Switzer Super Report

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Winning strategies

May is finally here and what everyone wants to know is if the 'sell in May' rule will play out once again this year. There's been a lot of talk about this year being different, so today, I take a look at the indicators and tell you how I'm playing this market.

Also in the *Switzer Super Report*, Charlie Aitken says this week's interest rate cut has opened up an avenue for change in stocks and he explains where you should put your cash. We have a great feature on Archibald Prize winning artist Tim Storrier and whether the renowned prize boosts the value of artwork. Plus, we look at whether it's time to jump back into Chinese stocks, and we warn you about the three most common SMSF trustee breaches and their consequences. Enjoy the report.

Sincerely,

Peter Switzer

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It's May! Should we sell or stay?

by Peter Switzer

May is upon us and it's the most significant month to take stock of where we are, where we have been, and where we could be heading.

Regular readers know I'm a student of market history and the 'sell in May and go away' rule has a lot of support on Wall Street. In fact, one of Australia's best fund managers, Wilson Asset Management's Geoff Wilson, told me on my Switzer program on Sky Business that his 'dear old dad' invested on that basis and more times than not he got it right!

Last year, over the May to October period, the S&P 500 dropped 19% from 1,363.61 on 30 April 2011, to 1,099.23 on 3 October – a fall of 19%. Since then to the end April 30 this year, the market has headed 27% higher to 1,397.91.

In Australia, the S&P/ASX200 hit a high of 4,913.8 on 21 April 2011, around a week and a half before the start of May, before falling to 3,863.9 on 26 September. That's a 21% fall. Since then, to the end of April, it had risen 14% to 4,396.6.

Bucking the trend

The critical question for us is will 2012 be a year where the 'sell in May' rule ends up being bad advice?

BlackRock's Bob Doll thinks the market grinds higher, but that doesn't rule out the possibility that we will see some significant sell-offs before the stock market embraces another big spike up.

There is also a pretty important consideration for Aussie investors and that's around the fact that we have performed relatively badly compared with Wall Street since the post-GFC rebound on 9 March 2009. Are we set to close the gap? The likes of Geoff Wilson and Phil Ruthven of IBISWorld have predicted an eventual big market rally, with Phil telling us that a 40% jump in one year would not surprise him!

So, what are we seeing that could make us believe in the optimistic story?

The ISM manufacturing number in the USA was a good sign, despite the fact there has been some mixed economic news out of the States. Also, the recent company reporting season has been a bottler, with earnings up around 6% compared with an expectation of 2%. Some 73% of 287 S&P 500 companies that have reported outperformed analysts' expectations. Also, Ben Bernanke has reasserted his commitment to keep interest rates low, which suggests if the US economy needs a third stimulus package, it will get it. Don't you love election years?

Back home, the Commonwealth Bank cutting interest rates by 40 basis points will be a confidence jogger for both consumers and business. It will also bring term deposits down making stocks – especially great dividend payers – much more attractive.

What I'm doing

I know Europe will cause some ructions to stock markets now we're in the May zone, but I will be buying dips and believing that the S&P 500 could head towards 1,550 by year's end and the S&P/ASX 200 could easily bust through 5,000. However, just be prepared for some downs to go with the ups.

As I always say, if you don't like the heat of the stock market kitchen, then play a fixed income game. By the way, if you hate stocks, maybe you should do a 50:50 play – 50% in stocks and 50% in fixed income. In the long run, this mix traces closely the average march of stocks without the highs and those damn lows!

For my part, I say, sell in May – NOT!

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Cyclical stocks are bottoming. Here's what to buy

by Charlie Aitken

My friends, across just about all Australian east coast industrial cyclical sectors, it is the bottom of the cycle right now. How can I make such a bold prediction? Because the Reserve Bank of Australia (RBA) has finally fallen on its monetary policy sword and relief of households and businesses is starting in the form of lower borrowing costs and a lower Australian dollar.

