Switzer Super Report

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It's not that bad

As expected, the Government has taken the axe to super concessions in its Federal Budget and this will impact quite a few of you reading this now. Paul Rickard runs over what has changed, how it will impact you and what you can do about it in today's *Switzer Super Report*.

Also in today's edition, I talk about one particular market 'doomster' who is scaring the pants off investors, and I tell you why I think things aren't as bad as he predicts. Charlie Aitken gives his thoughts on the Federal Budget and three stocks, and our charts guy takes a look at Telstra to answer whether you should lock in profits now. Plus, we teach you about three methods of reading stock market volatility, and look at the problems that arise in family SMSFs. Enjoy today's edition!

Sincerely,

Peter Switzer

Inside this Issue

Government takes the axe to super concessions
by Paul Rickard
03

02 **Don't get spooked by all the doomsters**
by Peter Switzer
Should SMSFs be in shares or fixed interest?

03 **Government takes the axe to super concessions**
by Paul Rickard
What the changes mean for you and the actions you should take.

05 **Thoughts on the Budget, TLS, IAG, FMG**
by Charlie Aitken
The Federal Budget, Telstra, IAG and Fortescue.

07 **How to read fear in the stock market**
by Ron Bewley
Three useful measures of volatility.

09 **Chart of the Week: take profit in Telstra?**
by Lance Lai
Should you lock in your gains now?

11 **The family SMSF: problems and solutions**
by Andrew Bloore
It can be hard playing happy families when it comes to money.

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Don't get spooked by all the doomsters

by Peter Switzer

I would really like to concentrate on the Federal Budget and how it will help stock prices later in the year but I have to address some pressing issues for self-managed super fund (SMSF) investors pondering their exposure to stocks. The first is: can we trust Europe? And the second: will 2013 be the year of the big stocks spike or will we be hit by a pile of negatives that markets will cave into?

This week in Las Vegas, the world's premier 'doomster' Nouriel Roubini has been talking about a 2013 "global perfect storm" that has sent a few anxiety-ridden shock waves through those investors who listen to this overrated forecaster.

Sure he got the global financial crisis (GFC) right, but if you were an American who has listened to him since 2008, you would have missed the S&P 500's 100%-plus comeback. His excessive negativity would have imprisoned you in term deposits or bonds where you would have been lucky enough to get 1-2% interest!

Even here our S&P/ASX200 index got as low as 3,145.5 on 6 March, 2009. We are now at about 4,275.10, up 36% in three years and if we add, say a low 5% for dividends, that averages out around 18% a year, which compares to around 6.5% on average for those who played the term deposit game.

The doomster

But that said, let's put Roubini's argument in a nutshell and I emphasize 'nut' (though I do respect the fact that when you predict bad news every year eventually you will get it right). He argues issues in the USA, Europe, China and Iran will challenge the global economy and stocks will cop it.

So he sees more eurozone debt and political issues adding to a US slowdown after the generally positive election year as well as the Iran nuclear intransigence and finally China, which he says could be a train wreck. And this all totals up to a bad equation for stocks. He expects to see countries exit the eurozone, with Greece the favourite followed by Portugal and even Spain.

On the US front, he tips the S&P 500 falling to 1,300 and economic growth at 2% – that will be checked for his accuracy, I can assure you! The index is now at 1,356.96 but many analysts see it heading to 1,450 and 1,500.

My outlook

I think if the US scenario is right, the US Federal Reserve boss, Ben Bernanke would try a third quantitative easing stimulus package, which would help stocks, but I am hoping the US can beat the doomster's predictions.

I am also confident that China is not a train wreck and if the positive forces outweigh the negatives by October or so and the Reserve Bank of Australia (RBA) here cuts interest rates as a response to the Government's budget surplus goal, then a lower Aussie dollar will, along with lower rates, help our stock prices trend higher.

I have a number of highly respected forecasters who have been negative for a few years who are in the camp that a share price spike happens at the end of 2012 and getting into 2013. I'm putting my money on them, though, as I say, the doomsters who always tip market misery have to get it right three years out of 10 — that's history's lesson.

