Switzer Super Report

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I hope I'm right

Regular readers know that while I was prepared for a pullback in May, I'm still cautiously optimistic on stocks overall. But not everyone agrees with me and in today's note I debate with a well respected professor on the issue.

Also in the *Switzer Super Report*, Charlie Aitken adds a new stock to his high conviction list. Plus, Ron Bewley analyses how the market has been responding to fear, and Andrew Bloore runs us through the remaining things on the SMSF to-do list before the end of the financial year.

Enjoy today's report!

Sincerely,

Peter Switzer

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I sure hope I'm right about the eurozone: Peter

by Peter Switzer

So here we are again keeping our fingers crossed that the European Union (EU) leadership can come up with something that will stop spooking and rocking stock markets. And it comes as I received a great, yet critical email from a subscriber – the respected Professor Ron Bird of UTS.

Ron is concerned about my and other commentators' optimistic views on the euro drama. He challenges my hope that a bit of growth added to austerity will bring "happy days again". Not sure I used those exact words because happy days, I have always contended, will happen when the worst of the European debt problem is behind us.

I have been hoping that would happen by the end of this year but it was based on my belief that rational behaviour from Europe's leaders must eventually win out. I think the stock market will insist on it.

Growth vs. austerity

Ron argues that growth with austerity is an oxymoron, but I disagree. Austerity is simply a policy of deficit-cutting by lowering spending and/or raising taxation. A big deficit could create 4% growth, but an austere fiscal setting could force an economy to live on 1% growth, which would raise unemployment, but there would still be growth. The end-result might be 10% unemployment rather than 13%.

Austerity is not like pregnancy – you can be a little, or very, austere.

Ron and others say Greece has too much debt it can't pay, but that's not right. They can't pay it in a preferred timeframe, but if they go through five years of reform, sell-off assets such as islands, boost productivity and get the population to pay the right amount of tax, they could repay their debts over time.

Anyway, if they lift their game, they could borrow to pay off current lenders and then take on new creditors.

Ron agues markets are stupid and that too much was lent to the likes of Greece, and I think he is right. He also insists that the eurozone proposition was dumb in the first place without a fiscal union and I agree with that as well, but this doesn't solve the problem.

Titanic troubles

Ron says the Greeks need to devalue their currency to get economic growth, but as they are on the euro, that little tactic to solve their debt problem is not available to them. He concludes: "All the attempts to solve the problem, while they remain part of the monetary union are just like 'moving the deck chairs around on the Titanic'."

He predicts the future this way: numerous banks around the world will have to write-off massive debts "and therein lies the problem, which is the reason that we should not be optimistic regarding any easy solutions."

Interestingly, he says there will be buying and selling opportunities helped along by optimistic commentators who contribute, "to the irrationality of markets and so masking the true issues from market participants."

Will the debt challenge be beaten?

Ron is a fatalist and believes this debt challenge can't be beaten and the day of reckoning will come no matter what. I reckon history says we muddle through crises like these and despite the flaws of Europe's monetary union, now is not the time to dump it. That would create uncertainty, kill off both business and consumer confidence, and send the world economy

into a Great Depression.

The name of the game now is to take the 'Bernanke option' and print money in Europe and get growth happening. When economies are growing, you can create jobs, you can tax more and cut spending.

Europe has allowed the Germans to call the tune on what austerity looks like, but it won't be swallowed by Europeans. If the Greek radicals win the next election, Greece will be crushed by their own people who will hoard their euros, stop spending and the bankruptcy rate will race the unemployment rate to the finish line.

US-style bailout

On the bank and debt issue, the Yanks bailed out their banks with the Troubled Asset Relief Program (TARP) and most of that money has been paid back. Companies such as AIG and General Motors were saved using taxpayer's money and the repair job with them has been pretty good. The US is recovering and the stock market is up over 100% since the worst days of the Global Financial Crisis (GFC).

