Switzer Super Report

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Euro-anxiety

The leaders of Europe kick-off their two-day summit in Brussels today, and global markets are holding their breath. The politicians are spruiking 'decisive action', and I hope that's what we get. But this is Europe we're talking about and that's why I've got euro-anxiety, as I explain in today's note.

Also in the *Switzer Super Report*, Charlie Aitken's team at Bell Potter Securities have stepped in until he returns next week to provide some stock recommendations, including one very interesting speculative buy. Plus we take a look at the cheap resources sector, explain how to boost death benefit payments, and look at the new-age paperless SMSF. I hope you find today's report useful.

Sincerely,

Peter Switzer

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I've got a case of euro-anxiety again

by Peter Switzer

It's been another week where stock market optimism was actually given a chance, with US housing data looking unquestionably better than it has for years. So we now have to see if the EU leaders can spoil the party with a crucial summit over the next two days. It's euro-anxiety again!

As an advocate of long-term investing and a follower of Warren Buffett's advice to be greedy when everyone is fearful, I know the worst will eventually be behind us and stocks will soar, but it is the waiting game that is hard to cope with for most investors.

Waiting for the rally

During the week I interviewed Matthew Kidman, who writes in the Sydney Morning Herald, was a fund manager at Wilson Asset Management and who wrote the book Bulls, Bears and a Croupier Who Stopped Gambling and Made Millions. Kidman is a stock market historian and thinks we are in the last year of a secular bear market and it turns around in 2013, though he says it could start in the last quarter of this year.

He confirmed IBISWorld's Phil Ruthven's claim that when the market decides that the worst is behind us, it will spike by 40% in one year. Kidman says it could even be 60% and so this is the kind of gamble that we face in deciding to be in or out of the market.

Those who have heeded my historical warnings to 'sell in May and go away' and then get back in for a Christmas rally have done well, but this is market gambling that most SMSF trustees are willing to play.

By the way, Michael McCarthy of CMC Markets knows there are reasons to be fearful right now with our financial fate in the hands of the EU. However, he sees reasons to be optimistic on stocks, including the VIX, or fear index, in the US, which is now below 20. To put that in perspective, this hit a reading of over 80 at the height of the GFC!

Recovery news

Another good sign to emerge this week came from the US where home sales, home prices and pending home sales came through positively and with historically significant improvement. Economists know that a lasting economic recovery needs to have a strengthening housing sector as the foundation and that has been missing in the States since 2007.

Now this is all of the good stuff, but the bad stuff remains and it will be spotlighted in Brussels at the EU summit. I loved the heading from a Reuters article that summed it up neatly with: "It's the Politics, Stupid."

Bill Clinton, of course, made "It's the economy, stupid," famous and it has become the basic tenet of most political debates. But right now, it's politics that is holding up the solution of Europe's economic problem – particularly Angela Merkel and how she is bowing to Germany's fear of being dragged down by its EU indebted partners, the PIIGS (Portugal, Ireland, Italy, Greece and Spain).

Create growth

Sure the PIIGS have to clean up their act, but they also need growth to bring down unemployment and create economic growth so they can collect taxes to use to pay back their debt.

Right now, Germany's view is treat 'em mean and they'll be keen, but this is like asking someone on the dole to pay off a home loan.

I say giving them work, making them put in the long hours and garnisheeing their wages to cover their debts is a better approach for an individual who is in debt compared with the soft option of letting them declare bankruptcy. The EU officials have to come up with a better solution or else stocks will continue to struggle.

I'd love to finish with "Go the Europeans!" but these guys have sapped me of my usually unbridled enthusiasm for optimism. Hey, that could be a good sign as Kidman argues the market comeback follows a feeling of capitulation, where even the most positive investor says that he or she has had enough.

I hope we can avoid that market development and that's why this EU summit is important. It is also why I have euro-anxiety again.

HOT STOCK TIPS

Two stock ideas for your SMSF

by Bell Potter Securities

Charlie Aitken's team at Bell Potter Securities has stepped in during his absence to bring you a very interesting speculative stock buy and their recommendation on Westpac. Charlie will be back with his commentary next week.