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Government takes the axe to super concessions

by Paul Rickard

Those boffins in Treasury who dislike super have had their way and to find savings, the Government has axed the 'over fifties, fifty thousand concessional cap for super balances under $500,000'. I hate to say it, but I foreshadowed this in Budget preview: five potential changes to the cap – it was just going to be too complicated to administer and it was an easy saving.

Everyone's concessional cap is now $25,000 from 1 July, 2012.

Forget talk of a 'two year deferral'; this proposal will never see the light of day again. The best outcome will be if the promised indexation of the concessional cap finally occurs and it is increased to $30,000 in 2014/15.

There are also three other changes that could impact you from 1 July.

1. Additional 15% tax on concessional contributions for high-income earners

Widely telegraphed in advance of the budget, those earning more than $300,000 a year will have their concessional contributions taxed at 30% rather than the standard 15%. What wasn't covered was the actual definition of 'income' – it is not a simple $300,000.

Firstly, concessional contributions (your employer's contribution, salary sacrifice contributions and contributions by a self-employed person claiming a tax deduction) will count as income. For example, if your taxable income is $280,000 and your employer makes $25,000 in concessional contributions, you will trigger the threshold because your income will be assessed as $305,000.

$280,000 + $25,000 = $305,000

The additional tax of 15% (30% in total) will apply to those concessional contributions that take your income over $300,000, which in this case is on the extra $5,000.

More importantly, income includes investment losses. For example, losses on borrowing money to buy shares or from negatively geared property. Technically, the definition of 'income' is:

taxable income + concessional contributions + adjusted fringe benefits + total net investment losses = income

This is going to catch a few people out (I guess a lot more than Treasury's forecast of 128,000). Let's take an example. Assume your taxable income is $200,000, which has been calculated after deducting a net $90,000 loss on three investment properties. You also receive $10,000 in fringe benefits, and your employer makes super contributions of $18,000.

Under this measure, your income is:

Taxable income	$200,000
Concessional contributions	$18,000
Fringe benefits	$10,000
Net investment losses	$90,000
Total	**$318,000**

As you can see, your total income is $18,000 above the $300,000 income trigger, which means your concessional contributions will now be taxed at 30% instead of 15%.

Another issue that arises is, who collects the additional tax? Although there will no doubt be industry consultation, the Government has foreshadowed that in the SMSF sector, each fund will

be responsible for collecting the additional tax. Trustees will need to obtain records of their members' income.

2. Government co-contribution reduces to $500 max

Announced a few months' back, but not given a lot of coverage, the government co-contribution reduces to a maximum of $500 for a low-income earner who makes a personal super contribution. The matching rate also reduces to 50%, so to get the maximum $500 co-contribution, the personal super contribution will need to be $1,000.

There is no change to the income threshold (the person's income has to be under $31,920 to get the maximum co-contribution), however as the benefit has been cut to $500, it phases out completely once the person's income exceeds $46,920.

3. Low income earners won't pay contributions tax

The one positive change (again announced a few months' back) is the Low Income Superannuation Contribution (LISC). Effectively, a person whose income is less than $37,000 will have the contributions tax on concessional contributions returned to the fund, meaning they won't pay any contributions tax. Worth a maximum of $500 (15% of 9% of $37,000), the Australian Taxation Office (ATO) will generally pay the LISC to the superannuation fund.

Like the co-contribution, a key eligibility requirement is that at least 10% of the person's income must come from employment.

Actions to take before 30 June

If you are over 50 and eligible to make contributions, this is the last chance to take advantage of the higher $50,000 concessional contributions cap. Talk to your employer about salary sacrificing, or if self-employed, make tax-deductible contributions. You have until 30 June – don't exceed the cap!

The Government Co-contribution is still $1,000 in 2011/12, and the matching rate is 1:1. If you have a low-income spouse, or adult children who work part time, consider 'arranging' a personal contribution of $1,000 to their super fund. The maximum benefit is payable if the person's income is under $31,920 – in 2011/12, it phases out completely once their income exceeds $61,920. At least 10% of their income must come from employment.

