Switzer Super Report

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Euro watch

Stocks have come up against some hurdles, but I don't think it's anything to fret about. Even so, many investors have been alarmed at BHP Billiton's pull-back on spending and newspaper reports of the "end of the mining boom". Charlie Aitken and I tell you what we think today.

Also in the *Switzer Super Report*, we suggest three general asset allocation profiles to fit the different risk profiles of someone in their 40s, 50s and 60s and above. Plus, we list the benefits and traps of transferring assets into your super fund, and also explain the difference between prices when buying investment art at a gallery or at auction. Hope you find this helpful.

Sincerely,

Peter Switzer

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36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

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Could the ECB make BHP A-OK?

by Peter Switzer

Not surprisingly, we've seen a bit of cautious negativity on stock markets this week with the Dow Jones off three days on a trot. So does this mean we're in the calm before the storm?

I don't think so, and beware silly stories from media experts desperate to find reasons for recent sell-offs, which have been small. Last night one news service tried to say "Greek woes" were to blame – yeah, right.

The simple fact is global markets are in a profit-taking phase ahead of the early September revelations from the European Central Bank (ECB) and the European Union (EU) leadership. And all of this is making me jumpy about what I should do about BHP Billiton.

What about BHP?

When do I buy it? Should I go before the ECB's meeting on September 5, or should I wait until after? Another question could be, why would anyone want to buy BHP now?

That's an easy one to tackle, so I will take this first. I don't invest for one week's, one month's or even one year's time. I put a three-year outlook on my purchasing of great companies and I ask, will the share price be higher in two or three years' time?

Given its share price is around $33, even if it gets to $40 in two years, that's a $7 gain or 21%. Even if that happened in three years, that's 7% a year with dividends of around 3%, which totals up to 10% a year.

Why three years? I reckon the global economy will make a comeback sooner, especially if the ECB acts wisely in September, but it will take time and that's why BHP's share price could linger longer at low levels.

If the ECB screws up, I reckon the share price will tumble on a bad decision for the global economy, but if they get it right, then cyclical stocks will do OK and could even be great, but I'm not that optimistic.

Be greedy?

Clearly, my thinking on BHP is driven by my belief that Warren Buffett was absolutely on the money when he said he liked to "be greedy when everyone is fearful," and so maybe it's close to the time when I need to be greedy on BHP.

So, it gets down to my confidence in the Europeans. Of course, BHP is in the news after it placed $50 billion worth of expansion projects on hold, including Olympic Dam, but this will help its bottom line and I'm sure with the share price hovering at low levels, Marius Kloppers will be trying to pull off some smart plays to restore our faith in him.

I'm going to wait a few days and see how markets play out, but I suspect I will punt on the ECB. Of course, I could split my bet and buy half before and half after the decision, which could be wise, as a bad decision could actually give me a dollar cost averaging opportunity on a company I want for three years.

A lot is riding on this damn ECB meeting.

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My thoughts on BHP, AMP and Emeco

by Charlie Aitken

After meeting with AMP's chief executive Craig Dunn this morning I am even more of a believer in our strategist's bullish view on AMP.

Firstly, I'd like to say I think Craig Dunn is very impressive – very calm, very presentable, very on top of the topic. I also believe the market doesn't know him well, yet.

AMP is the major top-20 buy if you believe, like I do, that the five-year Australian equity bear market has ended and a change of federal government is pending.

This stock so reminds me of **Telstra (TLS)** at the lows. This stock is a major high conviction buy. It remains cum the 12.5 cent interim dividend, meaning you can buy the stock and receive the dividend until it goes ex-dividend on 3 September.

For the 2013 calendar year, we forecasts AMP to grow its earnings per share (EPS) by 10%, with the return on equity (ROE) rising to 15.2%. The price to earnings ratio (P/E) is 11.4-times bottom of the cycle earnings, while the yield is 6.9%.

The five-year chart is at a major inflection point and I believe this stock will be in a positive earnings and dividend revision cycle for the medium-term.

Markets have bottomed, legislative risk has peaked, capital position is rock solid and the brand is on the improve.

I am super high conviction on AMP at these levels.

