Switzer Super Report

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Proven strategy

As most of us are in stocks for the long-term, we have the benefit of using history to help us determine a proven investment strategy, and I talk about mine in my note today.

Also in the *Switzer Super Report*, we've spoken about how a change is in the air in recent weeks, and I'm not just talking about the autumn chill. Today, Charlie Aitken expands on the stocks and sectors he thinks will lead the way in the second-half of this year. Plus, Professor Ron Bewley helps you understand when and when not to worry about volatility in the stock market, and we bring your attention to potential tax issues that arise when transferring overseas super home to Australia. Have a good one!

Sincerely,

Peter Switzer

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Sticking to this proven investment strategy

by Peter Switzer

We had a potential financial planning client who only had $6 million to invest around August last year and while many of us would have loved to be him, he once had $20 million!

That's why he came to see us, but because he was so pessimistic after reading a whole pile of stories from journalists who know very little and who continually quote doomsday merchants that are either talking up their own investment book or who are simply economists who are bad guessers, he was not up for change.

Missed opportunity

He wanted to play it safe and I could understand his view as a 6% term deposit on $6 million would return a nice $360,000 a year, but I still regret that I didn't argue with him. I guess there were 14 million reasons – the amount of dollars he had lost – but I am still annoyed because he has missed the bounce in the local stock market from 3,863.9 on September 26 last year to 4,360.4 where the S&P/ASX200 index is today. That's a 13% bounce and so if this potential client had even slipped $1 million into an exchange-traded fund (ETF) he would be up $130,000 in only five months and that's ignoring dividends.

Regular readers know I have been cautiously optimistic that stocks are going up this year, as I was last year and the year before that. I must admit, I only care what happens on a financial-year basis because that is the only one that is relevant to my investments tax-wise.

We've had two good financial years, but the current one is still in negative territory and we have to beat 4,608 by the end of June to finish in the black on share prices. So we need another 5.6% to achieve that, which is not much, but it will be across the tricky months of May, June and July. That said if you add in dividends, we are probably line ball and possibly ahead if your stocks are great dividend payers.

My strategy

When it comes to investing, especially in a self-managed super fund (SMSF), you need to have an investment strategy you can stick to. For me that meant that across 2008 and 2009 I stuck to my strategy of buying great quality companies that paid dividends, which meant that I dollar-cost averaged the holding price of many of my stocks; this is exactly what I am going to do going forward.

I know there will be some dud days, weeks and months, but history is on my side and at the moment some big names are giving me reason to remain cautiously optimistic.

Mario Draghi, the European Central Bank (ECB) boss, seems to copying the US Federal Reserve's Ben Bernanke and this will help the eurozone eventually get through their problems. Bernanke is playing the US market like a concert pianist. Smart people, like Barclays Capital's Larry Kantor, think stocks go higher this year and so do BlackRock's Bob Doll and Meredith Whitney – a US bank bear who is now turning more positive.

Meanwhile locally, Bell Potter Wholesale's star stock tipster Charlie Aitken, who was a tad negative a month ago, is turning positive believing that interest rate cuts and a lower dollar will help our stock market play catch up. He has noticed us not overreacting to overseas stories and this has helped shore up his rising confidence.

I really wish I had talked that potential client into playing my game. However, some people are too stubborn and like to play a changeable game, but that

increases your chances of mistiming and mistake making.

The lesson is: have the guts to stick to an investment strategy that has history on its side.

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Stocks to be bullish about

by Charlie Aitken

There was a little bit of chill in the morning air this morning, but certainly no chill in global equity markets as stronger than expected earnings from many of the world's largest companies combined with comments from Fed Chairman Bernanke generate 'goldilocks' conditions.

What makes me bullish is many of the biggest consumer and industrial cyclical companies in the world are reporting strong earnings growth – Apple, American Express, Caterpillar, Boeing, DuPont, 3M, and even Harley-Davidson!

I genuinely don't think this is lining up as the third 'sell in May and go away' year. This is lining up as 'buy in May and stay', particularly in Australian equities.

There really is something Darwinian about equity markets at the moment. It's a form of 'natural selection' where the strong countries and strong companies are taking from the weak. That is completely different to last year when record high correlations saw the weak and the strong perform in tandem.

Get ready for the shift

While that development is encouraging, what comes next is a massive asset allocation shift from fixed interest, but particularly ultra-low yielding government bonds, into equities. The prospect of that asset allocation shift excites me, but particularly in Australia where 10-year government bonds are now at a 61-year low yield of 3.64% (unfranked) and we have an ageing population that needs yield to live on.

That is why Tuesday's first quarter inflation data was so important. There is absolutely no inflation issue in broader Australia. If anything we are bordering on having a deflation issue. I still think the first quarter GDP number to be released on 6 June will print negative, which when you overlay the small increase of 0.2% core inflation in the quarter opens the door for a very sharp reduction in cash rates.

I think we are on the cusp of back-to-back 50 basis point rate cuts, which would see the cash rate down at 3.25%. That's still a big premium to the world, but far less restrictive than 4.25% in a low growth, low inflation overlay.