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Thoughts on the Budget, TLS, IAG, FMG

by Charlie Aitken

It seems to me that Swan et al are trying to force the Reserve Bank of Australia (RBA) to use aggressive monetary policy via constrictive fiscal policy. This budget surplus nonsense isn't about anything other than trying to force a deep rate cut cycle ahead of the next election then claim that the government somehow organised it. Isn't the world of populist politics wonderful?

But Swan's surplus and spending cuts in a slowing economic environment will ensure the RBA has no choice but to slash rates and that will see the Aussie dollar fall. I think that's telling me to sell any stock reliant on government spending and switch to those exposed to consumer, rural and business spending. I am also getting more bullish on inbound tourism as the Aussie falls.

Dividend yields more attractive

Yields are being crunched in the government bond market, followed by yields in constant maturity treasuries (CMTs), floating rate hybrids and eventually term deposits, making fully franked equity dividend yields more attractive by the day.

All the grey nomads parked in fixed interest will be forced into equity yield as the year progresses. Sure, days like yesterday reminded retirees why they hate equities, but as incomes get squashed in the second-half of this year, those of you who are retired will likely find you're being forced into high fully franked equity yield.

When you sit back and think about where investors will be forced to go in the second half of this year, it points you to high sustainable dividend yield stocks and east coast cyclicals. One thing I'm sure of is the second-half of this year and beyond will prove that many of these industrial cyclicals weren't structurally challenged – it was just a giant cycle. This is all now about a little bit of short-term pain for long-term gain.

My strategy

My key strategy remains to short the Aussie dollar and long my high conviction large cap equities portfolio, where I have been increasing high fully franked yield and east coast exposure. Yes, some of that list took a hit yesterday, but that just increases their attractiveness in the short and medium-term.

AMP, ANZ (cum 66c)**, BHP, CWN, FMG, NAB, STO, SWM, TLS, WBC** (cum 82c)

Telstra (TLS)

I got a lot of questions on Telstra yesterday after its stock price made another fresh three-year high driven by yield chasing. Most investors were asking me if it's time to take some profits? Well, Telstra has been our best total idea return in years, with the Future Fund's selling turning out to be a true gift from the Nation at what will prove to be the low forever.

The way I see this now is if you are a long-term investor, you should continue to hold Telstra as it heads towards $4, but if you are a short-term trader, Telstra's outperformance of riskier industrial and resource stocks would suggest there are grounds for a trading rotation in the short-term from Telstra to other stocks.

The reason I remain fundamentally positive on Telstra, despite the huge rally (plus dividends), is because I think the company is in an earnings and dividend upgrade cycle, while I also believe, as I wrote a few weeks ago, that Telstra would be re-rated if it bought a little extra growth in the form of Consolidated Media Holdings (CMJ).

I think the market would applaud Telstra buying Consolidated Media and adding to its FOXTEL exposure, and I think you can see that is an accurate call as both stocks have rallied since rumours of a deal emerged. Telstra yields 7.8% fully franked, even at current prices, and it's hard to see a yield like that underperforming in a falling cash rate environment.

Insurance Australia Group (IAG)

Another larger cap industrial I like is Insurance Australia Group. On our updated earnings estimates, IAG trades on 9.6-times full-year 2013, while offering 49% earnings per share (EPS) growth and a prospective 6.8% fully franked yield. Of course, this assumes a normalisation of the claims/natural disaster cycle, which is overdue for IAG. Either way, IAG is seeing premium rate rises that should drive insurance margins back up to 12.2%. We've lifted our 12-month target price on this stock to $3.90 from $3.60, and it's currently trading at about $3.46.

Fortescue Metals Group (FMG)

And finally today, just a short note on Fortescue. We had operatives on the ground at Port Hedland earlier this week and feel the expansion is on track and on budget as guided, while the production for this quarter is playing catch-up after last quarter's cyclone interruptions. The company continues to sell all the iron ore it can produce.