I believe Australian cash rates will be 50 to 75 basis points lower by Christmas. That should equate to around 80 basis points of mortgage rate relief to the average Australian. Yes, the first of the rate reductions will be saved by households to pay higher household living costs, yet the further ones this year will translate to activity and confidence. In a share market sense, that means you have to start buying a few Australian industrial cyclicals that are priced as structurals.

Where I'd put my money

The first place I'd be putting industrial money to work is in equity-market linked earners. Rumours of the equity market's death are greatly exaggerated. As cash rates come down further in the second half of this year, partly in response to reduced government spending, you will see all the grey nomads who have their SMSFs parked in cash realise those unfranked falling cash returns won't pay for their retirement lifestyle expectations. The fear of not enough income (FONI) will become widespread.

SMSFs will be forced into fully franked equity yield for those who want real returns greater than inflation. It's that simple in my view. You can see the US equity markets are trading at four-year highs, not because the US economy is going fantastically well, but because the Fed's zero-interest-rate policy has forced any American who relies on investment income to buy equities if they want a real return higher than inflation. In the US, the alternative to equities is a 10-year Treasury bond yielding 1.95% or cash account yielding zero. Some banks even charge you to place a deposit with them!

In Australia cash still remains an alternative to equities, but Australian 10-year government bonds with a yield at a 60-year low of 3.55% certainly don't. Cash management trust rates of around 3.75% unfranked are also starting to look pretty unattractive, while even yields on hybrid securities have fallen with the bank bill swap rate (BBSW).

The difference in Australia remains that the banks and their never-ending fund issue continue to offer reasonable term deposit rates. However, under the cash rate scenario, I believe even those term deposit rates will drop below the low 4% unfranked mark later this year and that will be the trigger for broader retail investor yield chasing in domestic equities.

I don't believe the current trend of SMFSs favouring cash and fixed interest over equities will prove to be structural. It's a fad, driven by emotion (fear of losing your capital) over economic common sense. Yes, there is less volatility outside of equities, but there are also increasingly lower returns to be found. Return is a function of risk, but you are being paid to take the risk, for example, when National Australia Bank shares yield 7.6% fully franked versus a one year NAB term-deposit yielding 5.5% unfranked.

All the fixed interest gurus will be into me saying I'm a biased equity guy. Yeah whatever, the same biased equity guy who recommended buying Telstra (TLS) with your ears pinned back from the Future Fund at the bottom as they switched to fixed interest.

Equities vs fixed interest

I may well have drunk too much good water in

Melbourne yesterday but I'm genuinely bullish about the prospects for Australian equities in the second half of this year. The Aussie-dollar headwind is easing, the RBA headwind is easing, global growth is recovering, China is on track and it's now only a matter of time before we get a change of Federal Government. A huge percentage of Australian listed companies are priced on price to earnings ratios (P/Es) and dividend yields that suggest they'll suffer no growth forever. Just about everything is priced as a 'growthless oligopoly utility', a situation that will prove way too pessimistic.

What we are all underestimating is how quickly confidence can improve. Confidence drives sentiment and sentiment drives asset prices.

If I am proved right on the second half 2012 call, you need to start positioning now. Many cyclical stocks currently discounted as 'structural' will gap higher even off the whiff of the cycle turning.

Shorts will cover, new money will come in from the sidelines, and there won't be a willing supplier of stock. You could see major gaps higher when the consensus view belatedly agrees that the worst is behind us later this year.

Over the next few weeks I will work with our industrial analysts to find a few bottom-up stock ideas that fit the theme, but I am sure one of the first places to look is in equity market-linked earners. As I write above, rumours of the death of equities have been greatly exaggerated.

Go Australia…Charlie.

Ausenco (AAX): Buy

We continue to rate Ausenco as a Buy. We expect the company to demonstrate that the positive earnings momentum delivered during the second half of 2011 is likely to continue. This improvement is expected to be driven by double-digit revenue growth in contrast to the second half of 2011, which was primarily driven by a reduction in the company's fixed cost base.