Stocks are cheap vs bonds

You can see why I am BULLISH on the second half of 2012 in Australia and Australian equities. Not only are Australian equities grossly, grossly cheap versus government bonds, but there are clear catalysts for that value to be released.

The heavy underperformance of Australian equities has been driven by three factors: the high Australian Dollar, high yield alternatives in fixed interest, and political risk. I could also add in genuine scaremongering by some of the independent newsletters and unhelpful comments from other respected commentators about equities as an asset class.

But now the Australian Dollar has peaked (its lower than 12 months ago but nobody has noticed), fixed-interest yields have peaked, and opinion polls suggest when an election is called there will be the greatest Federal landslide in Australian history. I can't stress enough how these three headwinds turning to tailwinds will be for Australian equities as an asset class.

What we are all underestimating is how quickly confidence can return to households and the asset class. Confidence is like a virus.

What to buy

Personally, I think all roads lead to equities in the second half of this year in Australia. There is going to be a giant switch from unfranked fixed interest yield to fully franked equity yield, while those seeking capital growth will chase Australian resource and resource service stocks.

On that basis I really think it's time to buy listed fund managers, listed asset managers, and dare I say it, listed stockbrokers. Macquarie Group (MQG) reports tomorrow and if they rally post reporting a tough period, it is telling you to wade into the listed asset managers at what is the bottom of the price, volume, inflow and margin cycle.

I have **AMP (AMP)** in my high conviction list as the asset management play, but we also recommend **Perpetual (PPT)**, **IOOF (IFL)**, **Platinum Asset Management (PTM)**, and **K2 Asset Management (KAM)**. In the banks, obviously **Commonwealth Bank (CBA)** and **National Australia Bank (NAB)** have more market leverage via Colonial and MLC than the other two do. The pending bank reporting and dividend season will be solid in Australia and my number one recommendation remains the very cheap NAB.

My high conviction large-cap buy list of **AMP, BHP (BHP), Crown (CWN), Fortescue (FMG), NAB, Santos (STO), Seven Group (SVW)** and **Telstra (TLS)** remains a variety of industrial and resource stocks. Some offer high fully franked sustainable yields, some offer strong earnings per share (EPS) growth, some offer both. I don't think this is about financials vs. resources. Yes, financials have greater yields than resources, but resources have greater growth. To me it's about equities as an asset class versus everything else.

Of course my call on Australian equities breaking out of the nine month trading range and doing significantly better in the second half can only be right if BHP shares perform. Interestingly BHP ADRs are up at $35.43, while – hold the phone – the US natural gas price has rallied 5% to US$2.08btu. BHP has bottomed and will continue to see short-covering/underweight covering support.

I can see FOMO (fear of missing out) and FONI (fear of no income) breaking out everywhere in the second half of 2012 in Australian equities, yet consensus remains bearish and conservative as do equity valuations.

This will accelerate when the independent newsletters, which have great influence in the SMSF market, fall on their bearish swords.

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Understanding volatility: know when not to worry

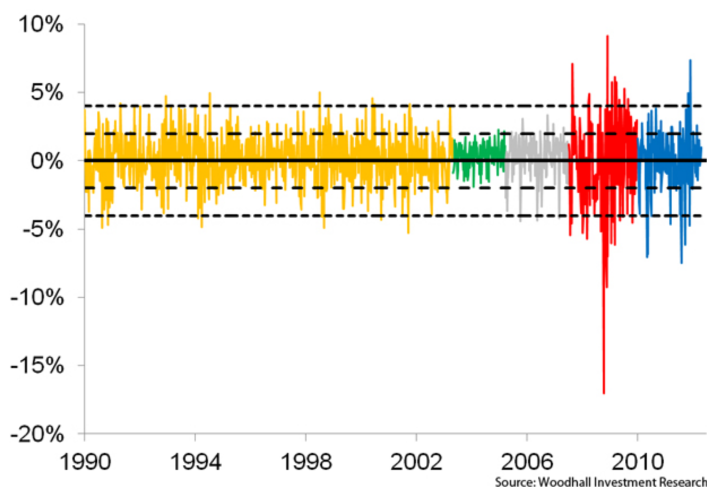
by Ron Bewley

Without understanding current levels of volatility, it is impossible to put day-to-day or week-to-week returns on the stock market into perspective. Do you know when you should be concerned and when you shouldn't?

If we refer back to my last column (Why we need to understand volatility), I presented a chart with the different regimes of annualised volatility clearly marked.

In the chart below, I show the same sort of information, but in a different guise – these are the weekly returns on the ASX200. The different stages of volatility, known as regimes, are shown in different colours and the dotted parallel lines are reference lines for when volatility reaches ±2% and ±4%.

Chart: Weekly returns on the ASX200



In this metric of weekly changes, the volatility regimes that move in a 12% range (that is, the gold and grey) can be interpreted as most weekly changes were within the bounds of ±4%.

