Switzer Super Report

Issue 72, 5 April 2012

Where to next?

Our stock market is up 7% in the first three months of this year and up 12% since October, so is it time to follow the old market cliché to 'sell in May', or should we hang in there? I tell you what I'm doing in my column today.

Also in the *Switzer Super Report*, we've got three stock recommendations, one of which is an interesting speculative buy. Plus, we look at the problem of exchange-traded commodities that don't necessarily track what you think they might. And, we tell you why you need to write down your investment strategy and how this could help you get out of trouble with the law.

Happy Easter, and have a great long weekend. The next report will be in your inboxes this Tuesday.

Sincerely,

Peter Switzer

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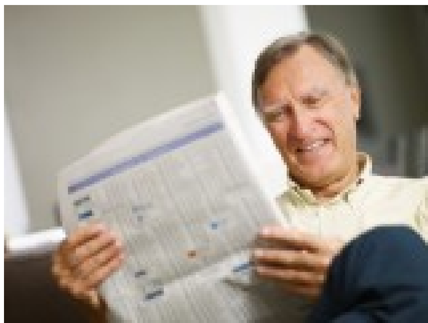

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36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

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One positive quarter down. Where to next?

by Peter Switzer

With the end of the quarter concluding a great three months for stocks – the S&P/ASX200 rose 7%, and is up 12% since last October – the next obvious question is: can stocks keep going up and can local stocks catch up on the big gains Wall Street has churned out?

The market started turning down in April last year and behaved psychotically until about October with a real scary session over August and September, but history actually says April is a pretty good month. On the other hand, the month of May is not so merry for stock players, but could this year be different?

Fear is subsiding

The good news helping stocks is the big jump in US stocks and this is coaxing investors out of the cash or fixed-income option. The VIX, or fear index, is down to 14-15 and this is a measure of share players' skittishness and these readings are good for shares.

Some US investors think the United States has decoupled from Europe, but that could be wishful thinking.

The big test ahead will be the depth of the eurozone recession with this week's reading of the PMI, or manufacturing activity, not pretty reading. It fell to a three-month low of 47.7 in March from 49.3 the previous month.

However, the Poms did release better-than-expected factory numbers and so did the Yanks, and if we throw in the Chinese PMI figure, the outlook for the global economy looks more positive. However, we have to be mindful that the Europeans remain the biggest threat to a good year for stocks.

That said, I think the effort of the European Central Bank (ECB) to provide €1 trillion to European banks for 1% for three years is a powerful weapon for optimists. In addition, the EU finance minister's decision to build up the region's firewall to the size of US$1 trillion is another plus.

This is how the finance ministers summed it up in their official statement: "Finally, robust firewalls have been established..." and that's why Wall Street shot up last Friday.

Where to for domestic stocks?

On the local front, our stocks are up 12.3% since early October and we shouldn't squeal about this, but we do have a desperately weakened economy outside of the mining and the related construction businesses.

I believe the Reserve Bank of Australia (RBA) will be forced to cut interest rates at least two more times this year and that will help kick up consumer and business confidence and this could offset some expected increases in the Aussie dollar. Lower rates and a more contained dollar in the context of a better-than-expected global economy should help our stocks this year, although a pullback has to happen.

That said, I would tip nothing like we saw in September.

Eye on China

Meanwhile, I like the observations of Jordan Kotick, managing director of technical strategy at Barclays Capital. I have watched this guy for years and he has a great strike rate. He expects a good run for China bulls and the Shanghai Composite Index, which does impact our indexes.

Using Dow Theory analysis for the Shanghai Index and the MSCI China Transport Index, Kotick argues there is a strong buy signal.

Dow Theory says the transportation and industrial averages must go higher together to indicate a sustainable bull market.

"In September of 2011, the transports [in China] made a new low, but it wasn't until January of this year that the Shanghai made a new low," Kotick pointed out on CNBC. "So if the Shanghai composite can hold the lows, then what you have is a Dow Theory bull signal for China in the second quarter."

This is just one reason why I am happy to risk the tricky May-October period this year, but as I'm a long-term investor of good companies, even if I am wrong, I will just buy those companies and bring my average share price for holding these money makers down.

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Three stocks that have my eye

by Charlie Aitken

Ausenco (AAX) – Buy

Ausenco appears to be in a strong position to continue the positive earnings momentum it delivered in the second half of 2011. We believe this momentum is likely to be increasingly revenue-driven given the strength of new contract awards so far in 2011 and 2012.

The company has been awarded $130 million worth of new work across four projects in the last week dominated by the Constancia copper project in Peru, which is expected to deliver $100 million in incremental revenue. We estimate Ausenco has been awarded contracts (both announced and unannounced) worth an estimated $212-$257 million in the first three months of this year.

We continue to rate this company as a Buy. It appears to be winning material work in the higher margin segment of the key growth regions of South America, Africa and North America. On the assumption it can execute these contracts well, and deliver sufficient staff numbers, we consider the company well positioned to deliver a strong result in fiscal 2012.