- 12-month target price: $5.03
- Wednesday's close: $4.48

Virgin Australia (VAH): Buy

Virgin is beginning to see the early results of a major change in strategy announced by incoming CEO John Borghetti in late 2010. This strategy revolves around improving the yield of the domestic business by focussing on increasing market share in the corporate and government and, to a lesser extent, the regional airline segments. In our view, the strategic repositioning has the potential to significantly change the company given it has been predicted on minimal incremental capital expenditure. On the assumption the company can deliver sustained earnings improvement; we consider a medium-term re-rating likely.

- 12-month price target: $0.50
- Wednesday's close: $0.385

Woodside Petroleum (WPL): Buy

Woodside has surprised the market with an excellent deal on the Browse LNG project. The company has finally delivered some good news about the company's future. The last couple of years have been dominated by delays and cost blow-outs on Pluto, uncertainty over growth projects like Browse, Sunrise and Pluto expansions as well as selling by the company's major shareholder Shell. New MD Peter Coleman has also re-based expectations for growth in his first 12 months in the job. We view the announcement as a turning point and reiterate our Buy recommendation.

- 12-month target price: $47.30
- Wednesday's close: $36.66

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Is it time to jump back into Chinese stocks?

by JP Goldman

One of the traps for the unwary investor is buying into markets that have a great story behind them without regard to current trends. One such case is China.

We all know the story: China is growing rapidly as market-opening reforms are allowing its industrious citizens to catch-up with the living standards in the West. With per-capita income still only around one-fifth that of the United States, there's still a long way to go.

At the same time, China's population of 1.3 billion is 4.5 times that of America's. China's market opportunities are already huge and on current trends are destined to grow much further. Domestically, China is building out its infrastructure to facilitate the conversion of relatively unproductive rural workers into highly productive urban ones. And still reasonably cheap labour costs also mean it remains an export powerhouse and the "workshop to the world".

Past its peak

Yet you wouldn't know it by looking at the Chinese stock market. China's Shanghai Composite Index peaked backed in October 2007 after a furious speculative run-up in the previous two years. Even today, however, stock prices remain 60% below their peak. Last year, prices dropped 21%.

The equity losses are all the more surprising when you consider that the economy has hardly skipped a beat in recent years, and underlying corporate earnings still appear to be growing well.

During the global financial crisis, year-on-year quarterly growth bottomed at 6.5% in early 2009, but had bounced back to 11.9% by year-end. In 2010 and 2011, the economy grew by 9.8% and 8.9% respectively. The economy's resilient performance has been reflected in earnings growth, with the measure of forward earnings from the MSCI China index growing strongly since the global financial crisis.

As should be evident, the fall in the market, therefore, has largely reflected falling valuations – the price-to-forward earnings ratio for the China MSCI index has slumped from 15 in mid-2009 to only 9.2 by the end of April. That compares with a longer-run average of 13.

Why the concern with China?

The massive stimulus program unleashed during the global financial crisis (GFC) to keep the economy afloat unwittingly helped spark a bubble in property speculation. Chinese policy makers have been trying

to reign in lending in the wayward sector ever since – with mixed results. Together with a slowing in exports to the troubled European region, the China pessimists have been vocal in expressing their long-held expectation that the time was ripe for the fast-growing economy to hit a wall.

But China continues to defy expectations. Only this week we learnt that China's official purchasing managers index for the manufacturing sector inched back up to 53.3 in April – a two year high. Annual economic growth slowed to a still robust 8.1% in the March quarter, and officials are aiming for growth of around 7.5% for the year as a whole.

Digging deeper in China's property problems, moreover, it appears excess building and inflated prices have been largely concentrated at the top-end of the market and among mainly China's rich investing elite. These are the type of investors likely to hold their properties for the long-term rather than dump them on the market. More broadly, the process of urbanisation continues to fuel solid underlying demand at the more affordable end of the market.

Finding a bottom

We're not there yet but China's stock market is trying to find a bottom. Once policy makers judge the economy has slowed by enough to loosen their tight credit reigns more extensively. It could lead to a major switch in local investor interest from property to stocks. International investors are also poised to re-enter the market given its cheapness, once they're comfortable that China's economic landing will be soft rather than hard.

So investors should be on the lookout for a change in trend.

