Switzer Super Report

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Playing catch-up

There's a change in the air and it's not just the colder weather. As I talk about in my note today, there's good reason to believe the gap between US and Aussie stocks will narrow. And I'm not the only one predicting a change; Charlie Aitken has made a significant adjustment to his view on Australian equities.

Also in the *Switzer Super Report*, Professor Ron Bewley gives you a master class in the importance of understanding volatility - something that can help you sleep easier in times like these. Plus, Andrew Bloore lays out the conditions you need to meet if you want to make your super even more tax effective and claim a tax deduction on your personal contributions. Happy reading!

Sincerely,

Peter Switzer

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We'll begin to catch those Yanks

by Peter Switzer

My view on the stock market this year is more cautiously positive than last year. For your information, I always start my forecasting with what is going to happen on Wall Street and then I hope the follow-the-leader pattern happens and we also head in the same direction.

I got it right last year for my US call, but the Australian market let me down. So, what's the story here and will we play catch-up with Wall Street this year?

One of the most frustrating aspects of being in the prediction game is that the criteria you use is never the same and changes in crucial determinants can have a big bearing on what happens to markets and individual stocks.

Let's look at the reasons why our S&P/ASX200 index has lagged the S&P 500. Over 2011, we were down 14.5% while the S&P 500 was flat and the Dow was up 5.5%. And this year, the Yanks have come out of the blocks like Usain Bolt while we've looked like a retired athlete who has got on the grog! The S&P 500's up 8.8% while we are up 5.8%, but at least we are heading in the right direction.

Here are the reasons for our bad showing last year:

• Relatively high interest rates that both attract potential foreign share buyers and which actually make shares less attractive.

• The high dollar has hurt various exporters and import-competing businesses. David Jones is losing business to Bloomingdales in New York because the dollar takes well-heeled travellers overseas to buy their suits and frocks.

• China's slowdown has hit the likes of BHP and Rio and bank stocks worldwide have been beaten up and these six stocks – the four bank and the two big miners – make up a massive chunk of the index!

• Government policy has been a turn off with the carbon tax and the mining tax hitting various industries and businesses as well as undermining their relative competitiveness.

• Leadership issues and the hung parliament have not helped confidence levels and that does not encourage investment and positive economic activity.

• The industrial relations system is now more pro-worker than pro-business and while you can argue that's okay on an equity basis, it is not a plus for both real business and stock market investment.

• Generally, in an increasingly globalised and competitive environment our more generous wage system puts some of our producers at a disadvantage. The likes of Harvey Norman are not only competing with low-cost online rivals they have to beat low-cost competitors overseas.

• All of these factors have contributed to a general wariness towards investing in Australian stocks at a time when the GFC and its impact on share values as well as super balances have spooked many investors. Cash and fixed income is relatively more attractive and as we have not had a massive injection of money from the central bank, as we didn't need it, our stocks have lagged.

What will change?

Going forward, I expect interest rates will be cut at least two more times, which will bring the dollar down. China will progressively look healthier and the US recovery will continue though it could slow a bit.

And I believe over 2012 and 2013 there will be a decent spike in Aussie stocks and we will start to catch up on those tearaway Yanks.

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It's time to change strategy

by Charlie Aitken

Yesterday, I upgraded our view on Australian equities to 'bullish' from 'selectively bullish', feeling the headwinds that have driven the heavy underperformance of Australian equities are easing.

My view remains that if you are bearish on anything Australian, it should be the Australian dollar, which in turn makes me increasingly bullish on underperforming large cap Australian equities. As the Aussie falls, this gap will close in favour of Australian equities. I'd be buying SPI futures and BHP shares today, while shorting the overvalued Aussie.

Stay in May?

For the last two years the tactical trading strategy of "selling in May and going away" has worked brilliantly in Australian equities. Thankfully, at a strategy level we have been on the right side of it on both occasions. Will it be third time lucky for that strategy, or is it time to reverse the seasonal playbook?

From May 2010 to July 2010 the ASX200 lost around 800 points. From May 2011 to October 2011 the ASX200 lost around 1,200 points. Obviously, these back-to-back serious corrections make everyone wary of the pending Northern Hemisphere summer, but I think this year the right approach in Australian equities is to "buy in May and stay".