The optimists haven't led US investors astray since March 2009!

Even in Australia, we are up around 30% since then, which is 10% a year and with dividends and franking credits, you could be up maybe 15% a year. That looks better than term deposit rates. We're only muddling through, but that's what I have always predicted.

Sure the debt remains, but I prefer to think the next US president will engage with gradual deficit and debt reduction – but the USA will need a growing Europe to assist in keeping the global economy strong enough to permit it to start getting its house in order.

One day Ron, we will see who was right, but I would rather bet on a muddle-through thesis than Greece leaving the eurozone, possibly followed by Spain! The effect that would have on European banks and what that would do to our Big Four banks as well as their customers with loans really is not something I want to contemplate.

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A new stock enters my picks list

by Charlie Aitken

Facebook continues to get the big thumbs down from investors, with losses suffered for those who supported the third biggest initial public offering (IPO) in US history at about 16%.

The fact lead underwriter Morgan Stanley downgraded revenue forecasts for Facebook on the morning of the IPO, after raising the price and volume of shares to be sold, really isn't a good look. That was followed by a trading glitch on the NASDAQ that saw trading of the stock delayed by 30 minutes.

Wall Street has stitched up Main Street horribly in this Facebook IPO process and the ramifications for US investment banks are not good in terms of further regulation. Watch this space, this Facebook IPO debacle will have legislative and regulatory ramifications for the entire US investment banking industry. For those dabbling in US stocks, I'd be shorting Morgan Stanley shares and buying an Australian Bank dollar for dollar. There's an idea.

Still bullish

It seems I am the lone voice of Australian equity optimism again. It's lonely, it's hard, it opens me up to all sorts of criticism from those greyer than me with different agendas.

Nobody sees it, but recent market history suggests there could be a V-shaped index and risk equity recovery from this trading correction. Nobody is positioned for that scenario right now.

After nearly five years in what has been a bear market for Australia equities, I am becoming quite conditioned to sharp falls in the benchmark ASX200 Index. I had a quick look back at the last two years in Australian equities and while I wasn't surprised to see at least eight sharp index falls, what interested me more was every one of those falls was followed by a complete recovery to the level the index started falling from.

Of course, this short-term stuff is no guide to where the index is in two years from now, but it is telling you to shut your eyes and buy something in this dip as history suggest we all underestimated the speed and scale of short-term recovery. If nothing else, you should buy for a short-term trade because every previous recovery has been V-shaped.

Risk, growth and sustainable equity yield are stunningly cheap. The cheapest I have ever seen in my career. That's all I know and that's why I continue to recommend taking advantage of fear in the right stocks.

What to buy

I think the Australian Dollar's 30-day downtrend is bottoming. This means you buy resource stocks and those who service them. Resource stocks and resource service stocks have been treated as negative derivatives of the Aussie dollar and the Aussie bouncing back to slightly above parity (101US cents) should translate to solid short-term gains in resources and resource service stocks. The biggest macro shorts in Australia are in resources and resource services and the scene is set for a solid short-squeeze.

A bottoming Aussie dollar is telling me to rotate from expensive defensives to more cyclical, financial and China-facing equities. You can generally buy those names on up to 50% price to earnings ratio (P/E) discounts to perceived defensives and that relative and absolute rating gap is simply too wide, particularly given that the high earnings growth in fiscal 2013 won't be in defensive sectors.

As you know, I am focused on to 2013 financial year. The market is focused on the next Bloomberg

headline about Greece, but from an investment perspective, I am focused in FY13 and where our analysts can see clear growth plus yield, at a deep value multiple. Pick and stick, trying to look forward taking advantage of the market's pricing of the present.

New to my list

I am going to add **Woodside Petroleum (WPL)** to my high conviction large-cap buy list. Woodside has been hit as hard as all leading resource stocks, despite having contracted LNG prices and volumes. The spot LNG price is actually up at a record high, which means as Woodside's legacy contracts, roll off higher prices should be achieved for new contracts.