How to buy China

Although there are many ways to invest in the Chinese market, perhaps the cheapest and easiest is through the iShare's FTSE China 25 listed exchange traded fund (ASX:IZZ). This invests in the largest and most liquid Chinese stocks listed on the Hong Kong market, and charges an annual management fee of only 0.72% for its effort. Being unhedged, it should also gain if the Aussie dollar starts falling.

One word of warning, however, is that this index has relatively high sector concentration: the financials market makes up 53% of the index, while telecommunications and oil and gas companies account for a further 18% and 15% respectively. That said, when sentiment finally turns in favour of China once again, it's likely to lift all boats.

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The Archibald Prize: is it a jackpot for art investors?

by Alistair Bailey

Jason Benjamin said it was "like a pub fight – everyone comes out to watch it". John Olsen called it a "chook raffle", while The Art Gallery of NSW describes it as Australia's most extraordinary and prestigious art prize.

However you view it (for the record, Olsen echoed the Art Gallery's sentiment in 2005, presumably as he had just won with the superb self-portrait entitled Janus), The Archibald Prize is sure, whether deliberate or not, to court controversy, perhaps not to the stratospheric levels that the Turner Prize does in London, but the Archie has had its fair share; William Dobell's Joshua Smith, Adam Cullen's Wenham, Craig Ruddy's Gulpilil and Richard Bell's In mob we trust, have all ensured that the Archibald's significance has been coupled with a good dose of notoriety.

Winning the prize can be the catalyst to ensuring a long and illustrious career, or not. Take WB McInnes as an example. A seven-time winner of the prize, and although he has a solid auction record of $109,000 set in 2005, of the 495 trades at auction, 485 have been under $15,000 and the three recorded sales in 2012 barely scratched $5,000. Compared to the other extreme, Brett Whiteley, merely a two-time winner, he has an auction record of $3.48 million and 15 sales at auction in excess of $1 million.

A prize-winning artist

So what does the award mean for the 2012 winner Tim Storrier?

Storrier's winning portrait *The histrionic wayfarer (after Bosch) (self portrait)* has been the subject of many a debate on not only the manner in which the winner is selected (by the trustees rather than a board of experts), but also on what constitutes a portrait. Whether one agrees with the result or not, what is not under debate is Storrier's immense talent.

Tim Storrier
The histrionic wayfarer (after Bosch) (self portrait)
Archibald 2012
Art Gallery of New South Wales
31 March - 3 June 2012

As a 19-year-old, Storrier became the youngest artist to be awarded the Sulman Prize (which along with the Wynne Prize, hangs with the Archibald). This was the market's first real awakening to a young artist that had raw talent to burn. Over the ensuing years, Storrier became, and still is, recognised as one the finest draftsmen this country has ever produced.

However, it was the development of his minimalist blazeline paintings in to hyper-realist surreal paintings and installations that really defined Storrier in the market.

People often tell me about how good Storrier's oil paintings are. I wouldn't know, as Storrier is a devotee to acrylic paint. Now there are those that are far more learned than I in fine art, however they will tell you, as I do, that acrylic and oil paints behave very differently. Storrier may well be one of Australia's great draftsmen, however he is arguably one of the world's great masters of acrylic paint. He has the ability to make acrylic look and behave in a similar fashion to oil paint, which is nothing short of technically brilliant. It is this ability, coupled with a unique take on the Australian landscape, that has seen his work collected widely in corporate and institutional collections in Australia and around the world, including the Metropolitan Museum (New York), The National Museum and Tate Museum (London) and The Louvre (Paris).

So, with a CV so strong, why bother entering the prize now? Storrier's position in the context of Australian art seems to be well and truly determined. What is there to be gained?

Well, aside from the prestige of having the major prize on his long list of achievements, I believe we need to take a closer look at the secondary market activity for his work to find the answer.