Starpharma (SPL) – Buy (Speculative)

VivaGel for the treatment of Bacterial Vaginosis (BV) is potentially a blockbuster. Starpharma has estimated that US$300-350 million is spent globally on clindamycin and metronidazole-based topical treatments for BV. In our modelling of Starpharma we have assumed that VivaGel effectively doubles this market and takes half of it by being the only product with strong data on prevention of recurrence. There is potential that the product can ultimately grow into a billion-dollar best seller as awareness of BV fuels product uptake.

VivaGel is well into Phase III for Bacterial Vaginosis and it has announced that its Phase II Bacterial Vaginosis (BV) Prevention of Recurrence trial is now fully recruited, as is one of the two Phase III trials. The company has indicated that all BV trials are expected to be complete in the second half of this year. In January 2012 Starpharma received a Special Protocol Assessment (SPA) from the FDA related to the BV application, which considerably de-risked the programme. We look for further favourable Phase II data on prevention of recurrence later this year, and see strong upside emerging from a licensing deal in 2013.

Investment view – Multiple opportunities emerging. We value Starpharma at a $1.96 base case and a $3.92 optimistic case. Our target price is $2.30, but we see room to increase this should the second Phase II trial mirror the success of the first.

In view of the near-term VivaGel condom-related royalties from Ansell, VivaGel Bacterial Vaginosis moving towards completion of Phase III, and the potential for strong upside in drug delivery, we see excellent prospects for Starpharma re-rating to our target price. We believe the next twelve months will see Starpharma reach several milestones, namely:

1. completion of the last BV trial;
2. launch of Ansell's VivaGel coated condom and the triggering of related milestones and royalties;
3. a potential licensing announcement for the BV programme or dendrimer-docetaxel; and
4. potential new collaborations in drug delivery and agrochemicals.

- 12-month target price: $2.30
- Last close: $1.33

Disclosure: Bell Potter Securities acted as lead manager in the October 2011 placement and SPP and received fees for that service.

Westpac Bank (WBC) – Accumulate

A former bank CEO once said the only relevant thing is to increase revenues and reduce costs, and we expect a transformation of Westpac's domestic retail and business banking (RBB) operations along these lines in the medium term.

Our analysis suggests the business (excluding St.George and BankSA) continues to lag its peers in key areas such as revenues generated across the branch network and from footings, average branch lending and deposit volumes, and expenses to originate these footings. Benchmarking Westpac's RBB against its peers enables us to determine the extent of any potential value uplift. Lifting Westpac's revenue per footing from 1.75% to 1.81% (using ANZ as best practice bank) would increase revenues by

$213 million (+1% to 2013 revenue estimate) and net profit after tax (NPAT) by $149 million (+2% to 2013 NPAT estimates) – the equivalent of $0.48 per share uplift.

Reducing its cost per footing from 0.84% to 0.66% (using NAB as best practice bank) would lower pre-tax costs by $663 million (9% savings on the 2013 cost base estimates) and increase NPAT by $464 million (+7% to 2013 NPAT estimates) – the equivalent of $1.50 per share value uplift. The total uplift is around $2 per share with more of the value to be derived from the cost base (no surprises given the extent of WBC's branch network and overlap with SGB in NSW). The resultant 36% divisional cost ratio is achievable as we understand this is also targeted by similar operations within Commonwealth Bank.

We have made minor changes to our estimates with the adverse impact of recent rate cuts largely offset by productivity and efficiency benefits as discussed above (leading to 35-38% Group cost to income ratio in the medium term).

Given the potential uplift from transforming Westpac's RBB into a best practice bank, better fundamentals heading into the second half of 2012 (net interest margin resilience as wholesale funding costs stabilise, stable asset quality and tight cost management resulting in positive 'Jaws'), sustainable dividends supported by strong internal capital generation (78% payout comfortably ahead of its 70% target) and 15% expected return on equity (ROE) despite higher capital adequacy, we remain comfortable with the bank's 'Accumulate' rating and $23.00 price target (inclusive of the $2.00 uplift).

- 12-month target price: $23.00
- Last close: $20.92

Resource stocks are historically cheap

by JP Goldman

It's hard for the Australian stock market to fire when one of its largest sectors has come under intensified pressure due to concerns over the global economic growth outlook. While this sector now looks compellingly cheap, the news flows have so far remained unsupportive of a price turnaround.