The company recently sold a 15% stake in Browse to the Japanese group MIMI at a valuation that stunned all of us. However, Woodside has been one-way traffic south in the past month, losing around 16% from the post deal highs.

Woodside has been treated like any other oil and gas stock as WTI Oil came down, but is now back to the cheapest forward P/E I can ever remember yet the company is past the capex/delays/cost blowout phase and is ramping up Pluto production. It also has a new CEO, Peter Coleman, who seems to like to under-promise and over-deliver, unlike previous Woodside management.

The company is trading on 10.8-times calendar-year 2013 earnings, offers +30% earnings per share (EPS) growth and a 4.78% yield. That is a very attractive set of numbers and I see Woodside as low-risk, high-reward buying at current prices. The company also has an investor briefing day on Monday 28 May, which I believe should be positive. In fact, it only has to be 'non-negative' to be positive for the share price.

Woodside offers high quality assets, high barriers to entry, high growth, pricing power, high quality management, a high quality Board, rising return-on-equity (ROE), and a rising dividend yield all for a value multiple. That's why it's coming into my high conviction large-cap buy list.

That large cap list is now: **ANZ, AMP, BHP, CWN, FMG, NAB, SVW, STO, TLS, WBC** and **WPL** .

Go Australia, Charlie.

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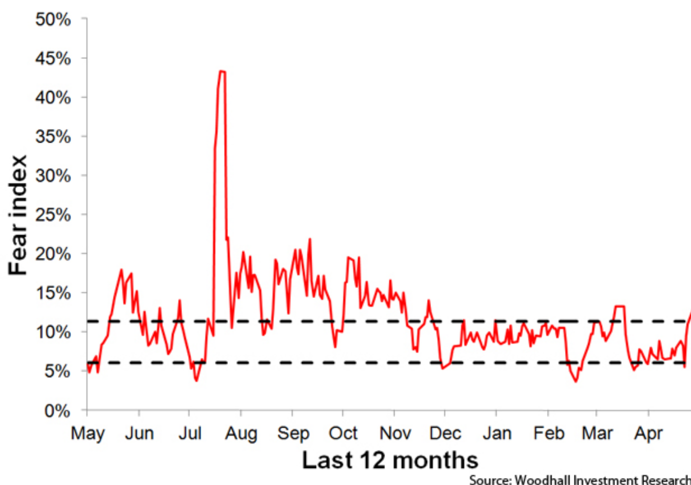
Is the volatility caused by Greece normal?

by Ron Bewley

The old Warren Buffett maxim of being greedy when others are fearful requires some measure of fear in order to know when to be greedy. As I discussed in my last column on How to read fear in the stock market, we have a fear index that is based on the amount of excess volatility – or irrational volatility.

This chart shows the last 12 months of the fear index, known as the VIX, up to the close of Tuesday 22 May.

Chart 1: The Fear Index



Reading fear

The two dotted lines mark a range where the fear index resided much of the time before the onset of the global financial crisis (GFC) – 68% of the time in fact. Thus, fear is unusual when the index spends a lot of time above or below the dotted lines for more than 16% of the time (since the time spent outside the range before the GFC is: 100% – 68% = 32% ÷ 2 = 16%, that is 16% above and 16% below the range). Too low and investors might be getting complacent; too high and investors may be more likely to overreact to bad news.

Unfortunately, last week produced a great case study.