Under the hammer

Storrier's work went on a run in the auction market from 2002 to 2007. As auction results continued to strengthen so did the primary market prices. With a scarcity of works available on the primary market due to long waiting lists and an infrequent exhibition calendar, the pressure on pricing was evident. Storrier was one of the 'must have' artists at the peak of his creativity. And then we started to hear that investment bank Lehmann Brothers was in a spot of bother…

The impact of the global financial crisis (GFC) has been well documented, but it created a rather unusual set of circumstances for Storrier's work. In 2009, a number of relatively recent Storrier works hit the market due to forced sale by distressed vendors. Major works were being picked up by those brave enough to be bidding at that time – they were few and far between, let me tell you – and Storrier's cast iron prices softened quite considerably.

The catalyst for this was two-fold. The obvious first being that appetite to bid on Fine Art was generally compromised by the frequency and ferocity of margin calls and a lack of confidence in the broader markets.

The second, no doubt forced by the first, saw a seemingly large number of paintings hit the market in close succession at clearly knocked-down prices. Works still sold well – sometimes for over $100,000 – but well off the comparative prices of a few years ago. In some cases, prices softened in the secondary market by up to 40%. A belief that works are selling cheap coupled with there being a volume of work on the market has a stigmatism that over-shadows the context of these results in which they were set. This whole scenario became further compounded with a number of works trading on private treaty.

Return on investment

To put some of these results in to context – many of the works presented during this time were dated from the mid-1990s to early 2000s. A major work by Storrier in the mid-90s would have sold for around $30,000 to $40,000. By 2009, primary market works were consistently selling from about $150,000 up to as high as $400,000. So while selling well under gallery prices, these works still gave the owner a return on their initial investment. Moreover, these works were still assets that were saleable within an illiquid market – no small feat for an illiquid asset. So what we learn from this is that it's important to look at results in context.

It took until late 2010 for Storrier's prices at auction to find some familiar footing, which included a new auction record of $248,000 (inclusive of buyers premium) for Evening (2005). This in itself is interesting. With over 1,000 trades at auction now accumulated from etchings, to photographs, drawings to major paintings, we are now seeing works from a particular period attracting more attention than others in the same oeuvre painted at a different time. This is not unusual; Sidney Nolan's 1950's Ned Kelly

works have a currency that is far beyond that of those painted in the 1970s, for example. If you are going to purchase Storrier's Burning Rope, then, particularly for investment, there is a period to aim for. The same for Burning Logs, paper planes and now faceless portraits!

The bottom line

It is important to realise that not every work Storrier has created is going to be a great investment; this can be down to any number of reasons. However, it is pertinent to remind ourselves that of the top-30 prices realised for his works at auction since 2004, all have been over $100,000.

Is winning the Archibald going to have much of an impact on Storrier's work? On prices, probably not a great deal in the short-term and certainly not the same impact that it would have had on Jeremy Kibel or Luke Cornish, for example, or that it did have for Del Kathryn Barton.

Winning the Sulman will have had more of an impact for Storrier than taking out the Archibald. What winning has done is remind us that Storrier is one of the major living Australian artists and as such, still warrants serious consideration as part of an investment portfolio or collection. Just remember though, the investment lies in the quality.

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The three most common SMSF trustee breaches

by Andrew Bloore

There are very serious consequences for breaching superannuation law and regulations, both for trustees and the self-managed super fund (SMSF). While SMSF trustees have the advantage of managing their own retirement savings, they also have the very serious task of ensuring that the fund, its investments and all its undertakings are done in accordance with super law.

The most common SMSF contraventions as at 30 June 2011, according to the Australian Taxation Office (ATO), are:

1. Loans or Financial Assistance to Members (almost 21% of breaches)

Section 65 in the SIS Act prohibits SMSF trustees from lending money or giving any other financial assistance using the fund to its members or their relatives. SMSFR 2008/1 confirms that financial assistance is considered to include any arrangement where SMSF assets are converted into other assets, diverted, diminished, put at risk, or if there is any prejudice to the SMSF's financial position.

In order to avoid breaching this section, trustees must be vigilant when dealing with members and their relatives. Often, the need to access cash quickly makes borrowing SMSF money a common temptation. To prevent this from happening, it is important to separate bank accounts of the SMSF and individual or business accounts to avoid inadvertently using funds of the SMSF for personal use.