In the quiet (green) regime, nearly all of the weekly returns were within ±2%. Therefore, when the grey regime came along, it was quickly noted that the green regime had ended as the -2% bound was sharply breached. Importantly, that meant that gearing levels (for those with a margin loan outside of super) should be reduced back to normal levels and equity exposures might be pegged back a little.

Interestingly, the grey regime was asymmetric, that is +2% was rarely breached but -2% was often breached. We believed at the time this was due to the short-run bubbles in equity prices that were probably associated with investors setting up super funds under the new rules to begin in 2007. As money piled into equities, prices were ramped up for a month or two before a small, sharp correction got the market back on track.

Of course, the range of weekly returns blew out in late 2007 and 2008. The 'unexpected' was the order of the day and it was unlikely that the market could establish a rally until this level of volatility (or risk) subsided.

Where we are now

The blue regime, which has been in place since the start of 2010, has now settled down and all recent weekly returns have been less than 2% in magnitude. This calm market state means that a rally might more easily be sustained than when the market was twitchier and equity exposures might be increased on the basis of a risk-return trade-off with other asset classes.

Thus, we now have a reference for assessing what constitutes a big market move and what action we might consider taking. In the next issue, I will introduce three other measures of volatility which help us better understand how to manage a share portfolio.

Ron Bewley, Executive Director, Woodhall

Investment Research.

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Watch out for tax on overseas pension transfers

by Andrew Bloore

If you have migrated or returned home to Australia, you may be able to transfer your retirement benefits from an overseas super fund to a complying Australian super fund, and benefit from the concessional tax environment.

An amount paid from a foreign super fund has two components:

- the applicable fund earnings (also called the growth component), which are any earnings on the overseas super fund while the individual was an Australian resident; and
- the balance of the transfer.

The tax paid on the foreign super lump sum depends on when the benefit is received, whether the individual makes an election concerning applicable fund earnings, their age and their non-concessional caps.

The balance of the transfer is not assessable to the individual or the fund, however it counts towards the non-concessional cap. Therefore any breach of the cap may attract excess contributions tax.

Paying tax

The applicable fund earnings are taxable and the amount to be paid depends on the outcome of the following three scenarios:

1. The Australian super fund receives the transfer within six months of the individual becoming an Australian tax resident.

The applicable fund earnings are not assessable to the individual or the fund, but they are treated as a non-concessional contribution and subject to the non-concessional cap.

2. The Australian super fund receives the transfer **after** six months of the individual becoming an Australian tax resident, and no election is made regarding the applicable fund earnings.

The applicable fund earnings are not assessable to the fund but are treated as a non-concessional contribution subject to the caps. It will be assessable to the individual at their marginal tax rate (MTR). The Medicare levy may also apply.

3. Australian super fund receives the transfer after six months of the individual becoming an Australian tax resident, and an election is made regarding the applicable fund earnings.

The applicable fund earnings are assessable to the fund at 15%. It doesn't count towards either the concessional or non-concessional caps. It isn't assessable to the individual. The entire balance must be transferred to the Australian super fund in order to use this election. This means that the member cannot do a partial transfer from their overseas fund.

Important: Once an election is made regarding who pays the tax on the applicable fund earnings, the choice is binding and can't be revoked or varied (ATO ID 2012/27).

An issue to consider is in a circumstance where the amount transferred meets either scenario one or two above and is close to the non-concessional contribution cap. The individual should consider the potential impact of exchange rate fluctuations, which may cause the transfer to breach the caps. If the breach was due to foreign exchange movements, the Commissioner may exercise his discretion to disregard the excess contributions based on this and the circumstances of each case (PS LA 2008/1).

Transfers from the UK

Further restrictions apply to UK pension transfers. Any transfer from a UK registered pension scheme to an Australian super fund will be subject to tax up to 55% in the UK unless the Australian super fund is a qualifying recognised overseas pension scheme (QROPS).

Among other requirements, a QROPS status means that the trustee agrees to report all rollovers and payments from the benefit for 10 years after funds are transferred out of a UK pension.

Payments made after 10 years must also be reported unless at the time of the payment the member is not a UK tax resident and has not been within the preceding five tax years. If the amount withdrawn is considered an 'unauthorised payment', such as exceeding 25% of the account balance of the UK transfer amount, transfers to non-QROPS funds, and family law payments, the payment may be subject to UK tax even if it occurs in Australia.

Importantly, if an account is made up of UK transferred amounts and other amounts (including fund earnings), any payments are taken to be made from the UK transferred amount first. It is important to check that your fund meets the definition of QROPS, and can comply with these requirements if this situation applies to you.

Finally, if the member is aged 65 but below 75, they need to meet the work test during the financial year before the contribution is made from their foreign super fund to their Australian super fund. This means that they are gainfully employed for at least 40 hours in a consecutive period of 30 days in the financial year.

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Don't miss this!

Charlie Aitken on Super TV talking about his favourite stocks. We update the videos on Super TV every week, so check back regularly to hear discussions on the latest hot issues.

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