Fortescue has had a series of positive pieces of news in the last few days:

- No diesel fuel rebate cut in the budget (was rumoured to cost FMG $150m if changed).
- Moody's upgrading FMG's debt rating.
- Comments from Teck Cominco last night about "buying a producing iron ore company" (Teck own 3.9% of FMG)
- The Aussie falling to 1.00 US cent … FMG's cost base is in Aussie dollars.
- WTI Oil falling to $96.50. Diesel is FMG's biggest variable cost.
- The iron ore price continuing to hold above $140.00 per tonne.

So fingers crossed, the worst of this anti-Fortescue short-seller sentiment is behind us as fundamentals take over. Anywhere under $5.50, I see Fortescue as a trading and fundamental buy with the company simply priced for its 55mtpa (million tonnes per annum) current production.

Go Australia, Charlie.

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How to read fear in the stock market

by Ron Bewley

Over the past month, I've introduced the concept of volatility based on the closing price of the ASX200 each day or each week. While that understanding is of major importance in managing a share portfolio, there are three other measures of volatility that are needed to get the most out of measuring uncertainty.

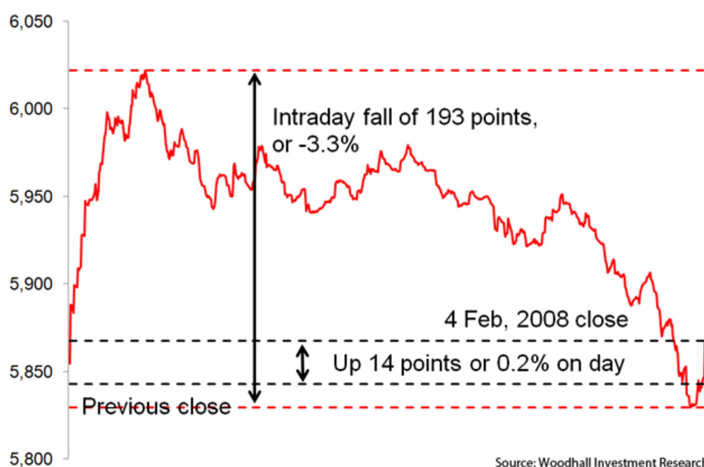
1. Intraday volatility
2. The VIX, or fear index
3. The disorder index

Intraday volatility

Let's look at this example: the market fell from about 6,800 in early November 2007 to just above 5,100 in late January 2008. It then rose to above 6,000 on 4 February 2008 before it again retreated.

As I show in the chart, the market rose about 170 points before morning tea on that day only to fall 193 points before rallying back above 5,850 at the close.

Chart: Intraday variation on the ASX200 on 4 February 2008



Volatility measures that only use end-of-day pricing would consider that day to have been quiet and mildly positive (up 14 points). But to anyone watching the screen that day – as I was – it was a terrifying experience. As a result, I devised a measure of excess volatility – or fear – that represents intra-day movement outside the close-to-close prices. I update my fear chart each week on myWoodhall Investment Research website.

The VIX

There is a commonly used 'fear' index for the S&P 500 called the VIX. It measures implied volatility from options taken on that index. The argument is that when traders fear a fall, they want to use put options to limit their losses and this activity increases implied volatility. Recently, the ASX has created an 'Aussie VIX' for our market. I obviously prefer my measures, but I acknowledge the usefulness of the VIX versions.

My analysis leads me to an important conclusion. When fear is high, expensive markets can fall rapidly and overshoot, and cheap markets can fall further and/or stay cheaper for longer. I will discuss my mispricing measure at a later date and go into more detail on my fear index next time.

The disorder index

A third additional measure of volatility is derived from co-movements of stock or sector returns on a given day. For example, the returns of the 11 major sectors often go up or down together. In that case, cross-sectional volatility – which I call disorder – is low. When returns go in opposite directions, or quite different orders of magnitude in the same direction, disorder is high. I update the disorder index each day and put the time series on my website each week.