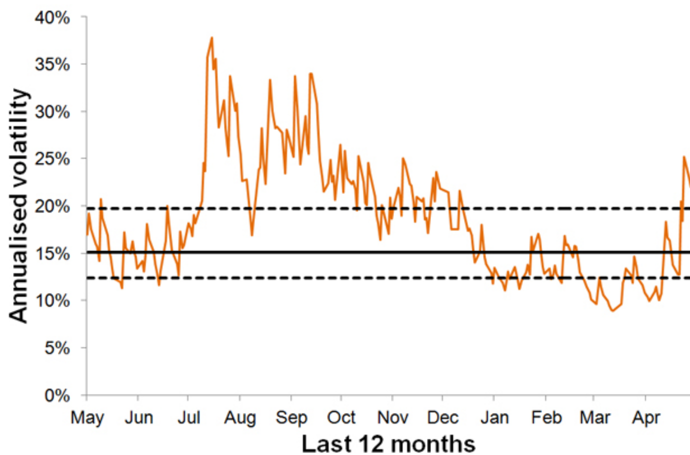
When it became clear that the Greeks were going to have to go to the polls again in mid June, the uncertainty led markets sharply lower – about 5.6% down for the week on the S&P/ASX200 – and that took away all of the gains for the year. However, fear hardly budged, just peeking above the upper line on Monday when the market went up!

Ordinary volatility

If we turn to 'ordinary' market volatility for the same period in Chart 2, we can see that it got well above the upper dotted line, which in this chart represents the average volatility during the GFC. The lower dotted line is the average before the GFC and the solid line is the average volatility since the GFC.

Although it is hard to be confident when volatility is high, our research shows that normal fear coupled with the underpricing we have in many sectors (see woodhall.com.au) presents possible buying opportunities at a good discount. Of course, it would be foolish just to dive in headfirst but making some trades spaced apart by a few days might give investors a reasonable average price.

Chart 2: Market volatility



With China being committed to stimulating its economy and Europe starting to lean towards a less harsh stance on austerity, the medium term looks a lot brighter than it did last Friday! There are plenty of blue chip stocks that have taken a big hit: BHP, RIO, CBA, WBC and many more. And as of the time of writing (Tuesday 22 May) the bounce back has so far been small.

What I've been doing

I sold all of my Sonic Healthcare in my super fund on May 10 at a slight (untaxable) capital gain of about 10% over about a three-year period with a dividend yield of about 5% (partially franked) – not great, but it charged up from $11.28 at the start of the year and my earnings were better than cash over the holding period. I made that sale because the Health sector was overpriced by 6% and, therefore, I thought it less likely to make strong gains in the near future. I just put the proceeds back in the market today with a buy on RIO at $56.80. We have that sector underpriced by nearly 20%!

At the time of writing, Sonic is up a fraction from my sale of it 12 days ago (now $12.77), but RIO is down about 9% over the same period. RIO was $60.30 at the start of the year and climbed to $72.30 in February. I have been waiting for more than six months for an opportunity like this to arise to get my RIO exposure to where I wanted it. Clearly I am backing the China story. I am slowly getting out of my defensive stocks and into growth – hopefully before everybody else does!

Ron Bewley if the executive director of Woodhall Investment Research *Pty Ltd.*

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End of financial year checklist: part 2

by Andrew Bloore

This week I'll run over the remaining things you need to check off your to-do list before the end of the financial year. Due to changes in the Federal Budget, it may work to your benefit to consider some of these actions this financial year rather than next year.

Last week I ran over the first four actions on the list, which were:

1. Government co-contributions
2. Transitional concessional contributions cap for over 50s reverting to general cap
3. Directed termination payments (DTPs) benefits ending 30 June
4. Off market transfers

You can click here to re-read them.

Here are the remaining things you need to think about before 30 June.

5. Settlement of contributions

For last minute contributions, ensure that settlement, and not just the contribution occurs before 30 June. Refer to TR 2010/1 to understand when a contribution is deemed to be made depending on the way it is transferred into the superfund.

Benefit and Strategy

The contributions will occur in the intended financial year. Especially since 30 June falls on a Saturday, making last minute contributions on 29 or 30 June may only settle on the following Monday. By allowing sufficient time for settlement, it avoids a contribution mistakenly made in the next financial year, and if those caps are fully used, it may inadvertently breach the caps.

