Switzer Super Report

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Returning optimism

I've noticed some things in the market recently that are making me feel a little more optimistic about the potential for stocks this year, and I explain what they are in today's note.

Also in the *Switzer Super Report*, Ron Bewley explains a strategy to help your money last a lifetime, Lance Lai looks at whether it's time to jump back into stocks, and Andrew Bloore explores whether self-managed super funds can run a business. Plus, we have some stock picks from Charlie Aitken's Bell Potter Securities team until he returns at the end of the month. I hope you enjoy today's reading.

Sincerely,

Peter Switzer

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I'm having a Kath Day-Knight moment

by Peter Switzer

Regular readers who label me as a generally optimistic investor might have noticed I have been negative since around April when I thought the run up of share prices from last October had to come to an end. A pullback or correction was on the cards and the entry of Greece, Spain and all of the European Union's debt problems have helped to drive stock prices lower than they needed to go.

But now I feel like I'm having a 'Kath Day-Knight moment' . Yep, as Kath from the television comedy series Kath & Kim might say: "I can feel it in me waters that we could be in for some upside."

What I'm noticing

Let me piece together the positives that I am seeing right now. Here they are:

• The VIX, or fear index, has eased to around 17 from the high 20s a few weeks ago, meaning investors are less fearful.

• US markets are above their 200-day moving averages and that line is trending up.

• Ben Bernanke is not desperate enough to go for a third quantitative easing stimulus package (QE3) and while I think he is keeping his powder dry in case Europe screws up, I think he is also betting that the US economy might just be able to get out of this current slowdown without more money supply expansion.

• On Europe, I liked the recent J.P. Morgan analysis that compared the attack on Germany by other EU countries, as well as the USA, telling it to give some ground on either fiscal austerity or Euro bonds or anything that helps both the banks and governments of the eurozone, to "a group of hyenas trying to bring down an elephant." And then CNBC's Art Cashin of UBS pointed to the headlines that the German Chancellor, Angela Merkel, is starting to give some ground on some bond funding.

• I suspect the G20 meeting made some progress on helping Europe and the International Monetary Fund (IMF) secured more funding.

• The fact that central banks are stiffening up for a rescue bid if something goes wrong on financial markets is also a plus.

• We are seeing better economic and policy stimulation news out of China.

• The share prices of BHP and Rio Tinto are heading up.

• The Aussie dollar is now above parity.

• And Lance Lai, my charts guy from my Switzer program on Sky News Business channel, who has been negative and on the money, is now seeing bullish signs in his analysis of the S&P 500, the German DAX index and the Shanghai Composite. You can read his note in today's report for more on that.

The risks

Sure, the Europeans could ruin all this with a bad play, a big-mouth official or some crazy government decision, but I feel it in me waters that we could have a 'short-term' period of better stock prices.

Unfortunately, I can't see the needed big-bang piece of good news that will spark this. But it will come, and that will really spark a lot of positive heat into the stock market.

I hope it comes sooner rather than later, but I suspect we have a bit of a wait on our hands.

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How to make your money last a lifetime

by Ron Bewley

Many people throughout their working lives take the default option of a balanced fund in accumulating their superannuation. However, a balanced fund alone when taking a pension during volatile times could erode your retirement savings significantly.

A balanced fund might be expected to return around 7% per annum, as assumed by the Association of Superannuation Funds of Australia (ASFA). But, owing particularly to the equity component of the fund, returns may vary quite significantly from year to year. This volatility is not much of a problem if, over time, the fund is in line with average returns, particularly in the accumulation phase. But when it comes to taking a pension, the need to draw down on the dips can really curtail the life of the fund.

Expected returns

Over the past five years to September 2011, the median return on a super fund, as calculated by SuperRatings and published in the Sun Herald, was 0.92% per annum. The worst performing industry super fund returned -1.87% a year and the worst other fund, -2.78% a year over that time.

All three figures fall a long way short of the 7% assumption used in the ASFA calculations that I discussed in my previous column. As a re-cap, ASFA's calculations showed that a balance of $850,000 would last a couple about 22 years if a comfortable pension of $55,080 is withdrawn each year.

Dismal results

If a return of 0.92% per annum were experienced in the first five years of retirement, and inflation remained at 3% per annum, the above hypothetical fund would last, not 22 years, but just over 15 years – and that's assuming the return goes back to 7% per annum after five years.

For the worst industry fund, a 'comfortable' standard of living would last nearly 13 years, and just over 12 years for the worst other fund.

If these figures seem bad, consider now that the hypothetical fund did not experience, say, the same 0.92% per annum for the first five years, but experienced volatility along the way within that five year period – as happened in reality. Unfortunately, the data are not readily available in order to perform those calculations. But, if the worst results started nearer the beginning of retirement, the longevity of the fund would be even less – possibly much less than the 15 years in the above example.

