Switzer Super Report

Issue 76, 19 April 2012

Feeling lucky, punk?

One day stocks are up and the next they're down, leaving us long-term investors in a 'Dirty Harry' predicament; that is, do we feel lucky? I tell you how lucky I feel, as well as the stocks I like, in today's note.

Also in the *Switzer Super Report*, Charlie Aitken gives some insight into two of his top high-conviction stocks. Plus, we put bond and equity ETFs side-by-side and compare notes on which ones offer the best returns, and we explain the two ways you can boost your spouse's super and why you may like to do it.

I hope you enjoy today's edition. Please let us know what you think. You can send questions or feedback to questions@switzer.com.au.

Sincerely,

Peter Switzer

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Three stocks I like for a 'Dirty Harry' market

by Peter Switzer

With Wall Street up big time one day and then nervous the next, it is apparent that wealth builders are in a *Dirty Harry* predicament.

Effectively, we are looking at numerous great opportunities based on current share prices, but we have to ask ourselves: ‘Do we feel lucky, punk? Well, do we?’

Lucky stocks

The penny dropped for me last night on my *SWITZER* program on the Sky Business channel when I was interviewing Tom Goode from JB Were in Melbourne. As he covered the **BHP Billiton (BHP)** production story, my crew flashed up the chart of the company’s share price and it screamed out to me that this has to be a great dollar-cost average opportunity. And I reckon **Rio Tinto (RIO)** fits into the same category for the long-term investor – both companies are great value now.

But you might be saying, but what if European nightmares this year send their share prices down even further?

Well, I’d say to you, buy more if you believe in the long-run China story, and that’s exactly what long-term investors have to think about: the long-term. To worry about Europe between May and October – the scariest months for investors – is to be a short-termer.

Sad news

It is significant to me that the sad news that Warren Buffett has prostate cancer came on the day I had my BHP epiphany as he always advises investors to be greedy when others are fearful.

As a long-term investor, I do feel lucky and I like the company, the management, their customers and their long-term story.

The same applies to Rio and I would throw in **Telstra (TLS)** too – I especially love their dividend.

Out there will be an eventual big spike in stocks and BHP and Rio will make a lot of long-term investors who kept the faith very happy and today’s share prices pretty well ensure I am on the money.

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My outlook for BHP and NAB

by Charlie Aitken

One thing I have learned in terms of contrarian value investing is that value alone is not enough to generate outperformance. You need value with a near-term catalyst for that value to be released.

BHP Billiton

In terms of BHP Billiton, I think the near-term value release has three concurrent potential drivers. I think the US natural gas price will bottom (happening), the company will wind back some of its more ambitious capital expenditure (capex) projects and they will rebase the dividend payout ratio higher at the full-year result.

Getting these type of contrarian value calls right basically means picking a sentiment bottom and the road to that sentiment improving. In the case of BHP, sentiment doesn't have to turn positive; it simply has to get less negative.

Over the past 10 years, I don't remember there being such a negative consensus sentiment towards BHP, which is one of the key reasons I have put the stock in my high-conviction buy list.

It's worth remembering BHP generates over 50% of its EBIT (earnings before interest and tax) from iron ore. Export iron ore prices (at about $150 tonnes) continue to rise. If I am right and the natural gas price bottoms, alongside the other strategic developments required from BHP, then the market will go back to focusing on BHP's earnings and cash flow strengths, not the capex spend and natural gas negatives. The market will go from glass three-quarters empty on BHP to glass half full. In share price terms, that will be up around 20% in my opinion. So that's my thesis on BHP, with the stock still trading at eurozone-crisis lows due mainly to US natural gas prices.

National Australia Bank

So where else can we see large cap value with a near-term catalyst for value release? National Australia Bank (NAB).

The upside in NAB shares is substantial. The very simple fact is NAB trades at a discount to its peers due to its capital consumptive, yet return-on-equity constrictive, UK legacy businesses. On May 10, NAB are having a strategy update, and if you join the dots in media speculation about private equity interest in NAB's UK branch network, I think it's fair to come to the conclusion that NAB will announce a UK exit strategy. That would be very much welcomed by equity investors.

NAB is undeniably cheap. The earnings matrix below shows NAB trading on nine-times fiscal 2013 estimates with a 7.9% fully franked yield.

These numbers DON'T include the uplift from exiting the low return UK businesses or the £2.9 billion in capital that would return to NAB's capital base. There is even a fraction of earnings growth, which you wouldn't expect on those price-to-earnings ratios and yields.

I want to be long NAB into the May 10 analyst briefing (and beyond).

While there are many commentators telling investors to switch to fixed interest, I just fail to believe NAB offering a 7.9%FF yield is going to underperform (in after-tax terms) an unfranked Australian government 10-year bond offering 3.80%pa over any reasonable investment period. I can't think of a time where NAB's dividend yield premium (pre franking credits) was at such a large premium to an Australian government long bond. On that basis, you are being paid a monumental premium over the so called 'risk free rate' to buy NAB shares. That monumental equity risk premium is ahead of a clear path to value release

and that is why NAB is the only bank in my high-conviction buy list.

