Switzer Super Report

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Go for gold

The US Federal Reserve continues to hold off on a third stimulus package, so the market's focus is returning to Europe. They've started saying the right things, but can the Europeans improve their poor track record and go for gold? I discuss this in today's note.

Also in the *Switzer Super Report*, Caltex has issued a new hybrid note that's paying an attractive interest rate, but is it a risky investment? Plus, Charlie Aitken gives you his thoughts on Woodside Petroleum, we look at the probability of running out of income before you die, and we remind you of the rules preventing SMSF trustees from providing financial assistance to members. Happy investing.

Sincerely,

Peter Switzer

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Will the Europeans go for gold?

by Peter Switzer

In a big week when central banks could determine whether our share portfolio rises or plummets, the US Federal Reserve disappointed markets by pretty well repeating what it has been saying for months – that a third quantitative easing package (QE3) is on the table, but it's not needed now. Fortunately, Wall Street bought it, with a small fall on the Dow of only 0.29% to 12,971.06.

Significantly, the Dow has dropped below the psychologically important 13,000-level, showing that optimism is being challenged. Against that, the S&P 500 held on to its crucial 1,375-level, but was only 0.32 points above it. This is a numerical expression of what investors are both thinking and hoping.

Talk the talk

The heart hopes that the Europeans will match actions to the "whatever it takes" war cry of the European Central Bank (ECB) boss, Mario Draghi, however the head asks, quite realistically: "Can we trust these non-gold medal winners?"

As a former, pretty reasonable swimmer, I know it's hard to toss someone who is simply faster. It can happen in the 50-metre freestyle because everyone is so close on times. It can also happen in the 100 metres, as James Magnussen found out last night by one-hundredth of a second. But when it comes to the 200 metres breaststroke, you seldom get surprise packages.

The best show up and the also-rans swim to their times.

The European leadership wouldn't even be selected for the 'Olympic Games' for leaders, but this week they have let their mouths do their talking. Tomorrow they have to show they can not only talk the talk, but also can walk the walk.

And while the ECB's Draghi got the headlines with his "whatever it takes", Jean-Claude Juncker, the Chief of the Eurogroup, which is made up of the eurozone's finance ministers, also let loose.

This week he said:

- "We have come to a crucial point…"
- "There is no more time to lose," and
- "No one should doubt the will of the involved forces to show determination."

Even the German Chancellor Angela Merkel and French President François Hollande, have vowed to do "everything possible to protect the eurozone".

So, that's the talk; what about the walk?

Walk the walk

First, the ECB could start buying Spanish and Italian government bonds to lower the borrowing costs of these countries, which have been unsustainably high recently. Second, the eurozone's temporary rescue fund – the European Financial Stability Facility – could also buy bonds.

Professor Ian Harper from Deloitte Access Economics says Europe needs money supply to encourage demand and economic activity, and that's how the market will look at what the eurozone leaders say. If the measures will bring down the cost of borrowing for governments and they help stimulate economic growth, then our share prices will head higher.

If they don't deliver, expect a big sell-off, which could be made worse if the US job numbers disappoint on Friday night our time.

Go for gold

My first memory of a gold medal-winning Aussie was Ian O'Brien, who won the 200 metres breaststroke event at the 1964 Tokyo Olympics. He was the best on times and he won like a champion, but by 1968 in Mexico, he was an also run.

Let's hope the Europeans can go from loser to winner tomorrow, which would be an Olympic gold performance that will help our share portfolio.

These guys can either boost or butcher our bottom lines, so keep your fingers crossed.

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Caltex comes to the hybrid market

by Paul Rickard

Caltex has been grabbing the news headlines lately on its decision to close the Kurnell Refinery in Sydney in 2014 and convert it to an import terminal. Now the company has announced details of a $300 million hybrid securities issue to raise capital.

The proceeds will be used to support the costs associated with converting the refinery, and to help strengthen its balance sheet.

The question for us is, should we buy it?

The details

Caltex expects the Notes to be classified as 'intermediate equity content' by Standard & Poors, thereby improving the likelihood of it preserving its BBB+ rating (three notches above 'investment grade').

The 'Intermediate equity' classification means Standard & Poor's will assess it as 50% debt and 50% equity. To qualify, this hybrid issue uses the standard structure – notes with a 25-year term, redeemable or callable at the issuer's option after five years, and the ability for Caltex to defer the payment of interest.