A better option

Consider now a retired couple who put three-years' worth of living expenses in cash (3 x $55,080) that only earned the rate of inflation, which is about 3%. They put the rest in the balanced fund, which earned the realised rates of return for five years (say 0.92%, -1.87% or -2.78%) after which it earned 7% per annum. This couple use the cash to fund their pension in the bad early years to avoid drawing down on the fund.

Following this approach that insulates the fund through three of the bad years, the worst fund that lasted just over 12 years in the above example, would now last nearly 17 years with the hybrid but segregated cash and balanced fund!

Avoiding draw downs

The problem with making draw downs on a fund is that all of the asset classes covered are usually drawn down at the same time. That is why the segregated cash fund and the balanced fund in the last example works so much better.

Of course, the results vary depending on when the bad years occur. In my next column, I will discuss some alternative strategies for making super funds last a bit longer in pension mode.

Ron Bewley, executive director of Woodhall Investment Research.

Watch Ron discussing annuities with Peter Switzer on Super TV.

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A bank to buy, one to hold and a speculative stock

by Bell Potter Securities

Here are three stock recommendations from Charlie Aitken's team at Bell Potter Securities. Charlie will be returning from leave at the end of the month.

National Australia Bank (NAB): Buy

We've looked at NAB's market risk metrics and believe related fears dragging on its share price are largely unfounded. In our view, the market continues to factor in downside risks to its trading book and residual Special Purpose Entities (SPE) exposures (previously nabCapital), possibly to the same extent as the bank's experience during the GFC. This issue probably accounts for half of the bank's extreme share price discount (the other half being its UK legacy bank).

While NAB's risk weighted assets associated with market risk increased by 78% to $5.3 billion in the six months to 31 March 2012, this was largely driven by the implementation of APS116 that came into effect on 1 January 2012. However, this is a sector specific issue bringing the market risk charge for the majors back to their respective GFC levels.

NAB's actual charge of $422 million in the first half of 2012 is higher than in the second half of 2008 and the first half of 2009, suggesting the market is extrapolating the fact and pricing NAB on a worst-case basis (no surprises given the ongoing European crisis). However, this is an outcome that we strongly feel is completely at odds with the bank's much-improved capital base and overall de-risking progress since the GFC (e.g. stronger funding, liquidity, organic capital generation, etc.). NAB's general and actual market risk charges and comparisons with Fundamental Tier 1 capital are also below the sector average and remain ahead of those of the major offshore banks.

- 12-month price target $26.30.
- Latest close: $23.45

Mesoblast (MSB): Speculative Buy

Diabetes represents strong new upside for Mesoblast. Mesoblast is now running a Phase II trial of its Mesenchymal Precursor Cells in Type II diabetes, with the trial expected to report data late this year. This follows on from highly favourable data in non-human primates which was reported in November 2011 and January 2012, and more recently elucidation of the mechanism of action of the MPCs in diabetes, which relates to the bone protein osteocalcin.

With diabetes so widespread and growing, there is huge potential value for MPCs in this space. The current standard of care for diabetes of insulin therapy and/or oral diabetes medication have together created a global market worth about US$34 billion per annum, serving 8% of the world's adult population. By contrast heart failure is probably only a US$6 billion global market. We see success in diabetes as boosting confidence in other intravenous applications of MPCs such as anti-inflammatory disorders. We currently apply a conservative 5% probability of clinical trial success for diabetes under our base case valuation and a 10% probability of success under our optimistic case valuation, which equates to $1.93 per share base case and $4.80 optimistic case.

We value Mesoblast at $10.67 base case and A$21.29 optimistic case. We expect significant news flow over the next twelve months as assisting in the stock being re-rated to our target price.

- 12-month target price: $16
- Latest close: $6.17

Commonwealth Bank (CBA): Hold

Following CBA's BankWest (BWA) update, there are still opportunities to grow in WA given stronger fundamentals, e.g. lower unemployment, migrant growth and a resource-based economy. Cross-sell remains higher in WA (2.1 products per customer compared with 1.6 on the East Coast) and we sense WA will always be BWA's focus market. Management is seeing some green shoots in the Perth housing market based on population growth, low vacancy rates (1.6%) and overall not a lot of availability in the system – and anecdotally looking to a turnaround in 12-18 months.

The net interest margin (NIM) has improved since the GFC due to better wholesale funding terms (as part of the CBA Group) and the 6-12 month outlook remains stable/positive with some moderating after that (again in line with our estimates). Asset quality appears to be stable and now keeping to the first half of 2012 trend. BWA is a great deal for CBA and continues to perform well in WA, although the East Coast remains a 'Work in Progress' and is subject to fine-tuning/reshaping to maximise returns. Until the latter is optimised, the West Coast operations will continue to "subsidise" those on the East Coast – clearly not a sustainable proposition.