When disorder is high it is likely that investors are jumping in and out of sectors making it difficult to

know where the market – or your portfolio – is heading. In my view, this is another variant of fear and I use my disorder measure to confirm or otherwise what my fear index is saying. But the important thing for me is that I have an objective measure of market sentiment. I have used these tools every day for years to better understand what to do – if anything.

Since the beginning of the year, volatility, fear and disorder have behaved as they did before the onset of the global financial crisis (GFC). So even as the French and Greek elections play out, I feel that our market is more likely to take bad news in its stride than it otherwise would have done. Had these fear measures been high, I would have sold more than I did last week to be ready to buy back in at a later, more peaceful date.

Ron Bewley is the Executive Director of Woodhall Investment Research.

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Chart of the Week: take profit in Telstra?

by Lance Lai

I have been away in California over the past two weeks and have been unable to update you on my position on Telstra (TLS). For those who follow my views on this stock, hopefully you would have accumulated it in my absence. This is a good safe stock and one that my son holds on my recommendation.

If you missed my previous note on Telstra, or you would just like a recap, you can read it in [Chart of the week: accumulate Telstra on the dips] (10 April 2012).

If you followed my recommendation to buy any dip at $3.31, followed by a second parcel, you would have accumulated Telstra at:

- $3.31 in the morning of 19 April 2012.
- $3.39 in the afternoon of 19 April or morning of 20 April.

The stock is now at $3.65, up 10.3% on the first parcel and 7.7% for the second parcel. This is a great result for three weeks.

Here is an update of the chart with some new annotations I have prepared for you.

Source: Accountancy Invest

What I like about the chart

Telstra is now at about $3.65 (based on last close) and is still in a strong uptrend, with room to extend higher based off weekly indicators.

1) This stock has got time on its hands, the down-trend has now been well and truly broken, and it is free to roam up, pull back, and roam up higher. The 200-day moving average is comfortably pointing up, not in a vertical fashion, but nice and steady. Strategy, BUY THE DIPS.

2) If you like short-term trades, it is time to start thinking about taking some profits, to then re-enter again at better levels.

What I don't like

On this stock, what I don't like about the chart doesn't really apply. Rather, it is what is making me think we're near a top and in need of a pullback soon.

1) The 200-day moving average is at $3.24, which is 12% lower. It is getting high and only a matter of time before there is a reversion to the mean. Nothing goes up forever. Like a rubber band, there is a snap back when stretched too far. It has gone up in a virtual straight line from $3.18 on 21 March 2012 to now, gaining 15% in six weeks. There is potentially some more, but one needs to be vigilant now and not give back too much if you have bought well.

2) There are two upward sloping white bands that I expected it to trade within, currently bounded by $3.27 on the bottom of the range, just above the 200-day moving average, and the upper range of $3.63. We're in fact trading above that upper expected range as the stock is extending itself in these times of uncertainty. This is the second thing that is making me not buy anymore for now, but think of selling down to take a profit.

3) There are no signs to sell yet here at the time of writing, but as soon as it appears, say a close below $3.62, or on hitting my little 'r' which is the first resistance at $3.73, whichever comes first, one ought to take some money off the table. Say 30%.

4) There is a chance that we can get to the two larger resistance levels marked 'R' on the chart, which are at $3.86 and $3.99. Should it get to these levels after hitting say $3.73, and there has been no pull back lower and no time for me to update, one ought to sell the other two thirds, one third each at each level. Cash in and wait. I would expect it to bounce around and present a better entry level again if it were to go ballistic up. Unlikely but in this climate, much is uncertain.

Please note: my views are not for the long term. My method results in views expressed that relate to an outlook that lasts weeks or at most months. For example, my view on Shanghai's Index has for now been met and completed since 22 March 2012, 11 days later. Currently, in regards to Shanghai, I am in a cautionary observant position. Your utilisation of this information needs to take into account the time frame I set. The stocks recommended as "Steady as She Goes" may be held for the longer term, which for me means months.