The Notes will pay interest at a margin of between 4.5% and 4.75% over the 90-day bank bill rate.

The notes are subordinated and unsecured and rank behind all senior obligations and unsecured creditors, and ahead of Caltex ordinary shares. Interest payments can be deferred, however interest deferrals are cumulative, and a dividend 'stopper' applies to the payment of dividends on Caltex ordinary shares.

Details of the issue are as follows:

Issue Size	$300m, with right to accept more or less
Security Type	Subordinated, unsecured, cumulative notes
Listing	ASX, stock code CTXHA, expected 6 September
Issue Price	$100 per Note
Term	25 years, maturing15 September 2037
Call Date	15 September 2017 (5 years), and then on every interest payment date
Step Up Margin	0.25% (if Caltex does not redeem on first call date)
Interest	Paid quarterly, 15 Dec, 15 Mar, 15 Jun, 15 Sep
Interest Rate	90 Day Bank Bill rate + Margin
Margin	Range of 4.50% to 4.75% (set in book build)
Interest Payments	Caltex can defer. Dividend stopper. Payments are cumulative.
Ranking	Behind all senior obligations and unsecured creditors, ahead of ordinary Caltex shares
Offer Opens	9-Aug
Offer Closes (scheduled)	28-Aug
Issue Date	5-Sep-12
Minimum Subscription	$5,000 or 50 Notes, then in multiples of $1,000 or 10 Notes

The institutional book build on Wednesday will set the final margin. At the lower end of 4.5%, this implies an interest rate of around 8.1% for the first quarter, while at the higher end of 4.75%, the rate would be 8.35%.

Pricing

Given the issuing costs and distribution risks, the issue of any listed hybrid security is opportunistic behaviour by the borrower, which makes commenting on whether the issue is fairly priced somewhat academic. The best guide is to look at adjacent secondary market issues.

The Origin Energy Notes (ASX code ORGHA) are currently trading at a margin of the bank-bill rate plus 3.90%. Origin is also rated BBB+, however it isn't on a negative credit watch and the ORGHA issue was structured such that it is classified by S&P as 100% equity. This increases the chance it will be redeemed after five years (rather than the nominal term of 60 years).

Caltex faces a different set of industry challenges, so there are sound reasons why it needs to pay a higher margin than Origin. Is 4.5% enough of a premium? Our sense is that the Caltex issue is probably in the ballpark.

Our View

It is only a $300 million issue, which won't be great for secondary market liquidity. Also, the incentives for Caltex to redeem the Notes after five years aren't strong; the step up margin of 0.25% is miserable, and as the Notes are only 50% equity, there is not quite the same urgency for Caltex to redeem and replace with a new hybrid security. So there is some chance this security ends up running past its five-year call date.

Caltex also faces a challenging operating and industry environment.

These are the negatives.

The positives – it's hard to argue with the interest rate margin and Caltex is not 'junk' – the Company has an 'investment grade' rating. Within a diversified portfolio of hybrid securities, this issue is probably worthy of a nibble.

There are more issues on the way (CBA is expected to announce a replacement issue for its PERLS IV issue, which is due for mandatory conversion on 31 October) – so keep most of your powder dry.

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Is Woodside headed back to $45?

by Charlie Aitken

Woodside Petroleum (WPL) remains a member of my high conviction buy list and I completely agree with our analyst Johan Hedstrom that it is undervalued.

Today I want to do a quick reiteration of our positive short, medium and long-term investment theses on WPL ahead of their interim earnings and dividend release on Wednesday 22 August.

The Woodside share price hit an all-time high of $69.92 in early 2008 when WTI Oil reached $145 a barrel as the 'peak oil' theory was priced in. The Global Financial Crisis (GFC) and then the shale gas boom in America saw 'peak oil' proven to be nothing more than a sensationalist myth (thanks Al Gore), with WTI Oil prices collapsing to $33 billion in late 2008.

Turning point

Yet in a very similar way to Australian gold major Newcrest (NCM) underperforming the gold price, Woodside has badly underperformed the WTI Oil price because of a series of production disappointments and capital expenditure (CAPEX) blowouts. But just like Newcrest, Woodside has finally turned the corner in a production ramp up and is well past the peak of CAPEX spend. And just like Newcrest, Woodside should become a free cashflow, earnings growth and dividend machine from this point.