BHP and NAB represent 16.12% of the ASX200 index. By becoming bullish on these bigger cap names, you can see why I am now bullish on Australian equities. For the market to outperform the region and Wall Street, which it is starting to do, you need the big index weights to see support. You also need the Aussie dollar to correct, which is slowly happening.

Go Australia, Charlie.

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Bond ETFs vs equity ETFs

by JP Goldman

Australian investors are increasingly spoilt for choice when it comes to seeking plain vanilla equity or bond market exposure through exchange-traded funds, or ETFs.

All the major ETF providers – StateStreet, Vanguard and iShares – have listed ETFs that track either the top 200 or 300 stocks by market capitalisation. And Vanguard, iShares and Russell also have a range of fixed income ETFs on the market (Read more on broad-based ETFs and bond ETFs).

Investors now have a cheap and easy way to manage their core asset allocation between these two major investment classes. The only question now is what weights to attach to them.

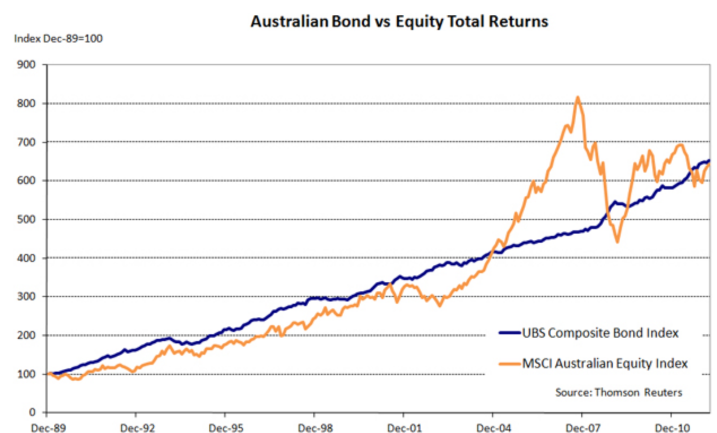
In this regard, a word of caution: given the recent poor performance of equity markets relative to bonds, there's been some commentary of late that the usual preference for the former in a growth portfolios is wrongheaded. Maybe safer bonds are better after all?

Comparing the two

Not helping the equity case is this startling fact: bonds have beaten equities not just in the past year or so, but over the past two decades.

Indeed, in the 22 years between December 1989 and December 2011, the annual compound return from the UBS benchmark Australian composite bond index has been 8.9%. And in exchange for this return, investors have had to endure a standard deviation in annual returns of 7.1%. In other words, investors had a two-thirds chance of getting a return each year between 1.8% and 16%.

In the equity market, the MSCI Australian equity index produced a compound annual return of 8.5% over the same period. Yet this time, investors had to endure a standard deviation in annual returns of 18.6% – or 2.5 times larger. Investors had roughly a two-third chance of getting an annual equity return between minus 10.1% and 27.1%.



So does this mean the old adage that equities produce the best long-run returns is bunkum? Not necessarily.

The past two decades have seen profound structural and cyclical changes in the economy that helped keep equity returns down, but most importantly, temporarily boosted the returns from bonds.

Will inflation rise?

The single greatest change over the past two decades has been a structural decline in the rate of inflation – and by consequence the level of interest rates. As bonds pay out a fixed dollar coupon each year, declining market interest rates boost their capital value – providing investors an added capital gain over and above that of their yield return in the year in which interest rates decline.

Cyclically, the recent global financial crisis has also caused central banks in Europe, Japan and the United States to slash their official policy rates to very low levels and print cash to buy bonds. These actions have driven down long-term bond yields to unusually low (and likely unsustainable) levels. The US 10-year bond yield, for example, is hovering around 2%.

As a result, the GFC has given the return on bonds an added cyclical boost in the past few years.

A change is coming

But as and when the global economy recovers, interest rates should rise to more normal levels – producing capital losses for bonds holders. And the return on bonds will be even worse if the huge private and public debt overhang in the developed world encourages central banks to tolerate higher inflation – which could start to unwind the structural decline in interest rates bond holders have enjoyed over the past two decades.

The most likely long-term return for Australian bonds is probably closer to 5.5-6%. And over the next three to five years, annual returns (factoring in capital losses) could be considerably less.

The pain of the GFC meanwhile has left equity markets reasonably cheap, and likely poised for above average returns over the next few years. The price-to-earnings ratio for the Australian MSCI equity index, for example, ended last month at 13.5 – compared with a 22-year average of 17.5. Prices could rise by 30% relative to current earnings just to get the PE ratio back to average – which equates to an added 5.5% annual return if achieved over, say, five years.

On top of this, equity investors should benefit from a trend rise in earnings over time (around 6% on average per year) plus a dividend yield of around 3.5 to 4%.