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The family SMSF: problems and solutions

by Andrew Bloore

While there are solid reasons for forming family SMSFs, there are important considerations to ensure that significant family events – like divorce, remarriage, stepchildren and death – don't affect the fund's ability to achieve its superannuation goals.

Family SMSFs comprise the majority of all SMSFs. It is common for two member SMSFs to be a husband and wife, with the option of adding their children as members at a later stage. While family SMSFs are advantageous for reasons such as succession planning, holding family assets in a tax preferred environment, and managing super with family members, there are some issues which need to be considered.

Keeping it in the family

SMSFs are limited to four members, so this could create a problem for families consisting of more than four people. Deciding who is or isn't included may trigger family politics. A solution could be to start a second family SMSF, with the parents belonging to both, or having the children commence their own fund, leaving the parents in the original SMSF.

Generational differences between parents and children may cause disagreements over investments, including risk tolerances and investment time frames. This is especially relevant when allocating a large portion of the balance in the fund to a single, less liquid investment, such as property. Difficulties may be created where older members reaching retirement require benefit payments, when their investment horizon and risk appetite are different to younger members.

The extended family

Life events will also affect a family SMSF. When children marry and start their own families, there may be no ability for the spouse to join the SMSF. If they wish to start their own SMSF with their new family, the member's super balance would be transferred to the new SMSF. Assets may need to be liquidated, incurring capital gains tax (CGT).

Marriage breakdowns present more complex consequences. If the spouses are the only members of their SMSF, and one wishes to leave, the SMSF may need to be restructured. This is because a single member fund with individual trustees must have two trustees. Where there is a corporate trustee, the remaining member must be either the sole director of the company, or one of only two directors.

Both the Family Law Act 1975 and the Superannuation Industry (Supervision) Act 1993 (SIS Act) provide for a super interest or a super payment to be divided or split by agreement or court order in the event of a relationship breakdown. In these cases, the split assets may attract CGT rollover relief for their total super balance transferred from the SMSF as a result of relationship breakdowns. The gains or losses of the transferring SMSF are disregarded and the receiving SMSF obtains the cost base of the transferring SMSF at the date of transfer.

Section 66(2B) and (2C) in the SIS Act provides for an exception to the prohibition against acquiring assets from a related party in the event of a relationship breakdown. Where spouses have separated and there is no reasonable likelihood of cohabitation being resumed, either or both parties may establish their own new SMSF and rollover assets from the old SMSF, as long as the rollover of assets is related to the relationship breakdown. These laws also apply to de-facto couples.

I do, I do, I do

Blended families and remarriages may also pose

challenges. Should a member pass away, their super death benefit will attract tax unless it's paid to a tax dependant. Where members of a super fund include the new spouse, the death benefit may be paid to the new spouse who is a tax dependant, rather than individual adult children in order to avoid tax erosion of the benefit. Further, on the death of the member whose super fund was in pension phase, their superannuation interest ceases, meaning it would no longer be eligible for tax-free status on its income and capital gains. This will occur unless a reversionary pension is paid to a dependant, typically a spouse. So while it may be tax-effective to pay death benefits to the current spouse, it may cause conflict between the member's children from a previous marriage.

One solution may be a conditional auto-reversionary pension. These allow a reversionary pension to be paid to the current spouse without them accessing the assets or the capital behind the pension. The assets can then be divided in any way desired by the member once all fund members have passed away, including to the children by way of a death benefit. It ensures that the assets remain in the super fund continuing to benefit from tax-free status, while preserving the assets in the fund for adult children, thus reducing estate disputes.

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Don't miss this!

Get up close and personal with Peter Switzer and Paul Rickard when they take the stand to talk about investing in alternative assets, like property and collectables, for your DIY super fund.

When: Friday 18 May, 12.30-2pm
Where: Sydney Mechanics School of Arts

Tickets start at just $20 for *Switzer Super Report* subscribers. Call the Australian Shareholders' Association on 1300-368-448 to book your seat now, or click here for more information.

Did you know?

Peter caught up with former Prime Minister John Howard to find out his views on the Federal Budget. See what he had to say on Super TV.