Since a change of CEO to the understated, low-profile Peter Coleman, the company appears to be moving to a culture of under-promising and over-delivering; always a very good combination for shareholders. The old CEO overpromised and under-delivered; always a bad combination for shareholders.

Below is Johan's bullet point summary of Woodside's most recent production report.

- Great production result of 20.1 million barrels of oil equivalent (mmboe), up 43% on the March quarter, with Pluto the key outperformer (eight cargos, including three spot).
- Production guidance for the year lifted from 73-81mmboe to 77-83mmboe. My estimate is for 78.4mmboe, which is now at the low end of range.
- Balance sheet strengthened in the second half with the $2 billion sale of its 14.9% stake in the Browse project to MIMI.
- One more exploration well at Ananke-1 for Pluto expansion to start drilling in the September quarter.
- No comment on dividend, but I have an estimate of $0.60 dividend per share (DPS) in the first half of the year and $0.64 in the second half. That $1.24 a share represents a 51% pay-out ratio. Consensus full-year 2012 dividend per share is $1.15.
- Yield for fiscal 2012 is 3.8% fully franked, and my estimate of $1.50 DPS for fiscal 2013 is 4.6%. Consensus DPS for FY13 is $1.25.
- Discounted cash flow valuation won't change much and is still around $47 a share.

Note well Johan's comments above on dividends; one of the key reasons we are recommending Woodside is a dividend surprise.

While dividends are very important, the simple fact is Woodside remains a grossly under-priced growth stock. Woodside is a calendar year company, so the estimates below are December year-end, but to be paying just 10.9-times for 22% EPS growth in 2013 is simply too cheap.

Year ending 31 Dec	2011A	2012E	2013E	2014E
Revenue (US$m)	4,802	5,450	6,757	6,815
EBITDA (US$m)	2,827	4,071	4,902	4,922
NPAT - reported (US$m)	1,509	2,073	2,306	2,377
NPAT - adjusted (US$m)	1,655	2,073	2,306	2,377
EPS - adjusted (A$/sh)	2.03	2.44	2.96	3.13
EPS growth (%)	1.90%	20.00%	21.40%	5.80%
PER (x)	15.9x	13.2x	10.9x	10.3x
FCF yield (%)	-7.80%	-4.10%	-4.60%	-5.50%
EV/EBITDA (x)	10.8x	7.3x	6.3x	6.6x
Dividend (A$/sh)	1.02	1.24	1.5	1.6
Yield (%)	3.20%	3.80%	4.70%	5.00%
Franking (%)	100%	100%	100%	100%
ROE (%)	13.30%	14.80%	14.80%	14.00%

Key: E = estimate, A = actual, ROE = return on equity, EBITDA = earnings before interest, tax, depreciation and amortisation, NPAT = net profit after tax, EPS = earnings per share, PER = price to equity ratio.

What I believe happens from here is that Woodside will get re-rated as the share prices of those building massive east coast coal seam gas (CSG) to liquefied natural gas (LNG) plants mark time on concerns about the technology and further capex blowouts. Woodside is past the capex blowout stage and North-West Shelf conventional gas to LNG is a proven, relatively low-tech process that should attract a significantly lower discount rate in valuation models than the unproven in large scale CSG to LNG process.

What about Shell?

In my conversations with investors, there seems to be broad agreement that Woodside under Peter Coleman is turning the corner. The only, and I stress only, pushback I get on the company is the perception of a Shell overhang.

This reminds me of Telstra (TLS) at the bottom when everyone was scared of the Future Fund's selling. It turned out they were giving anyone who bought Telstra stock off them a true "gift from the Nation".

Shell currently owns 190 million Woodside shares (or 23%). With the Aussie dollar at a record high vs. the euro and at 105 US cents, Shell may well be tempted to sell their remaining stake. Yet, just like the Future Fund selling Telstra, clearing this overhang will be extremely rewarding.

However, I have no idea what Shell's intentions are and I don't intend holding back buying Woodside shares waiting to find out. Trying to second-guess Shell is not how you are going to make money in Woodside from here. In fact, forgetting about Shell is most likely the right approach.

Woodside shares are down 50% from all-time highs, yet earnings (and dividends) are going to rise by 50% from 2011 to 2013. The company is starting to consistently beat analysts' expectations, while the CEO/Chairman combination of Peter Coleman and Michael Chaney will prove a team to back.

Woodside remains a high conviction buy and a clear candidate for a 'buy-the-fact, short-cover the fact' response to the first-half result and potential interim dividend surprise. Our medium-term price target remains $45, with the risk/reward equation heavily favouring total return reward from these depressed share price levels.

