional contributions for the year where the amount payable is $20 or more, up to a maximum payment of $500. It forms part of the contributions segment, and therefore the tax-free component of any super benefit. It is a different payment from the Government super co-contribution which is determined separately.

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A safe strategy for building a stock portfolio – Part 2

by Ron Bewley

In the first part of this two-part series, I explained the strategy behind gradually building a portfolio by starting with a core satellite approach. I also looked at when to buy your stocks and how to choose them.

This week, let's start to build the portfolio further by choosing a few more stocks for when new money comes into the fund – from concessional or non-concessional contributions.

Tread carefully

More care is now needed about which sectors and stocks to buy as stock selection becomes increasingly more important with the value assigned to them. Depending on risk tolerance, the universe of stocks can be extended to include the top 200.

I am not sure that anyone less than an expert should put DIY super funds outside the 200. I hardly ever have more than one such stock (usually none) and any such stocks would have the lowest weights in my portfolio.

How many stocks?

The aim should roughly be to get up to about 15 stocks over time. With no more contributions to the index exchange-traded fund (ETF) after the initial four parcels (totalling $80,000), the dominance of the core will dissipate over the years as new money is invested.

Indeed, if a good 'opportunity' comes along, the investor can think of selling the core and rebalancing into stocks – but only with the appropriate advice or training. Recall how I dodged a few bullets in August last year by selling SPDR's index ETF STW (read, Special Feature: How I handled the market dive).

The aim of this simple strategy is to slow down the enthusiasm of buying 10 or 15 stocks in rapid succession. There is a learning process that is best learnt by 'doing'. Also, if the market happens to move down quickly at the start of the process, the investor who is only in stocks (and not the index) might find the going tough and sell at a temporary bad time. But no course of action is foolproof.

Have a vision

The vision of what the portfolio should look like after a couple of years requires lots of thought. Mine is very much that I keep the number of stocks at less than 20 so that I can follow them all and read up on them and their recommendations – every day!

If I choose a smaller cap stock, then I like to split the work in that sector with one or two others of that ilk to reduce the risk of single stock exposure. Having had a stock go to zero (MFS) during the GFC, I am not inclined to suffer that fate again. Being a so-called 'expert' does not dull the pain.

Dealing with price gains

The one pleasant problem I have not yet resolved properly in my own mind is how I should deal with a stock that I own (such as Lynas, LYC) that rapidly climbs in value.

To sell it off too quickly to keep balance in my portfolio will mean I never get a big return to offset my under-performing stocks. To hang on too long often ends in tears. I prefer a rule that states the maximum holding I might have in any stock of any market cap.

Rapid growers in price tend to start as smaller cap stocks and of smaller weight in my initial holding. So selling off when they look like growing towards my biggest holding is a halfway position that has so far

worked for me. But I do enjoy this problem the most. I previously wrote about how I handled the situation for Lynas. If I get a general rule, I am happy to share it with you and revisit the issue in a future contribution!

Ron Bewley, Executive Director, Woodhall Investment Research.

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Why asset valuations are worth every cent

by Jo Heighway

One the most popular questions I get from trustees is, "Why do I need to get a valuation?"

The question usually arises due to concern over cost. The difficulty and cost associated with valuations will greatly depend on the nature of the asset. Shares, managed funds and other listed investments will generally be no problem given how easy it is for the auditor to obtain daily valuations online. On the other hand, SMSFs with real estate, exotic assets or investments in private companies or trusts will require some additional work, which could see costs rise.

In what circumstances might your auditor require a valuation, and why?

Commencing a pension

If super laws require that when you commence a pension, all super fund assets must be revalued at the date the pension commences.

With the Australian Tax Office (ATO) focusing heavily on exempt pension income claims, it is becoming increasingly common for the ATO to review pension funds and ask for copies of valuations used at pension commencement. If assets have not been revalued to market value, with appropriate evidence to match, the ATO may well decide to disallow the exempt pension income claim, meaning the income of the fund is fully taxable like an accumulation fund.

Current valuations on a regular basis will also ensure that the correct minimum pension (and 10% maximum if applicable) is calculated prior to 30 June each year. Get this wrong and it means extra tax for your SMSF.

Selling assets to your SMSF

It is very common for members to want to transfer assets held personally into their SMSF. There are only limited types of assets that can be sold or transferred to your SMSF, such as:

- Listed securities acquired at market value (only available to 30 June 2012);
- Business real property;
- Widely held trusts; and
- In-house assets (up to 5% of market value of fund assets).

However, none of these assets can be transferred into your fund unless the transfer is done at a fair arm's length market value.

So how can you show your auditor that the sale price was market value?

For listed investments it's easy. But when you are dealing with business real property and in-house assets in particular, it is especially important that you have collected enough evidence to support the price paid.

The larger the transaction, the stronger that evidence must be. And in reality, it's unlikely your auditor will accept anything less than a formal valuation where a commercial property is involved.

Formal valuations become more important still where the asset transfer represents an in-specie contribution to your fund. This is because the ATO will pay particularly close attention to the valuation of the assets just in case they could find you trying to escape excess contributions tax!

In-house assets

If you hold 'in-house assets' in your fund (that is, investments in, loans to or leases with related

parties), your auditor must sign off every year that the value of those in-house assets does not exceed 5% of the market value of the fund's assets.

So unless the auditor is provided with regular updated market valuations, they will not be able to give an unqualified audit opinion that in-house assets remain below 5%.

This means current market valuations of all super fund assets, not just the in-house asset itself!

Dealing with members and related parties

Any time your SMSF enters into transactions with members of the fund, relatives or related parties, your auditor and the ATO will give those transactions more attention. The law requires all transactions with related parties to be on arms-length market terms.

A common example is where a member's business leases commercial property from their SMSF. In this case, a rental appraisal would be required to ensure that the related tenant is paying rent at market rates – nothing more and nothing less.

Payments above market rent may give rise to extra tax under the special income rules. Below market rent may give rise to loans or financial assistance to members or related parties in breach of the super laws.

Putting your hand in your SMSF's pocket to pay for a valuation may seem annoying and unnecessary, but it's often the quickest and cheapest way to ensure your fund gains full advantage of the tax concessions on offer.

Be guided by your auditor in regards to valuations and understand what your auditor is trying to achieve.

When dealing with property, in many cases a real estate agent market appraisal may suffice (get two or three), but if the value of the asset makes up a large part of the total value of the fund's assets, you should get a licensed valuer to advise on the market value – they are qualified and provide a great level of detail and analysis in their valuations that is worth every cent.

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Don't miss this!

Charlie Aitken appeared on *SWITZER* on the Sky Business Channel earlier this week to talk about the stock market, the companies he likes and those he's not too keen on. Watch it on SuperTV.

Did you know?

You can find information on planning your estate – from trust deeds to death benefits – in the 'Super Strategies' section of the *Switzer Super Report* website.

You can also find out more in Tony Negline's recent articles on How binding is my death benefit nomination and Who will replace you as trustee when you die?