The main points from my meeting with Dunn are:

- AXA synergies, both revenue and cost, are surprising on the upside.
- There's a lower exit of AXA planners than expected.
- Capital position is strong. AMP wants a "fortress balance sheet".
- Dunn believes they have now ended uncertainty about the cost of regulatory change.
- Looking for small bolt on SMSF administrator acquisitions. No major acquisitions.
- AMP Bank going well, using cheap funding from CMTs.
- Seeing fund inflows picking up, and he's cautiously optimistic on this development and markets overall.
- AMP's looking forward to selling tonnes of high-yield manufactured asset management products to the yield hungry Japanese.
- Dunn commented on a potential change of Federal Government and the potential

opening up of the Industry Super Fund segment.
- 20% of all Australian super flows into the closed shop that is industry funds.
- Payout ratio to be 70% to 80%.
- -2.5% discount dividend reinvestment plan (DRP) will be most likely abolished through time, potentially replaced with the on-market buying version of a DRP.

BHP Billiton

BHP Billiton's results are always widely commented on by the financial press and broker analysts. Fair enough, BHP is the biggest mining company in the world and the biggest ASX200 index weight.

In my view, whatever BHP reported and said yesterday was going to be interpreted as bearish by the China/commodities bears and bullish by the China/commodities bulls. There is no middle ground in the views on China/commodities nowadays and BHP provides so much information, it is ammunition for both camps.

In my view, the BHP result of $17.1 billion, the delaying of major medium-term capex spend (they will still spend $22 billion in fiscal 2013), the second half operational consensus forecast of $12 billion, and the second half-year dividend payout ratio lift to 35%, were all good.

However, if I have one constructive criticism of BHP, it is that cost control through the 2012 financial year simply wasn't strong enough. A negative $3 billion contribution from cost increases is simply too big.

It is time for BHP to harden up on costs, particularly in Australia. The Aussie dollar is out of their control, but the good news is it is peaking.

Encouragingly, I think BHP gets this message. This is going to be bad news for parts of the over-geared front-end mining services sector and good news for BHP shareholders.

BHP remains a member of my high conviction buy portfolio. I think this year will be brighter for them as variable costs are attacked hard and commodity prices rally in Australian dollars.

BHP should be able to earn around $3.30 earnings per share (EPS) in 2013. I think investors will be prepared to pay 11-times for that $3.30 EPS as they get more comfortable with that being achieved. That equates to a $36.30 price target. However, I believe BHP will trade on 12-times fiscal 2013 estimates, which equates to a price target of $39.60.

Cum the 57 US cent final dividend, I think BHP is a buy from a trading and investing perspective.

Emeco Holdings (EHL) – Buy

Emeco is an equipment hire company, supplying earth-moving equipment to the mining industry. Emeco reported an annual net profit after tax (NPAT) of $71.1 million, well ahead of our $67.3 million forecast and ahead of previous guidance of $67-70 million. Operationally the result was broadly in line with expectations, with stronger margins (particularly in Australia) offsetting weaker-than-expected revenue growth. In the second half of fiscal 2012, NPAT growth of 61% was a highlight and benefited from the deployment of recently acquired capital, something that should remain a feature throughout 2013-14. Operating cash realisation was exceptionally strong at 111.4%, and this enabled net debt to finish the year at about $40 million more than expected.

- **Recommendation:** Buy (unchanged)
- **Price:** $0.90
- **Target (12 months):** $1.25 (unchanged)
- **Expected Capital growth:** 38.9%
- **Dividend yield:** 7.2%
- **Total expected return:** 46.1%
- **Market capitalisation:** $568.1 million

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Is your asset allocation right for your age?

by JP Goldman

At the heart of any investment strategy is asset allocation – knowing what investments are available, and how they should be combined so as to produce the stronger long-run returns for acceptable levels of risk.

Investors could buy any number of exotic investments – from rare stamps to fine wine. But here, let's confine ourselves to the five basic investments covering cash, bonds, property, equities and commodities. An example of an investment portfolio diversified across major asset classes using cheap exchange-traded funds (ETFs) is provided in my earlier articles: How to create a balanced fund with ETFs.

Let's examine how these asset classes might be combined for investments through different stages of your investment life-cycle, looking at examples for someone in their 40s, 50s and 60s.

Set your risk

The basic rule of portfolio construction is that (typically younger) investors with a longer investment time horizon should seek to take on more risk – in the form of accepting greater year-to-year volatility in portfolios returns.

Although volatility is never comfortable, those with a longer investment horizon know they have more time to recoup any short-run losses because markets tend to move in cycles. As a result, they should exploit this advantage and add risk in order to get a higher long-run return.

Those closer to retirement, however, are less able to accept a large short-run loss on their portfolio (as they will need to live off it sooner) and so should better protect themselves by having a higher share of their portfolio in less volatile investments.