That turnaround could come, however, with a little help from China and Europe.

Of course, I'm talking about the materials sector, which contains our bulk commodity exporters such as BHP-Billiton and Rio Tinto, and accounts for around 22% of the S&P/ASX200 index. A more narrowly defined sector grouping within materials is resources, which itself comprises the two sub-sectors of energy and metal, and mining stocks.

Broad exposure

If you like the mining sector but are unsure which stocks to buy, there is now a wide range of mining related exchange-traded funds (ETFs) available on the Australian market that provide broad exposure to the sector. The largest and cheapest at present is that provided by Betashares (ASX:QRE).

ETF Provider	ASX Code	MER[1]	FUM (A$m)[2]	Av. Bid/ Offer[3]	Depth (A$m)[4]
All Resources	RSR	0.43%	$6.10	0.47%	$2.01
SPDR Resources	OZR	0.40%	$11.10	0.34%	$1.52
Beta Shares Resources	QRE	0.39%	$23.40	0.36%	$2.37
All Metals & Mining	MAM	0.43%	$2.50	0.68%	$1.25
All Energy	ENY	0.43%	$2.00	0.60%	$1.42

1 *Management Expense Ratio.* 2 *Funds Under Management in Australia.* 3 *Average % between best bid and offer price.* 4 *Average dollar value of five best bids and offers. Source: ASX ETF Monthly Report.*

A major drag

While once the darlings of the share market before the global financial crisis, mining stocks have been a drag of market performance over the past year. Since its post-GFC peak in early April 2011, the S&P/ASX300 metals and mining sector has declined by 40%. Prices are down 46% from their overall peak in May 2008.

By contrast, the S&P/ASX200 index is down around 20% from its April peak of last year.

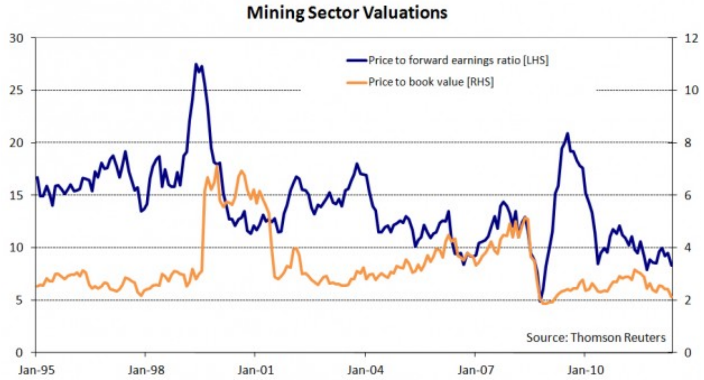
A decline in export commodity prices (albeit from very high levels) and fears over a slowdown in the Chinese economy have been largely responsible for the sector's plight.

Analysts' earnings expectations have been revised down sharply over the past year, and the market's valuation of those earnings has also been cut.

Historically cheap

But from negativity often arises value, and mining stocks now appear quite cheap by historical standards.

The metal and mining sector's price to forward earnings ratio, for example, has dropped to below 10 – a valuation rarely evident over the past few decades.



Similarly, the sector's price to book value is just over two, or close to previous lows since at least 1995.

As far as earnings are concerned, a small decline in profits is now expected this financial year according to analysts surveyed by Thomson Reuters, but – at this stage at least – earnings are expected to rebound by 10% in 2012-13, and a further 16% in 2013-14. If these earnings expectations hold up, and the price-to-earnings ratio returns to a more reasonable level (say around 12), the sector stands ready to provide very good gains on a one-to-three year view.

China and Europe

Of course much depends on developments in China and Europe. The slowdown in the Chinese economy over the past year has hurt demand for steel and led to price declines for both coal and iron ore. But China has no interest in slowing its economy too far, and is already trying to re-orientate its economy from speculative housing developments in major capital cities to infrastructure projects in more regional areas. Indeed, Chinese authorities are already starting to ease back in tight credit conditions, and a bottoming out in the economy could be close at hand.

All up, key mining export prices should hold up at still reasonably high levels, while the mining sector's current investment in new capacity will result in a lift in export volumes.