Go Australia, Charlie.

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The chance of running out of cash before you die

by Ron Bewley

Understanding risk is perhaps the hardest aspect of finance. One risk that should never be forgotten is the risk of running out of money before you die.

The simple default balanced fund option is perhaps not the best for everyone, but tailoring a retirement strategy to suit your risk profile is not easy. Real life examples would include such aspects as taking a variable amount of pension depending upon market conditions, taking profits from equities in particularly good years and, as I wrote in an earlier column, having several different buckets (or funds) from which to draw your pension.

How much do you need?

There are many different combinations of cash and equities weightings that you can hold in a stock portfolio, but which will help you make your money last longer in retirement?

In my previous column I discussed the nature of historical data on capital gains and dividends for the S&P/ASX200. (You can re-fresh your memory by reading How to make your money last a lifetime and Are equities really that scary.) I showed a risk analysis of alternative strategies of combing cash and equities based on that data and then compared that with how much the average person needs in retirement (according to the Association of Superannuation Funds of Australia's (ASFA) balanced fund assumptions).

Let me repeat those basic assumptions. Inflation is assumed to be 3% per annum (pa), cash attracts 5% pa, the retiree couple has $850,000 and draws down $55,080 pa – after adjusting for inflation – to maintain an 'ASFA – style' comfortable existence.

Getting real

Based on the ASFA figures, assuming the superannuation is invested in a balanced fund that returns about 7% pa, the retirees on average will exhaust their fund after about 22 years and transfer to the old aged pension.

However, if we introduce risk into the experiment – assuming volatility of 7% pa, which is consistent with an APRA study using data from the late 90?s and early 2000?s – the picture looks quite different. There is then a one in 100 chance the fund is exhausted before 14.3 years, but a one in four chance it will last 29.4 years or more.

If I dial up the volatility to, say, 12% to be perhaps more relevant to the future, there is now a one in 100 chance the fund is exhausted before 11.1 years! A long way from the 'headline' 22 years in the typical ASFA example.

Since equities are typically much riskier than balanced funds, it doesn't seem to be a wise move to fully invest in equities and draw down a pension. Using financial year data from 1985/6 to the present, I calculated the average capital gain was 5.9%, average total return (including dividends reinvested) was 12.1% and average total return including franking credits was 13.6%. The annualised volatility was 15.7%.

One million hypotheticals

Rather than do a simple simulation experiment, I performed a more advanced statistical method that samples from past data in blocks of varying length to create a variety of hypothetical futures. For example, the first draw might be returns from three consecutive years starting in 1987/88, the second might be a draw of four years starting in 2007/8, etc.

By joining up these histories into a string that lasts 50

years into the 'future', the first experiment starts with the 1987 crash and is followed straight after by the GFC, etc. I repeat this experiment one million times. Some of the million scenarios would be dreadful and some excellent, but most would be near the average that was actually experienced.

I assume the pension is taken at the beginning of each year so that $55,080 is drawn and the rest is in equities. The results are in the column headed '1? (for one year's worth of cash for the first pension payment) in the Table.

The average life expectancy of this equity fund (the median at 50% probability) is in excess of 50 years! Much better than for the balanced fund because the average return is much higher in equities. The downside is that there is a 1% (one in 100) chance the fund runs out before 10.1 years and a 10% (1 in 10) chance it runs out before 20.1 years.

The cash and equities balance

To compare performance of a different portfolio, I now start the experiment with five year's worth of the assets in a cash fund at 5% pa and the rest in equities – drawing down first the cash before taking any from the equity fund. The results are in the column '5?. The fund lasts about one year longer for the 0.1% to 25% probabilities, which is not a lot of gain.

If I now take the fund up to 10 and then 15 years worth of cash, there is not a lot left in equities to grow while the cash is being drawn down. However, with 10 years in cash, the downside risk at one in 100 is 15.5 years and this is better than for the low-volatility balanced fund with an average of 39.2 years and a reasonable potential that there will be inheritance money for someone when the couple passes away!

Table: Longevity of a cash-equity fund running out

Prob. of	Number of years cash allocation			
running out	1	5	10	15
0.1%	10.1	11.2	13.6	16.4
1.0%	12.5	13.6	15.5	17.2
5.0%	16.1	17.3	18.4	18.5
10.0%	20.1	20.6	20.6	19.3
25.0%	31.9	30.4	26.0	21.1
50.0%	>50	>50	39.2	24.0
75.0%	>50	>50	>50	28.3
90.0%	>50	>50	>50	36.4
95.0%	>50	>50	>50	47.8

Notes: For assumptions see text.