Within our asset classes, cash offers the lowest volatility in returns, but also the lowest long-run expected return (around 5%). Bonds offer a slightly higher return (around 5.5 to 6.5%), but with moderately greater volatility. Equities offer the highest long-run returns (which for Australian equities should be around 8.5 to 10%), but with largest return volatility.

Over recent decades, for example, the standard deviation in Australian equity returns has been just under 20% – meaning there's around a 15% chance of losing more than 10% in any given year. In 2008, the loss was closer to 40%, with the market rebounding 40% the following year!

Spice it up

We can also spice up the portfolio mix through the addition of international bonds and equities, along with commodities. While these don't necessarily offer higher returns, they have the advantage of adding diversification – meaning we can achieve higher overall portfolio returns for the same level of risk.

Based on historical performance and correlations over recent decades, some estimates of likely risk and returns by asset class are provided below.

Asset class assumptions

	Expected Return (%)	Standard Deviation (%)	Correlation with S&P/ASX200
Cash	5.0	2.5	0
Aust. Govt. Bonds	5.3	7.5	-0.5
Aust. Listed Property	7.5	15.0	0.5
Australian Equities	8.5	17.5	1.0
International Equity	6.0	16.0	0.8
Emerging Markets	8.5	30.0	0.8
Gold	2.5	10.0	0.3

Several points are worth noting. For starters, bonds have the added advantage of their returns generally being negatively correlated with the return from equities – that is, when the economy is weak and equity prices are falling, interest rates tend to fall also, which boosts the returns from bonds.

Note also that property and international equities are positively correlated with the Australian share market, but it's less than a perfect relationship – so they offer some modest diversification benefits.

Gold also offers low correlation with the Australian market, but assuming its real value is broadly constant over the long run, its returns might not be more than inflation.

Of course, opinions over likely long-run returns will differ among investors, and return volatility and correlations can shift around over time depending on the nature of economic shocks. But to my mind, these are reasonable working assumptions for setting up a core (or strategic) asset allocation.

Asset allocation by risk

Let's now assume someone in their 40s (being younger) wants a high-risk portfolio, someone in their 50s a medium-risk portfolio, and someone in their 60s, a low-risk portfolio.

If we crank through a portfolio optimisation, these assumptions suggest an investor wanting a low risk portfolio (such that the probability of a negative return year was less than 10%) should have around 80% of their portfolio in cash or bonds, and 20% in (mainly Australian) equities. Those seeking medium-term risk, would tilt their portfolio with 60% in bonds and 40% in equities. A higher risk portfolio would have most risk (naturally enough) in equities.

Risk-Return Portfolio Combinations

	Cash/ Bonds	Equities	Risk*
Low	80	20	10%
Medium	60	40	20%
High	20	80	30%

**Probability of a negative return year*

Of course, if you're relatively young, but still feel anxious about portfolio volatility, you might want to beef up your cash/bond allocations relatively more compared to that suggested.

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Benefits and traps of transferring assets

by Andrew Bloore

Most people contribute to their super fund using cash. However, unlike other super funds, self-managed super funds (SMSFs) give you the ability make contributions using assets rather than cash. These types of transactions are known as 'in-specie' transfers.

There are a number of benefits to transferring assets you hold personally into your SMSF, but there are also some common traps that often catch trustees off guard. Let's run over these now. But first, I'll cover off some basics.

The rules

The amount of an in-specie contribution is determined by the market value of the asset at the time the contribution is received by the fund.

As a general rule, SMSF trustees can't buy assets from related parties, which is an extensive term that includes you and your family members. However, there are five exceptions to this rule, provided the acquisition is at market value and completed at arm's length.

1. **Listed securities**
   Any share or other instrument listed for quotation on the Australian Stock Exchange or other approved exchange.
2. **Business real property**
   Property used wholly and exclusively in one or more business.
3. **Investments in a widely held trust** (such as managed funds)
   Where 20 or more unit holders hold at least 75% of the rights to capital and income of the trust.
4. **Term deposits**
   Term and other deposits with an approved deposit institution such as a bank.
5. **In-house-assets**
   A loan to or an investment in a related party of the SMSF, an investment in a related trust of the SMSF, or an asset subject to lease or lease agreement between the SMSF trustee and related party. The market value of the in-house assets can't exceed 5% of the total market value of assets held by the fund.