There was little new information for us to tweak our estimates with BWA's NIM and cost medium term outlook in line with our assumptions. As a result, we have left the $51.20 price target and Hold recommendation intact (also consistent with the bank's return on equity (ROE) profile). CBA remains a lower risk bank with value upside from further productivity gains (around 35% cost ratio in the Retail Bank achievable by 2013/14) and strong internal capital generation to support a payout ratio of greater than 70%.

- 12-month target price: $51.20
- Latest close: $52.09

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Can my super fund run a business?

by Andrew Bloore

Many small business owners like to run self-managed super funds (SMSF), but there are also some super funds that like to operate a business.

While carrying on a business within an SMSF is not forbidden, there are strict regulatory provisions in place that can make running a business in super difficult. These provisions may prevent trustees from conducting business activities without breaking SMSF law.

The rules

As with any SMSF activity, the SMSF trust deed must reflect its ability to carry on a business. If the deed allows this, then the Australian Tax Office (ATO) will consider the activities of the trustee when determining compliance rather than whether or not a business is being conducted.

The backbone to the SMSF provisions is whether any activity carried out by the SMSF trustees is done in accordance with the sole purpose test. Briefly, this means that the SMSF must be maintained for the 'sole purpose' of providing retirement or death benefits for its members or their dependents if they die before retirement. In order to determine if business activities breach the sole purpose test, the ATO will look at whether the carrying on of the business, instead of providing retirement benefits, is the sole purpose of the fund. In particular, the ATO will pay close attention to whether:

- the trustee employs a family member, their rationale for employment and the amount of remuneration;
- the business activity is commonly carried out as a hobby or pastime;
- the business activity has links to associated trading entities; and whether
- the assets of the fund are made available for the private use and benefit of the trustee and related parties.

Business limitations

SMSF law has robust provisions that enhance the sole purpose test and provide further framework for SMSF activities. An important provision in respect of carrying on a business is the prohibition of borrowing, subject to limited exceptions.

Businesses outside of super often use lines of credit or overdraft facilities to bridge short-term cash flow deficiencies or to grow and expand. Even though borrowing may be a normal trading activity for a business, these borrowing tools are strictly prohibited within an SMSF.

While a business may only intend to borrow for a short period, pay market rates of interest and repay the borrowing on time and in full, this would contravene the super borrowing provisions, irrespective of the counterparty.

Likewise, mortgaging an asset owned by the fund would breach the charge over assets restrictions. Therefore the business would solely have to rely on funds accumulated within the SMSF and any contributions made by the members, subject to contribution caps, to carry on the business.

More restrictions

Further restrictions involve:

• SMSF trustees are prohibited from lending money or providing financial assistance using the resources of the fund to a member or their relatives. This disallows members or relatives from acquiring an asset, product or service for less than its market value from the business within the SMSF, or selling to the

SMSF at greater-than-market value. While traditional business owners may take advantage of discounted goods and services in the ordinary course of business, these practices from a business within an SMSF will deem the SMSF non-complying.

• All dealings with the SMSF must be conducted on an arm's-length basis. This provision ties in with the financial assistance restriction discussed above, and also covers salary payments above market value.

• Acquiring assets from related parties is prohibited, subject to limited exceptions. If the business within the SMSF wishes to purchase equipment or assets from a related party, either as a one-off acquisition or supply contract, this would breach SMSF law. Therefore any purchases, regardless of value, must be from independent parties that are not considered related under super law. The related party definition is far reaching, including trusts controlled by members or relatives and companies that are sufficiently influenced by, or majority voting rights held by members or relatives.

Consequences of getting it wrong

Any breach of the super law provisions could have serious tax and legal implications for both the trustees and the SMSF, including civil penalties or criminal charges in severe cases. The SMSF may lose its complying status and therefore it's tax concessions.

Understand each course of action

Every action undertaken in the course of running the business will need to be checked against all SMSF laws at every stage. Each case is taken on its own merits and therefore there is no blanket answer as to whether carrying on a business complies with all the SMSF provisions.

It is imperative that the trustees of the super fund fully understand the limitations of an SMSF as well as the needs of the business to assess whether it is possible to successfully run the business in the SMSF. This includes funding requirements, asset acquisitions, necessary connections with related parties and seeking legal advice where appropriate.