This should coincide with a period of global stability, remembering the May 2010 and May 2011 corrections were driven, respectively, by fears of a US double-dip recession and the European sovereign debt crisis. Fingers crossed, outside of Iran, Israel or North Korea doing something very, very stupid, I just can't identify what the next global trigger for another minus 20% correction is. Yes, Spanish bond yields require close watching, but that's no different to any other day this year.

Look for large caps

Under that overlay and considering the Reserve Bank of Australia will certainly cut rates in May, the Australian banks will confirm record profits and dividends, the Australian dollar should be down around parity, and China will also be lowering its required reserve ratio, I believe there's every chance the ASX200 – led by large cap laggards – will perform well relatively and absolutely. It may well prove to be the best performing G20 market in raw total returns.

I just think there's a combination of economic variables in Australia pending that should make households, businesses and in turn, investors, less pessimistic. Even the Federal Budget will be less draconian than the political theatre would suggest, and Australia will keep its AAA rating. (PS. America losing its AAA rating hasn't hurt it.)

There's a tonne of cash sitting on the sidelines at the moment with virtually nothing trickling into active Australian equity mandates. My view is as the cash alternative becomes less attractive, due to cash rate cuts, and domestic equities start to slowly outperform, you will see switching at the margin from unfranked fixed-interest yield to fully franked equity yield. That's one of the key reasons I have a heavy amount of fully franked industrial yield in our high conviction large cap recommended list, alongside China facing resource production growth stocks with corporate appeal.

The high conviction large cap recommended list:

- AMP (AMP)
- Crown (CWN)
- Fortescue Metals Group (FMG)
- National Australia Bank (NAB)

- Santos (STO)
- Seven Group (SVW)
- Telstra (TLS)

Similarly, I believe foreign investors are running large underweights in Australia – the largest in many years – while hedge funds have found our largest stocks to be low-risk regional short funding vehicles (earnings downgrades, no merger and acquisition potential). As the Aussie comes down, that positioning will reverse and we will be surprised by the foreign investor demand for large cap Australian equities.

So I am getting more positive on Australian equities right as recent seasonality would suggest that to be foolhardy. If we can see the Aussie below parity in the second half of this year, and I think that is a very high probability, you will see Australian equities do very well. It's that simple in my view.

Go Australia, Charlie.

Other recommendations:

Bank of Queensland (BOQ) – Reduce

We've revised our projections for Bank of Queensland following its placement of Perpetual Equity Placement Shares (PEPS) to raise $150 million. While we are comfortable with the bank's credit risk, our previous net interest margin (NIM) decay was too aggressive in light of the recent 10 basis point rate rise and seven basis point free funds effect from new capital. NIM is thus increased by seven basis points resulting in 11% higher earnings per share across our forecasts. This leads us to raise our price target. However, the Reduce rating is maintained given structural headwinds in the bank's Owner Managed Branch (OMB) model in a low credit growth environment and downside risk from possible changes to the incentive structure.

Prior to the GFC, there was the expectation new OMBs would breakeven close to the end of the first year, with BOQ achieving 15% return on equity from the franchisee after three years. This is unlikely at present with its customers deleveraging and its net interest margin squeezed by expensive wholesale funding. With healthy upfront and trail commissions, the model in our view is biased towards loan generation. Our analysis also suggests that OMB loan growth typically exceeds system when transfer-priced loan yields increase, while deposit growth typically underperforms the system when transfer-priced retail funding costs decrease. Assuming a declining rate environment for assets and liabilities and with the transfer price having rebounded off recent lows, the OMB is probably assured of lower returns that would further crimp BOQ earnings. BOQ's growth thesis also relies on fresh OMBs coming into the pipeline to build up scale. New OMB entrants appear to have dried up since 2006.

- 12-month share price target: $6.15 (previously $5.50)
- Wednesday's close: $6.75

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Why we need to understand volatility

by Ron Bewley

Volatility – one of the major components of risk – can be thought of as the cost of expecting an excess return over cash from the market in the long run.

There is more than one type of volatility and understanding each and how they interact can help investors understand what is going on in the market and how the market might react to future unknown shocks or events.

From my previous columns, readers might now better understand how to construct a portfolio. In this current series, the focus is on managing expectations, entering and exiting the market, and sector rotation or rebalancing a portfolio. My first column on this topic sets the scene.