- 12-month target price: $5.03 (unchanged)
- Wednesday's closing price: $4.40

Gerard Lighting Corp (GLG) – Buy

We are initiating coverage of Gerard Lighting with a Buy rating. Cyclical factors are likely to create substantial headwinds for Gerard over the remainder of this financial year and into the first half of FY2013. Yet the transition to higher margin intelligent lighting products (ILP) is seeing Gerard outperform sector growth rates. Valuation at the bottom of the cycle is undemanding at 5.1-times full-year 2012 earnings before interest, tax, depreciation and amortisation (EBITDA), which is a 35% discount to its small-cap peer group.

The company has some aggressive growth targets. Management are targeting sales of $700 million and earnings before interest and tax (EBIT) of $70 million by 2016. To achieve this, they would require a continued transition to ILP products (we estimate $10-15 million EBITDA upside) and further acquisitions (GLG have acquired four businesses for $16 million since listing). Our forecasts are well below the target and, if achieved, suggest considerable upside from current share price levels.

- 12-month target price: $1.20
- Wednesday's closing price: $0.74

Cabral Resources (CBS) – Speculative Buy

Cabral Resources represents an early-stage investment opportunity ahead of initial drilling results, metallurgical test work and subsequent de-risking milestones, including a maiden resource estimate for its Morro do Gergelim project in Bahia State, Brazil in the third quarter. Cabral is differentiated among its peers by a strategic foothold in Bahia State. With possible access to government-funded rail and port infrastructure, the company is well positioned to unlock a significant location advantage in an emerging iron ore province. It had cash of $14.6 million at December 21, 2011.

It is fully funded to commence an initial 3,000m drilling programme at its 100%-owned Morro do Gergelim project and is awaiting final environmental approval for drilling. It plans to deploy two diamond drill rigs in mid-April for a 32-hole programme targeting 331Mt-644Mt of magnetite at Morro do Gergelim. Environmental approval is expected imminently.

- 12-month target price: $0.27

- Wednesday's closing price: $0.086
- Risk: Speculative

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JP Goldman

Buyer beware when it comes to commodity ETFs

by JP Goldman

With the growing array of exchange-traded funds (ETFs) available to Australian investors, there are now even greater opportunities to diversify your portfolio into exotic areas like commodities. In recent months, for example, several commodity-linked ETFs have been launched on the market covering oil, gold, agricultural prices and a broader commodities index.

One issues investors to be remain aware of, however, is that some of these ETFs may not track their respective commodity markets in ways one might generally anticipate. In recent years, some investors in the US – where commodity ETFs have been around a lot longer – have been caught out by this.

Watch what you're tracking

It's not true, for example, that the crude oil ETF launched by BetaShares (ASX:OOO) tracks the spot price of oil. Nor it is true that the BetaShares agricultural ETF (ASX:QAG) tracks a weighted average spot price of corn, wheat, soybeans and sugar.

This is because these ETFs don't invest in psychical commodities holdings but rather buy future contracts related to the price of oil and food, respectively.

An exception is the gold ETF. Storing gold is relatively cheap and easy – indeed much of the world's investment gold stock simply stays in a vault and investors merely swap its ownership with pieces of paper.

But in the case of commodities like oil and food, storage is costly and ETF providers instead gain exposure to price changes by investing in futures contracts and then selling these contracts as they near maturity in order to buy new ones with a longer maturity date. This is known as contract 'rolling'. In this way, these ETFs gain exposure to changes in contract future prices for their relevant commodity without ever needing to take physical delivery of the product.

Negative roll yield

So far so good, but here's the thing: where the commodities' futures price – say the price of oil in six months' time – is higher than the current spot price, investors holding and rolling these contracts over will suffer what is called 'negative roll yield' as they will have to sell their current futures contract near the spot price and buy a more expensive futures contract.

All else constant, it means when the futures market is in 'contango' – that is, the future's price is generally higher than the spot price – the returns from these commodity ETFs will underperform the spot price over time.

By contrast, when the future's price is generally below the spot price – known as 'backwardation', the ETF will outperform the spot price over time. That's because investors in the futures contract will ease a positive roll yield when they swap their higher-priced near-to-maturity contract with a cheaper more distantly dated one.

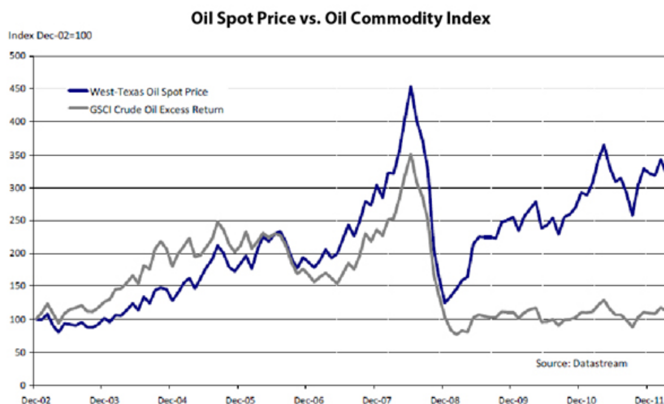
All this sounds technical, but the main point to understand is that when the future price is above the spot price – as is often the case – then the commodity-based ETF will underperform the spot price. If both the spot and futures prices are rising over time, an investor will still make money, but they may be disappointed to find it wasn't as much as was implied by the rise in the spot price alone.