The benefits

Cost savings: In-specie transfers have the benefit of potential savings on transaction costs. There are no additional brokerage costs because the shares are transferred off-market. Also, given current stock market volatility, there is no risk of missing out on market movements when shares are transferred because the SMSF remains invested in the market throughout the transfer.

Tax advantages: Contributing the asset into the SMSF allows the reduction or elimination (if the member is in pension phase) of the tax payable on future investment earnings. This is because SMSF income is taxed at 15% (and capital gains tax (CGT) is taxed at 10% for investments held for at least 12 months) instead of the individual's marginal tax rate, which is usually higher.

Tax deduction: If an individual is entitled to claim a tax deduction for personal contributions (which count towards the concessional contributions cap), this will apply to in-specie contributions as well. This deduction may help offset any CGT that is triggered on the transfer (see below). Alternatively, it will count as a non-concessional contribution. Either way, the contribution will be subject to the relevant contribution caps.

Beware the traps

Breaking your cap: Just like cash contributions, in-specie contributions are subject to the same restrictions. Exceeding contributions caps will result in excess contributions tax. Also, age related restrictions will determine if a contribution can be made, and any conditions that must be met, such as the work test.

Capital gains tax: An in-specie contribution is a CGT event as the transfer is a disposal due to a change of ownership. A capital gain or loss may be made from the CGT event according to the usual CGT provisions that apply to that asset. The proceeds are deemed to be the market value of the asset at the time of the CGT event. Further, stamp duty and goods and services tax (GST) may be payable depending on the transferred asset, the state it's located in, and the entity involved in the transfer.

Valuations: If the asset you're transferring isn't traded on an active underlying market, like shares on the ASX, a market valuation will be needed. It can be undertaken by either a qualified valuer or a person without formal qualifications. However, the valuation must be bases on reasonably objective and supportable data. A qualified valuer should be used where the value of the asset represents a significant proportion of the fund's value or where the nature of the asset indicates that the valuation is likely to be complex or difficult.

Wrong assets: It is important to understand which assets can be contributed in-specie to a SMSF. Strictly, residential investment property or private company shares can't be transferred to the SMSF. These aren't covered by the above exceptions. Violating this rule may have adverse consequences to the SMSF and the trustees. Importantly, ensure the trust deed allows in-specie contributions.

Watch out for these changes

The Government proposed to ban on- and off-market (i.e., in-specie) share transfers for SMSFs from July 2012, but this has been deferred until July 2013.

The concern with off-market transfers centres around price manipulation of the transfer, as the dates which appear on the off-market transfer forms can be chosen depending on the 'best outcome' scenario.

However, with numerous issues still to nut out, the ruling is yet to be finalised, which gives the industry more time to lobby the government to discard the ban altogether.

The main issue the government faces is that Corporations Law prohibits 'wash trades', which involves selling a share with the intention of buying it back on the market. By banning off-market transfers, a trustee would fall into this category in order to get the shares into their SMSF, which may impose serious penalties.

More suitable solutions are being put forward by industry experts, including more rigorous legislative controls around the time when off-market transfer forms are received by registries.

We eagerly await the outcome.

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Should you buy art from a gallery or at auction?

by Alistair Bailey

As the late art critic Robert Hughes once said, “prices are determined by the meeting of real or induced scarcity with pure, irrational desire.” How prices are determined, as we have examined previously, is far from a new dilemma for collectors or investors. It can become particularly evident when an investor looks at the apparent pricing differential between the art market’s two distinct markets – primary and secondary.

So in which market should you buy? Let’s take a closer look at these two markets to see the difference in price.

The Secondary Market

The Secondary art market is the term predominantly used to describe the auction markets. Once the domain of the dealers and a handful of collectors, it is this market that is most often quoted in the media – such as the sale of Arthur Boyd’s *Bride Running Away* through Sotheby’s Australia last week for a record breaking price of $1.68 million.

It’s often thought that because it provides tangible evidence of how a work trades in the public domain that it’s a more accurate view of value.

Private Treaty

There’s a third market that by its nature is virtually impossible to track and that’s the Private Treaty market. Results are generally only leaked selectively. Interestingly, one of the trends that has established itself particularly in the wake of the GFC has been the increased activity by the major auction houses in the Private Treaty space, with both Sotheby’s and Christies reporting increases of over 60% in turnover in works sold in this manner over the past 12 months. We have also seen the auction houses in Australia developing strategies to be more involved in Private Treaty. What has become most apparent is that over the past decade the Secondary market has gone from the realms of the dealer to that of the broader retail market.