It would naturally help if Europe also got its act together. Europe remains a major destination for Chinese exports, and the region's self-inflicted recession has hurt Chinese exports with knock-on effects to local mining companies. That said, there's even some light at the end of this tunnel, as following recent European elections, political leaders now seem more accepting to promote economic growth and not just fiscal austerity.

To that end, this week's European leaders summit could unveil the first moves in the direction of a growth promoting regional package.

Offsetting the 'death tax' for SMSF beneficiaries

by Andrew Bloore

Back in 1988, the Government introduced the 15% tax on super contributions and reduced the tax on benefits from 30% to 15%. They asserted that by doing this, they were not increasing tax, but rather bringing forward the tax that would have otherwise been paid on benefits. However, since lump sum death benefits paid to dependants were not taxed at that time, bringing forward the tax was effectively increasing the tax on these benefits.

Compensation

To compensate for the contributions tax, a provision of the tax act was introduced to allow super funds to claim a deduction based on the increased amount of the lump sum death benefit that was paid to a spouse, former spouse or child of the deceased. This anti-detriment provision made the lump sum payment equal to the amount that would have been paid if no tax was payable.

In simple terms, this means that any lump sum death benefit paid to a dependant under the anti-detriment provision is increased to effectively refund the amount of contributions tax already paid.

Also taken into account are the earnings that would have accrued on the amount of tax paid on those contributions. The super fund could then claim a deduction based on the increased amount of the benefit. These provisions are now contained in section 295-485 of the Income Tax Assessment Act 1997 (ITAA 97).

There are two methods that can be used to calculate the tax saving amount: the audit method or formula method. The formula method is used by the ATO in interpretative decisions and is most often used.

The benefits

The anti-detriment amount provides a welcome boost to the death benefit payment paid to beneficiaries.

The deduction claimed by the super fund may bring a substantial benefit to the remaining fund members. It can be used to reduce the tax payable in the current year or if a tax loss arises in the super fund, the loss can then be carried forward to future income years.

Why wouldn't everyone do this?

While the idea sounds great, there are certain reasons why it may not be appropriate for all lump sum death benefits.

Firstly, the fund's trust deed must allow for anti-detriment payments before allowing the trustee to pay it out the fund.

Secondly, cash flow must be considered. The anti-detriment payment must be made in full in addition to the lump sum death benefit. This payment must be made before the super fund can claim the associated tax deduction. The fund must therefore have the ability to pay the additional amount without relying on the deduction.

Importantly for SMSFs, there must be a source from which to make the anti-detriment payment. It cannot be drawn from another member's account, and therefore there must be an anti-detriment reserve established well in advance to accumulate to the amount of the required payment. This is not always done in SMSFs.

Alternatively, the payment may be made from life insurance policies that are allocated to a new reserve for these purposes. Again this must be detailed in the trust deed.

Also, if the member implements a re-contribution strategy, the anti-detriment payment is diluted or eliminated in some cases. This is because, under this strategy, benefits are withdrawn from the superfund when a condition of release is met, and then re-contributed to the fund as a non-concessional contribution. The amount re-contributed will no longer attract concessional contributions tax, and therefore there is no tax refund applicable to anti-detriment payments.

Finally, unless the super fund can make use of the deduction, the strategy is not beneficial. This is because anti-detriment payments apply to lump sum death benefits only. If the death benefit is to be paid as a pension, including a reversionary pension, the anti-detriment does not apply.

Pension phase limitations

Further, if the remaining members are wholly in pension phase, the income of the fund is tax exempt and any gains or losses are disregarded. Therefore the deduction to the super fund from the anti-detriment payment cannot be used unless a pension account is commuted back to accumulation phase or another accumulation account is created.

If the fund is wound up after the member's death, this would also prevent the use of the deduction and nullify the strategy.

Food for thought

As we await legislation on the increased contributions tax for individuals with income greater than $300,000, it will be interesting to see how this will affect anti-detriment calculations. If an individual's income subjects their super fund to 30% contributions tax in some years, and 15% in others, the calculation for the anti-detriment payments will need to consider the different contribution tax levels in order to correctly identify the increased amount of the death benefit.

This may cause additional administration burdens on super funds in record keeping and subsequent computation of the anti-detriment amount. We eagerly await the outcome.