6. Age 65 – bring forward rule

The bring forward rule for non-concessional contributions enables individuals under 65 to bring forward two years' worth of non-concessional contributions into the same income year, allowing a total contribution of $450,000 without breaching the cap. They can't then make non-concessional contributions to super for the next two years.

What are the benefits?

For individuals who have turned 65 this financial year but were aged 64 on 1 July 2011, a final opportunity exists to use this bring forward rule. For those wishing to contribute a large lump sum into super, such as sale proceeds from property or other assets, they should look at taking advantage of the bring forward rule. This is also valuable in contributing a lumpy asset into super up to $450,000 without having to do it in $150,000 tranches per year to avoid exceeding the cap. Bear in mind that if the individual is aged 65 at the time of the contribution, they will also have to meet the work test before the contribution is made.

If the individual over 65 doesn't use the bring forward rule this year, they will still be able to access the normal $150,000 cap in future years up to age 75, provided the work test is satisfied.

Strategy

Ensure that if the intention is to contribute sale proceeds into super, the sale process is settled with enough time to contribute the funds and settle into the super fund account before 30 June. Likewise for asset contributions, confirm the asset will be transferred into the name of the super fund before June 30. The risk of delayed settlement means the contribution will occur next financial year when caps are reduced to $150,000. Excess non-concessional tax will mean the fund may need to pay an additional

46.5% tax on top of the tax already paid by the individual, which depletes the contribution.

Importantly, ensure that any other non-concessional contributions have been taken into account, such as contributions made earlier in the year, and excess concessional contributions that are then classified as non-concessional. Also if personal deductible contributions made are greater than the individuals taxable income, these will also be classified as non-concessional and may cause the cap to be breached if it is of significant value.

7. Contribution reserving strategy

SMSFs are entitled to have a contribution reserve which holds unallocated contributions made to the fund. They are required to allocate the contribution to the member's account within 28 days after the end of the month in which the contribution is received.

What are the benefits?

A contribution reserving strategy is beneficial for a member who wishes to make a personal deductible contribution to the super fund and claim the deduction in the current financial year, without the contribution being added to their account in the same year to avoid breaching the concessional cap. The only time of the year where this strategy would work is in when the contribution occurs in the month of June. The deduction would be claimable in this financial year, and within 28 days after the end of the month, in July, the contribution is allocated and then counted towards the member's cap. This could also work for employer contributions and non-concessional contributions to avoid breaches of the cap.

Strategy

Members must check the SMSF deed to ensure the fund can use a reserving strategy. Also a reserving strategy, which is different to an investment strategy, should be in place. Ensure that the contribution is made after 1st June and before 30 June, otherwise contributions will be allocated in the unintended financial year.

8. Minimum pension for the year

Account based pensions are required to meet minimum annual pension payments. This includes transition to retirement (TTR) income streams. The minimum factors depend on the opening balance of the pension and the age of the pensioner. The minimum pension for both 2012 and 2013 financial years has been set at 75% of legislated minimums to assist funds that continue to be affected by the GFC.

What are the benefits?

If the fund doesn't pay the minimum annual pension percentage, the payment may not be considered a pension payment. This means that the assets that would be supporting the pension will lose entitlement to the exempt current pension income, so the income generated from those assets will be subject to tax. Paying the minimum pension before 30 June will ensure that the fund retains its pension status and retains the tax advantages of doing so.

Strategy

The minimum pension payment is only required to be paid annually. If it has not already been done, ensure the payment is done prior to 30 June. It is not too late to receive the payment now as long as it is received this financial year.

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Did you know?

You can search through past editions of the *Switzer Super Report* in the Archive on our website, or look up articles by the Expert.

Did you know?

George Boubouras, *Switzer Super Report* expert and the Head of Investment Strategy and consulting at UBS Wealth Management, spoke to Peter earlier this week about the chance of Greece leaving the eurozone. Watch what he had to say on Super TV.