Further, all transactions with members and relatives must be conducted at an arms-length basis. This means that if assets are sold to members or relatives for less than the market value, or bought from them for greater than the market value, it will be caught in section 65. Other situations to watch out for are releasing members or relatives from their obligations to the SMSF, or taking on their financial obligations. Using the SMSF to provide security or give a guarantee for the member or relative's benefit will also contravene this section.

2. In-house Assets (almost 18% of breaches)

Section 71 describes an in-house asset as a loan to, or an investment in a related party of your SMSF, an investment in a related trust of your SMSF, or a lease of an SMSF asset to a related party. Trustees are restricted from investing in in-house assets up to a maximum of 5% of the SMSF's total assets. Some exceptions include Business Real Property leased to a related party, investments in widely-held trusts, tenants-in-common property ownership, and certain investments in related non-geared entities.

Trustees need to be aware of the definition of related party, which is broad and encompasses members and standard employer-sponsors of the SMSF and all Part 8 associates. It is important to know both the SMSF's total asset value and the investment value on the day the in-house asset is acquired because the SMSF is prohibited from acquiring the in-house asset if the fund's in-house assets already exceed 5%, or the acquisition would cause the level to exceed 5%.

Trustees are required to prepare a written plan to dispose of any in-house assets which breach the 5% level. It cannot be diluted by simply acquiring non in-house assets.

3. Failing to lodge income tax returns on time

SMSFs must lodge a return with the ATO every year after being audited. At 30 June 2011, lodgement performance for 2009 was at 93.5%. The 2010 lodgement rate at 5 July was 79.39%. Trustees should be aware that different lodgement dates may apply to SMSFs depending on whether the return is lodged by

self-preparers or tax agents, the SMSF is newly registered, or the SMSF has outstanding returns.

Penalties

Breaching section 65 or 71 may result in either civil penalties or criminal charges against the trustees. The court may order the trustee to pay compensation to the fund, and may order the trustee to pay to the Commonwealth a monetary penalty not exceeding $220,000.

Where the contravention is made knowingly, intentionally or recklessly, with the intention to gain dishonestly or deceive or defraud, criminal penalties may be imposed. These offences are punishable by imprisonment for up to five years. In addition, the SMSF may become non-complying.

The ATO can apply administrative penalties on trustees who lodge SMSF tax returns late, and an interest charge on outstanding debt. SMSF trustees who continue not to lodge returns may receive assessments with penalties. Trustees who do not meet their fund's lodgement obligations may be prosecuted. The SMSF may also be made non-complying in serious cases.

Consequences of Non-Complying SMSFs

Non-complying SMSFs pay 46.5% tax on their income and the market value of its assets (less non-concessional contributions) in the year prior to becoming non-complying. Additionally, amongst other concessions, they are not eligible for CGT discounts or pension tax exemptions, and a general interest charge may be payable.

However when a contravention has occurred the ATO will not necessarily issue a notice of non-complying status or seek civil or criminal penalties through the courts. Instead, after careful consideration of all the circumstances of the case, Section 42A(5) of the SIS Act empowers the Regulator to give a notice to that SMSF that the entity is a complying superannuation fund in relation to the year of income concerned.

They may accept an undertaking from the trustee to rectify the contravention and undertake education, disqualify trustees, freeze SMSF assets or impose administrative penalties against trustees. However the overriding factor is that discretion will only be exercised where an attempt has been made to rectify the breach and ensure compliance in the future.

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Did you know?

The Federal Budget is only days away and while there's a lot of speculation about what could change, one thing the Government has cited is the re-introduction of a super surcharge, which was abolished back in 2005.

The surcharge will affect those who earn more than $300,000 a year, increasing the tax rate from 15% to 30% on Super Guarantee contributions made by employers as well as salary sacrifice contributions. We'll have more details for you after the Budget is released on Tuesday night.

Don't miss this!

Andrew Bloore from Super IQ spoke to me about the changes to superannuation and the re-introduction of the surcharge. Hear what he has to say on Super TV.