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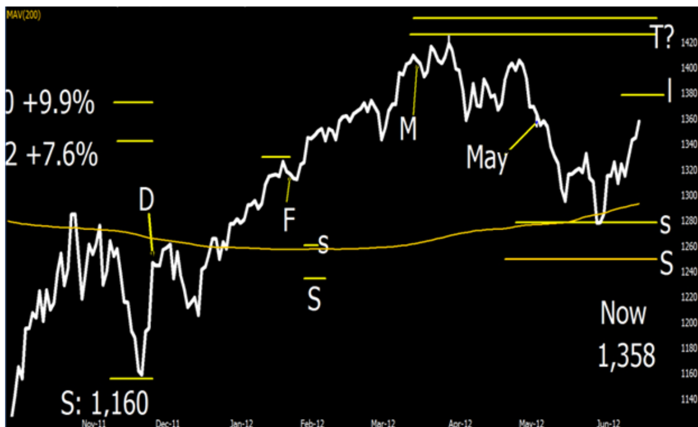
I sold In May. Is it time to buy again?

by Lance Lai

US S&P500 at 1,358. First support level at 1,278 held.

Real test to come.



When [I appeared on SWITZER on 10 May 2012](), the theme for the show was 'Sell In May and Go to Bahrain', and that was exactly what I did. This is marked 'May' on the above updated chart of the S&P500.

My first support level had me eying 1,278 or 5.6% lower, just above the 200-day moving average.

On Friday 1 June 2012, the day of my flight returning from Bahrain, the US market fell 2.4%, closing on 1,277, just one point below. Perfect! The following day, Monday, the index traded down to 1,266 and again closed on 1,277. Perfect again.

When you identify a support level, and the market closes ON IT and it starts to trade back up, then the chance of it bouncing strongly is HIGH. This is exactly what we have now.

I had a level below that at 1,249 marked by the big S, as major support, which was 7.7% lower. This was never hit.

So how do I see the situation?

Negatives

We've now had a very 'nice' and shallow fall. So nice and shallow, it almost feels inadequate.

If you watched my interview in May, and had been following my commentary in the *Switzer Super Report*, I had been alluding to a 'clear out' on the downside that was sorely needed. This is so that a solid base may be formed from which to launch off into higher levels. It doesn't feel like we've got enough of that.

The index at 1,358 is up 17% from the lows in November 2011. That was only seven months ago. On that basis, it is still 'too high'.

This is the reason for my little 'I' on the chart, which marks a level of 1,378, or 1.5% higher than where the S&P 500 is at present. We need to get through this level before we focus hard on the upside.

Positives

1) Momentum is clearly on the upside now with most indicators pointing to higher levels.

2) The 200-day moving average is now pointing firmly up, as indicated by the yellow line.

3) I have a Target marked 'T?' at 1,422, or 5% higher from here.

There are sufficient and indeed good technical reasons for it to trade higher from these levels. This is despite all the fundamental news flow that continues to be predominantly negative. If the charts are telling me things are pointing up, I switch off the negative news flow on the TV and other media. How it clears

and trades at and slightly above the 1,422 level will determine how high it will go.

Shanghai Stock Exchange: Now at 2,297.
Target level: 2,424, up 5.5%

Source: Accountancy Invest

Another chart I've been looking at is the Shanghai Stock Exchange. I have said in previous notes that support is at 2,244, or 7% lower, and this is marked 'S' in the chart.

Shanghai has traded lower, but it hasn't fallen to that level. It has gone as low as 2,276, or 5.8% lower.

Negatives

1) 200-day moving average is still pointing down. I expect to see support for Shanghai stocks at 2,244 – the same level as before, and that would be 2.4% lower than present levels.

Positives

1) The index is trying to stabilise above the low of 2,319 realised on 2 July 2010. It is currently at 2,297, only 22 points, or less than 1%, away from this level.

2) The top in this current round of volatility began on 4 August 2009 when the index peaked at 3,478. The low was reached at point one above before it began to bounce around, which is what we have had since. The current level represents a 34% fall from the August 2009 peak.

As much as this is not desirable, it is not the end of the world and reflects an index that was too high. If the index can stabilise here and recover, the gains could be more sustainable. This second point emphasises point one's importance.

3) I have a higher target level at 2,424 marked 'T', or 5.5% higher than present levels. Trading up here and how it trades in this range is very important.

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Did you know?

The end of the financial year falls on a Saturday this year. If you've left things to the last minute, you should act now to make sure all your loose ends are tied up before the end of next week. For some EOFY tips, please read:
End of financial year checklist: part 1
End of financial year checklist: part 2
Time income payments to save on tax
The dos and don'ts of SMSF tax deductions
Apportioning expenses for tax deductions

Did you know?

The new Switzer Super Service is offering FREE SMSF set up, valued at $1,500, for a limited time only. If you want to setup a self-managed super fund or have someone help take care of its paperwork, call us to see what the Switzer Super Service can do for you, or click here to setup your SMSF online right now.