The Primary Market

The Primary market on the other hand is new work, fresh to market from the artist. It’s the term generally used to describe the gallery scene manifested through exhibitions and increasingly through art fairs. I’ve said before that the Australian market is increasingly driven by the contemporary market and, as such, the primary market has a massive role to play in this.

Undoubtedly, buying in the primary market carries a different risk profile to acquiring works at auction. Investors must understand that investment in the primary market carries a unique risk that appears to conflict with every ounce of an investor’s psyche and is heightened with work by an emerging artist. It’s a big hurdle to accept that you will probably not realise a return by on-selling the work within a month, a year or even a few years. The less established the artist – the greater the risk.

So how do we know that we are making a sound investment decision? How can we buy the million-dollar Boyd when it is priced in the tens of thousands?

The stuffed shark

In 1991, much to the bemusement of the British public, Charles Saatchi commissioned what was to become the most expensive work by a living artist for £50,000. By 2004, *The Physical Impossibility of Death in the Mind of Someone Living*, better known as “The Stuffed Shark”, by Damian Hirst was purchased reputedly for US$12 million. Hirst’s

auction record in 1991? Zero.

The benefit of hindsight is obviously a wonderful thing when it comes to investing, but the astute investor looks for insight, so as a case study let's consider an artist such as Chen Ping. *Mist Mountain Big Tree Man* (illustrated) was purchased for $15,000 earlier in the year. As it stands – Chen Ping's auction record is equal to that of Damian Hirst's 1991 Auction record – zero. If the work were to be offered today at one of the forthcoming auctions in Australia, would it sell for $15,000? Probably not. So why would we consider this work a strong investment play?

Cheng Ping, Mist Mountain Big Tree Man, 2012, Oil on Canvas. Source: Art Equity.

Determining value

The lack of an auction record in this case is simply due to the fact that nothing has been offered for sale by this artist. An auction house, particularly in Australia, will also take a view that this artist is untried and untested in the secondary market and therefore won't warrant higher estimates.

Auction houses are in the business of selling – you should never lose sight of this. They are protective of the clearance rates that are reported. Consistency in sell-out exhibitions and growing waiting lists for works is arguably more important to monitor than the secondary market activity.

We should then consider Chen Ping's CV. Classically trained at the Guangzhou Academy of Fine Art, he has established a regular exhibition calendar that sees his work represented all over the world. The Guangdong Museum of Art has acquired his artwork and he has a very influential dealer who has been showing his art alongside works priced in excess of US$400,000.

All the while, his work has been increasing in price and selling consistently well. In 2005, works of a similar scale were on the wall at $7,500, in 2013 for his US show, works at this scale will be going on the wall at US$22,000.

Risk and reward

Clearly there is potential, but will it be realised?

Only time will tell, but the weight of curatorial reference and consistency in selling exhibitions, both domestically and internationally, suggests it is a good start. Will Chen Ping be selling for millions of dollars in 10 to 15 years time? I don't know, but it is certainly reasonable to suggest that he has the potential and the ability to rival the prices of his contemporaries.

The notable trait of very successful investors in this space is the term that they typically hold a work – something that is STILL too often underestimated in the Australian market. They also look to spread the risk over a handful of artists.

Of course, as I like to remind you, the golden rule is that the investment lies in the quality.

Alistair Bailey is now based in London and is the managing director of Art Equity Limited.

Disclaimer: Art Equity is the Australian dealer for Cheng Ping.

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Don't miss this!

More companies are set to release their full-year results:

Friday 25 August: ING Private Equity (IPE)
Friday 25 August: Telecom Corp of NZ (TEL)
Friday 25 August: Atlas Iron (AGO)
Friday 25 August: Whitehaven Coal (WHC)
Friday 25 August: Woolworths (WOW)
Monday 27 August: Atlas Iron (AGO)
Monday 27 August: ASG Group (ASZ)
Monday 27 August: M2 Telecommunications (MTU)
Monday 27 August: Toll Holdings (TOL)

Did you know?

Switzer will be presenting seminars on self-managed super (SMSF) in Sydney and Melbourne in September and October. The seminars are ideal for those looking to start an SMSF or for those who would like their super to perform better.

Tickets start at $20 per person, or $25 per couple.

Limited seats are available. for more information and to register, please visit: www.switzer.com.au/SMSF or call 1300 794 893.