Ron Bewley is the executive director of [Woodhall Investment Research](#).

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Don't be tempted to lend to members

by Andrew Bloore

Providing financial assistance to members is one of the most common breaches SMSFs make, and understandably so; it's tempting to want to dip into the retirement honey pot if you find yourself in a situation where you're strapped for cash and you have all this money sitting in super.

But breaking the law is not a wise financial choice.

Super legislation prohibits a self-managed super fund (SMSF) trustee or investment manager from lending money to members of the SMSF or their relatives, or giving them any other financial assistance using the resources of the SMSF.

The rationale for this centres on the sole purpose test, which requires the trustees to ensure that the fund is maintained solely for core purposes, such as benefits to members upon retirement, and certain, other ancillary purposes. Lending money or providing financial assistance to members and their relatives contradicts this fundamental objective of super funds.

To understand the extent to which this rule relates, the following terms need to be understood.

Who is a relative?

Unlike certain other provisions within super legislation that apply to the all-encompassing term 'related party', the financial assistance prohibition is limited to members and their relatives. A relative is defined as a parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the individual or their spouse, and a spouse of any of these individuals. Therefore the definition of relative is confined to a natural person, and does not include companies or trusts.

However, further rulings by the ATO have indicated this prohibition may still apply where financial assistance is provided to a member or a relative through a third party or interposed entity. For example, where an SMSF loans money to a company which then loans the money to the SMSF member.

What is financial assistance?

Whilst financial assistance is not defined in super legislation, it extends beyond the provision of loans and other kinds of money or property. It includes giving a guarantee, indemnity, security or charge, or assuming an obligation that is financial in nature to assist a member or relative using the resources of the SMSF.

The following examples are considered financial assistance in the context of this provision:

- Gifting an SMSF asset to a member or their relative.
- Selling an SMSF asset for less than its market value to a member or their relative.
- Purchasing an asset for greater than its market value from a member or their relative.
- Acquiring services from a member or their relative in excess of what the SMSF requires, or paying an inflated price for their services.
- Forgiving a debt owed to the SMSF by a member or their relative, or releasing them from a financial obligation owed to the SMSF, including where the amount is not yet due and payable.
- Delaying recovery action for a debt owed to the SMSF by a member or their relative.
- Satisfying or taking on a financial obligation of a member or their relative.
- Giving a guarantee or indemnity for the benefit of a member or their relative.
- Giving a security or charge over SMSF assets for the benefit of a member or their relative.

With a vast array of examples of where financial assistance is provided, the context and substance of the arrangement will determine whether this provision has been breached. Factors include whether the arrangement:

- exposes the SMSF to a credit or financial risk;
- is on non-arm's length terms that are favourable to the member or their relative;
- is inconsistent with the SMSF's investment strategy;
- is not a usual or commercial arrangement in the context of which SMSFs operate;
- equates to a loan with or without an interest component; or
- results in the decrease of assets of the SMSF either immediately or over time.

The next hurdle

Once it has been determined that an arrangement or transaction satisfies this provision, trustees or investment managers must consider the application of other provisions within super legislation. These include:

- the sole purpose test
- investment strategy requirements
- acquiring assets from a related party restriction
- in-house assets
- arms-length requirements

For example, an SMSF may loan money to a company which is a related party of the SMSF. Whilst this transaction is not a loan to a relative and is therefore not prohibited within this provision, it will fall within the in-house asset restriction which limits the loan to a related party to no more than 5% of the total assets of the SMSF. Further, the loan must be on arms-length terms, be consistent with the SMSF's investment strategy and satisfy the sole purpose test.

It is therefore imperative that each transaction performed by the SMSF is considered within the context of the entire super legislation, and not just individual provisions.

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Don't miss this!

The Reserve Bank of Australia will be making their next interest rate decision on Tuesday next week. Economists widely expect interest rates to stay on hold at 3.5%. We'll post the result on our website after the announcement is made at 2:30pm AEST.

Did you know?

Are you nearing retirement but haven't thought about a Transition to Retirement income swap strategy? It's one of the easiest ways to boost your super. Find out more in the Super Strategies section of our website.