What is volatility?

A basic tenet of finance is that day-to-day movements in a stock price are largely unpredictable. This concept, and a little statistical theory, helps us to translate day-to-day variations in price into what variation might be expected over the course of a year – the so-called annualised volatility.

By construction, volatility cannot be negative but it can get very big as during the global financial crisis (GFC) and other times. Many experts believe that volatility comes in clusters or short bursts before it settles back to some average value – the so-called mean-reversion property. I, and others, also believe that from time to time, the mean level shifts to a new level for an extended period. Being able to distinguish between a break in the mean and a cluster that will dissipate back to the old mean is central to the way I construct equity portfolios and asset allocations.

A stock price (or index) cannot fall by more than 100%, but it can rise by many multiples, so analysts transform the data before calculating volatility. In this transformed world, returns are symmetric; positive shocks of one magnitude are as likely as negative shocks of the same magnitude. Moreover, it is reasonable to think of annualised (transformed) returns, which are the sum of the daily returns, as being bell-shaped or normally distributed, even though day-to-day returns tend to be small with occasional big positive or big negative shocks.

Annualised volatility

Annualised volatility for the ASX200 or the S&P 500 has averaged about 12% for most of the time that these series have been in existence, but there was a mean shift higher during the GFC and one lower after the GFC.

I show my daily calculations in the chart from the ASX200 since 2000. The solid black line is the mean level (actually the median so that 50% of daily estimates are higher and 50% lower) that shifted down in 2003-2005 then back to the same 12% level until mid 2007. The GFC then took over and the recent data suggests that we are now back to the 12% mean as in pre-GFC times. The dotted lines are a simple extrapolation of the GFC level and a 'normal' level to better judge where we are up to.

For me, the disturbances in the second half of 2011 were a big cluster ready to return to the normal level. That is one reason why I did not panic last year! Indeed, I see the post-GFC period as starting in January 2010 and there have since been two big clusters, each largely due to the European debt crisis.

If we expect that volatility will be 12% for the next 12 months you can see why it is impossible to predict the market with any degree of accuracy. Even if we 'knew' the underlying trend, there is a one-third chance that our prediction for the market will be outside the range of our forecast plus or minus 12%, and one

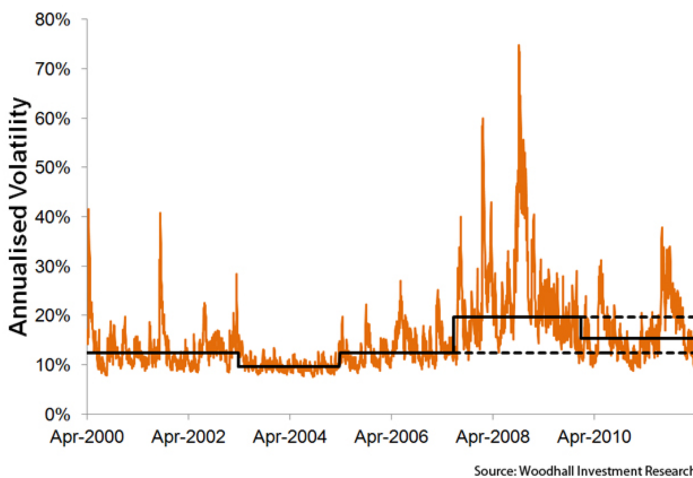
chance in 20 of being outside of our forecast plus or minus 24%.

The bottom line

These calculations come from the normal distribution and our transformed returns. For readers with no statistical background, it does not matter. The important point is the average return on the ASX200 is about 5% so the volatility swamps any forecast.

However, by understanding the concept of volatility – not its calculation – an investor can better navigate his or her way through the noise that bombards the market, but more of that in my next column.

Chart: Daily estimates of annualised volatility of the ASX200



Ron Bewley, Executive Director, Woodhall Investment Research.

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Personal contributions could be tax deductible

by Andrew Bloore

Making a personal contribution to your super is an effective way to grow your retirement funds. Some individuals may also be eligible to claim a tax deduction for 100% of these types of contributions in the year in which they are made, if the following conditions are met:

1) Complying super fund

Personal contributions must be made to a complying super fund in order to obtain super benefits for yourself or, in the event of your death, your dependants.