All up, perhaps a more relevant investment adage to keep in mind is that past returns are not necessarily a good indicator of future performance. Indeed, bonds returns are likely to remain relatively less volatile, but they're unlikely to keep beating equity returns in the next few years. The pendulum is due to swing the other way.

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How to boost your spouse's super

by Andrew Bloore

Contributing to your spouse's super may be a tax effective way to boost their retirement savings. It's also a strategy that could be particularly useful in instances where there is a gap in retirement age between you and your spouse.

There are two ways in which you can share your super with your spouse:

1. Spouse super contributions; and
2. Contributions splitting.

Spouse super contributions

Spouse super contributions may allow you to claim a tax offset for the contribution if certain conditions are satisfied. These contributions are particularly effective when made on behalf of non-working or low-income-earning spouses, or where one spouse has a greater super account than the other.

You may be able to claim a tax offset of up to $540 depending on the amount of the contribution made and the recipient's assessable income (AI), reportable fringe benefits (RFB) and reportable employer superannuation contributions (RESC) for the income year.

While there is no limit on the amount of the contribution, it is classified as a non-concessional contribution and therefore subject to the spouse's non-concessional contributions cap. As such you cannot claim the contribution as a deduction. However, the amount of the tax offset it limited to a maximum of $540, which is calculated as 18% of the lesser of:

- $3000 – [(recipient spouse's AI + RFB + RESC) - $10,800)]; and
- the amount of the spouse contribution.

The maximum tax offset tapers off when the recipient's total income exceeds $10,800, and is completely depleted when their income reaches $13,800.

To be eligible, the recipient must be your spouse. A spouse includes a person who, although not legally married to you, lives with you on a genuine domestic basis as your husband or wife. It doesn't include a person to whom you are married, but who lives separately and apart from you on a permanent basis.

While there are no employment requirements for you as the contributor, your spouse must meet the work test at the time the contribution is made if they are aged 65 but below 70. This means they are gainfully employed for at least 40 hours in a consecutive period of 30 days in the financial year. Spouse contributions cannot be accepted when the recipient is aged over 70.

Also, both you and your spouse must be Australian residents at the time the contributions are made, and the contribution must be made to a complying super fund to provide super benefits for your spouse or provide death benefits for your spouse's dependants.

You are able to claim the tax offset for spouse contributions in your tax return.

Splitting contributions with your spouse

Super contribution splitting also enables couples to grow two super balances. This may be relevant where spouses wish to even up their super accounts, or direct super to the older spouse nearing age 60 where benefits may be withdrawn tax free.

There are two types of splittable contributions:

1. Taxed splittable contributions; and

2. Untaxed splittable employer contributions.

Taxed splittable contributions allow you to transfer up to 85% of the financial year's concessional contributions to your spouse (up to the concessional contribution cap). These include contributions made by employers, including salary sacrifice contributions, and any personal contributions that are to be claimed as a deduction. The maximum that can be split is the lesser of 85% of concessional contributions for the financial year, and the concessional contributions cap for that financial year.

Untaxed splittable employer contributions are employer contributions for members of a public sector super scheme. The maximum splittable amount is 100% of the concessional contributions cap for that financial year.

You can split contributions regardless of your own age, but your spouse must be less than 55, or if aged between 55 and 64, they must not be retired. The payment of the contribution into the spouse's account is called a 'contributions-splitting super benefit', which is paid as a rollover super benefit.

Contributions splitting may occur in the financial year immediately after the financial year in which the initial contributions were made, or in the financial year in which the contributions were made if the entire benefit is being withdrawn before the end of the year, by a rollover or lump sum benefit.

Watch your cap

Importantly, contribution splitting doesn't reduce your contributions for reporting and contribution cap purposes. For example, if you make concessional contributions worth $30,000, exceeding the concessional cap of $25,000, the amount that could be split would be limited at the cap of $25,000 and not 85% of the $30,000 (which is be $25,500). Further, regardless of if you plan to split the contributions, you will still be considered to have exceeded your cap.

Some considerations to be aware of are that contribution splitting may only be made once during the same contribution period. Also, if you wish to claim a tax deduction for personal super contributions, you must lodge that notice before notifying your fund that you want to split your contributions.

Further, super funds are not required to offer contributions splitting, therefore it is important to check whether this will affect you and your spouse before attempting a transaction.

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Don't miss this!

Peter Switzer and Paul Rickard are talking to investors in Sydney tomorrow on **'SMSF Investment strategies and creating a portfolio of stocks for income'**.

Tickets are $30 each, a special price for *Switzer Super Report* subscribers.

To reserve your spot, call the Australian Shareholders' Association now on 1300-368-448. Or for more information, visit australianshareholders.com.au.

Did you know?

John McGrath of McGrath Estate Agents was on *SWITZER* on Sky Business earlier this week with his outlook for the property market. Watch what he has to say about the real estate market on Super TV.