How to set up a paperless DIY super fund

by Ron Lesh

Rustling through piles of self-managed super fund (SMSF) documents can be frustrating and time consuming, but in this ‘electronic age’, is it feasible to have a paperless fund? And can it be audited?

The simple answers are yes, and yes.

How to go paperless

The most important component of the paperless SMSF is the use of administration software that provides document management, storage and electronic delivery. The software needs to allow documents to be easily attached to transactions and funds.

The first documents required to set up a paperless SMSF are the fund establishment documents. These will include the trust deed, product disclosure statement (PDS), registers and application forms created when the fund was established.

The easiest way to collect these documents is with an automated establishment process that is integrated with the SMSF administration software so that it automatically attaches these documents to the fund ledger. Furthermore, having these documents available on the web provides easy access for trustees, administrators and auditors.

The second set of documents you’ll need include those that support fund transactions, such as broker buy and sell notes, rental statements, dividend statements, distribution statements, supplier invoices, bank statements and year-end tax statements. Your SMSF administration software needs to support both the manual and automatic attachment of these source documents to your transactions.

How to source your documents

Many of these source documents can be obtained by SMSF administrators automatically or through a web request to trustees. Using an integrated contract note service, obtaining dividend and distribution statements direct from registries and using the web to request other source documents from trustees means the process of obtaining most source documents can be fully automated.

Once the SMSF administrator has completed the work for the fund, the next step is to deliver the documents to the trustee and to have the documents signed – digitally! The trustee can view documents on a web portal through a web-based automated document delivery system and sign the documents digitally. Once signed, the SMSF administrator would be notified that the fund is now available for audit.

A paperless audit

The final stage of the paperless SMSF is the audit. All audit work can be completed on screen: audit planning can be documented, work papers prepared and reviewed, checklists completed and the audit report prepared. And because all source documents are already attached to transactions, the auditor can easily view, notate and lock documents.

The benefits

Running a paperless SMSF is possible. SMSF administration software available today provides administrators with the ability to:

- establish SMSFs through a web portal fully integrated with their SMSF administration software,
- attach source documents to transactions,
- collect many source documents automatically,
- request source documents from trustees via

the web,
- deliver documents to trustees electronically,
- digitally sign documents, and
- complete an electronic audit.

A paperless SMSF can make life a lot easier for SMSF trustees, allowing them easy access to their paperwork no matter where they are in the world.

The challenge for SMSF administrators is to embrace this new technology and use the technology to make the paperless SMSF a more widespread reality.

Ron Lesh is the Managing Director of BGL*, a compliance computer software firm.*

Don't miss this!

On Monday, the Australian Bureau of Statistics and the Reserve Bank of Australia (RBA) release the latest Consumer Price Index (CPI) figures, which show how fast the cost of living is increasing in the economy. Headline inflation is at a low 1.6%, while underlying inflation (which excludes volatile items) is at 2%.

The RBA has two measures which it uses to gauge inflation pressures, the weighted median and the trimmed mean, which are at 2.1% and 2.2%, respectively.

The RBA aims to keep inflation within a band of 2-3%, which means when inflation is low, they cut rates to stimulate growth, and vice-versa.

The RBA will be looking to see if recent interest rate cuts have lifted the pace of cost increases. If inflation remains low, the RBA will likely cut rates again. If it steps up a little, they will hold off for further clues on economic growth, barring any nasty developments in Europe. If it jumps, then rate cut expectations will fall, and this will be reflected in the markets, with stocks likely a little disappointed and the Aussie dollar strengthening.

We'll have the CPI results up on our website when they're released next week.

Did you know?

End of financial year
Watch out if you're planning any last minute BPay payments to your self-managed super fund intended for this financial year because the delay in processing these transactions means your transaction likely won't be recorded until next financial year. This could potentially push you over your non-concessional contributions cap of $150,000 in 2012/13.

If you need to make a transaction urgently, you should contact your financial institution first and see if they can help you.

Term deposits
Term deposit rates have fallen significantly in recent months, but you can still lock in returns of over 5%. According to the Switzer Super Report interest rate table, Teachers Mutual Bank has a three-month term deposit at 5.10%, while UBank is offering 5.11% for six months and RaboDirect, 5.12% for one year.

For a complete comparison table, please visit the Switzer Super Report website.