There is no limit to how much you can contribute and claim as a deduction. However, the contribution will count towards the contributions cap, and therefore any amount above the cap may be subject to excess contribution tax.

2) Age related conditions

If an individual is under 18 years old at the end of the income year in which the contribution is made, the deduction can only be claimed if the income was earned as an employee or a business operator during that year. So if the individual earned purely passive income, such as share dividends, they would not be entitled to the deduction for their personal contribution.

For ages 75 years or older, a deduction can only be claimed for the personal contribution that was made before the 28th day of the month following the month in which the individual turned 75.

Additionally, for individuals aged 65 and up to 75, the work test must be met prior to the contribution being made, whereby they are gainfully employed for at least 40 hours in a period of not more than 30 consecutive days in the financial year.

3) Employees to meet the 10% rule

If you are an employee at any time during the income year, you must meet the 10% rule to be eligible to claim a deduction for a contribution. This means that less than 10% of the total assessable income, reportable fringe benefits and reportable employer superannuation contributions must be in respect of activities as an employee.

For example, in 2011/2012 a self-employed doctor earns $100,000 from his medical practice. During the year, he also worked as an employee in a hospital where his total earnings were $10,000. Since his earnings as an employee were less than 10% of his total earnings of $110,000, he may still be eligible to claim a deduction for personal contributions to his super fund.

4) Notice of intent to claim a deduction

A written notice must be submitted to the super fund in the approved form 'Deduction for personal super contributions' advising the super fund of the amount you intend to claim as a deduction. The notice must be lodged at the earlier of either the day the income tax return was lodged for the year the contributions were made, or the end of the income year after the income year in which the contribution was made.

Once the notice is submitted, it can't be revoked or withdrawn. It can only be varied to the extent that amount intended to be claimed as a deduction relating to the contribution is to be reduced. This includes reducing the amount to nil. Further, the notice can only be varied before the earlier of the day the income tax return was lodged for the year the contributions were made, and the end of the income year after the income year in which the contribution was made. However if the deduction is not allowable, the notice can be varied after this date to reduce the

amount intended to claim as a deduction by the amount that is not allowable.

5) Fund acknowledgement

The super fund has acknowledged the notice of intent and agreed to the amount that the individual intends to claim as a deduction.

What to watch out for:

- **Super co-contributions**

If a personal contribution is claimed as a deduction, the amount that is claimed is not eligible for the government co-contribution. Instead, the amount of the individual's assessable income will be reduced by the amount of the contribution and the fund will pay 15% tax, so only 85% will be credited to the super fund. Alternatively, by not claiming the deduction and contributing the amount as a non-concessional contribution, the fund will not pay 15% tax so the full contribution will be credited to their account. If eligibility requirements are met, they will also receive the government co-contribution.

Careful consideration should be given as to which strategy provides the better outcome.

- **Implications on income**

Personal super contributions claimed as a deduction are included in the super fund's assessable income and taxed at 15%. While the amount of the deduction in respect of the contribution reduces the individual's taxable income, it will be counted towards their reportable super contributions. These reportable contributions will also affect the income tests for certain tax offsets, deductions, concessions, the Medicare levy surcharge, and other government benefits.

- **Watch out for the caps**

The personal contribution claimed as a deduction will form part of the concessional contribution and therefore will be subject to the concessional contribution cap. Ensure that the amount contributed is not greater than the caps to avoid excess contributions tax.

- **Deductible contribution exceeding taxable income**

If the amount of the personal deductible contribution exceeds the individual's taxable income, the excess is classified as a non-concessional contribution and is subject to an additional 31.5% tax on top of the 15% tax paid by the fund. Should this occur, watch out if the non-concessional cap has already been used, as another penalty tax of 46.5% will apply to the excessive contribution. By breaching both the concessional and non-concessional caps, the contribution could lead to a total tax bill of 93%, an outcome one would want to avoid.

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Don't miss this!

Paul Rickard was on SWITZER this week speaking to Peter about hybrid securities versus term deposits, which are offering better returns, and which ones to buy. You can watch it now on SuperTV.

Don't miss this!

We have a comparison table of term deposit rates on our website that we update every week so that you can find the best deals in town. Some of the banks have wound back rates in recent days, but there are still some good ones out there. Click here to view them.