Example

As an example, world oil prices effectively doubled in the three years ended in March – from around US $50 a barrel to US$100. But the underlying index

tracked by the BetaShares crude oil ETF – which also includes a currency hedge to offset changes in the Aussie dollar versus the greenback – only rose by 10%.

The difference in spot oil prices and the GSCI Crude Oil excess return index – tracked by the BetaShares ETF – is readily apparent in the chart below.



It pays to know what you're investing in. And as the saying goes: buyer beware.

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An investment strategy can get you out of a bind

by Andrew Bloore

A solid investment strategy is not only integral to the success of your self-managed super fund (SMSF), but it can also provide you with protection if you're ever called upon to justify an investment decision in the event of a loss.

The investment strategy sets out your super fund's investment objectives and the methods it will adopt to achieve those objectives. It enables SMSF trustees to make investment decisions consistent with their objectives and to increase and protect members' benefits for their retirement.

Having an investment strategy for your SMSF is not optional. The legislation requires each trustee to formulate and give effect to a strategy that has regard to the circumstances of the SMSF as a whole. When making investment decisions, these duties and obligations are imposed on SMSF trustees by super law. The investment strategy obligation forms part of the Superannuation Industry Supervision Act 1993 (SIS) covenants in section 52(2)(f) and these should be included in the governing rules of the SMSF.

What your strategy should include

The strategy should include, but is not limited to:

- The risk involved in making, holding and realising, and the likely return from, the SMSFs investments with regard to the fund's objectives and expected cash flow requirements;
- The composition of the SMSF's investments as a whole, including the extent to which the investments are diverse or involve the fund being exposed to risks from inadequate diversification;
- The liquidity of the SMSF's investments with regard to its expected cash flow requirements; and
- The ability of the SMSF to discharge its existing and prospective liabilities.

Also if the SMSF has any reserves, the trustees must formulate and give effect to a strategy for their prudential management consistent with the SMSF's capacity to discharge its liabilities (whether actual or contingent) as and when they fall due.

Things to consider

The investment strategy should also take into account, among other considerations, the size of the SMSF, its tax position, its membership profile, the costs of administrating an investment, ongoing management costs, access to appropriate advice and engagement of professionals. The strategy should be continually monitored, reviewed regularly and updated when necessary. This is especially important to keep it relevant and updated in light of legislative amendments, member profile changes and changes in the economic climate and financial or investment markets.

Trustees should also address any limitations or investment constraints, such as the sole purpose test and other specific investment standards of the SIS Act. These include borrowing restrictions (section 67), prohibition on acquisition of assets from related parties (section 66), prohibition on financial assistance to members and their relatives (section 65), in-house asset restrictions (section 71) and arm's length requirements (section 109).

Write it down

There is no explicit requirement for the investment strategy to be in writing, but it is the most prudent method to prove that an investment is made within the strategy framework. This is important because the SIS Act permits a person, such as a member or their

dependant, who has suffered a loss or damage from an investment to recover the amounts of that loss or damage from the trustee. However, the investment strategy forms a defence if the trustee establishes that the investment was made in accordance with an investment strategy formulated under the covenant in section 52(2)(f).

Further, a contravention of the requirement to have an acceptable investment strategy can result in the trustees being fined or sued for loss or damages. The fund can lose its compliance status and, as a result, its concessional rate of tax. A trustee who intentionally or recklessly fails to comply with their investment strategy is guilty of an offence and liable to a penalty.

So while an investment strategy is an important legal requirement, it is also a practical approach to ensure that the SMSF's assets are invested appropriately to provide benefits for members in their retirement.

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Don't miss this!

Peter Switzer and Paul Rickard, in conjunction with the Australian Shareholders' Association, will be talking about self-managed super fund investment strategies at three lunchtime events in Sydney in the coming months, and *Switzer Super Report* subscribers can receive a special discount on ticket prices.

Friday 20 April, 12.30pm-2.00pm: Investment strategies and creating a portfolio of stocks for income.

Friday 18 May, 12.30pm-2.00pm: Investing in property and collectables.

Friday 22 June, 12.30pm-2.00pm: Strategies to turbocharge your super, and taking money out.

Prices
Early bird tickets: $20 (last chance to buy today!)
Admission: $30 per person ($40 for non subscribers).

To register, call the ASA on 1300 368 448 and mention that you're a *Switzer Super Report* subscriber.

Did you know?

The Easter long weekend is upon us, which means the next edition of the *Switzer Super Report* will arrive in your inboxes this Tuesday due to the Easter Monday public holiday.

Happy Easter to all!