Switzer Super Report

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Iron ore slump

Aussie stocks have been dragged down by falling iron ore prices. But Charlie Aitken says something is not adding up. He tells us what he expects in today's report and what his recommendation is on Atlas Iron, BHP and the broader market.

Also in the *Switzer Super Report*, our guest contributor Peter Thornhill explains why his 'conservative' portfolio is 90% in shares. Ron Bewley recaps how his portfolio performed this earnings season, and names all his stocks. Plus, we find out the answer to the most commonly asked SMSF questions, and list the only three circumstances in which your SMSF can borrow. Enjoy!

Sincerely,

Peter Switzer

Inside this Issue

Ask the auditor: the top 5 questions SMSFs ask
by Jo Heighway
10

02 **Opinion is split on what lies ahead**
by Peter Switzer
Can the US maintain growth?

04 **Iron ore slumps. Time to buy Atlas Iron?**
by Charlie Aitken
Something is not adding up.

06 **How my stocks performed this season**
by Ron Bewley
Who they are and how they went.

08 **90% in shares: the conservative approach**
by Peter Thornhill
Why I call a high share exposure 'conservative'.

10 **Ask the auditor: the top 5 questions SMSFs ask**
by Jo Heighway
Jo has all the answers.

12 **SMSFs can’t borrow money, except...**
by Andrew Bloore
Your fund shouldn't be in debt.

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Opinion is split on what lies ahead

by Peter Switzer

D-Day for Europe and the world's financial markets looms, not on Friday with the Jackson Hole Symposium in Wyoming, but next Thursday when the European Central Bank (ECB) outlines its game plan for liquidity and bond-buying in Europe.

Here's hoping…

Trying to explain this to my news buddies, where you often have to show them the potential extremes of an upcoming story, I said a bad ECB decision on September 6 could send stocks slumping down like last August and September and could even sow the seeds of a severe recession next year or even a depression!

I don't think this will happen. In fact, I think the ECB will deliver at least OK news and that could lead to a mild sell-off on the basis that markets often buy the rumour and sell on the fact (i.e., the news).

However, I'm hoping for better than expected news on Europe's plans, which could actually excite the market.

Of course, I did use the word "hope" and hope is not a strategy for investors, but this is the flip side of the worst-case scenario.

Split opinions

The news next week will have a big bearing on what will happen to the global economy and therefore stocks next year. And right now the experts I respect are split on the future, which should not surprise anyone who has tried to work out financial markets in the past.

Dick Bove of Rochdale Securities is a buyer of stocks, but Dennis Gartman of the Gartman Letter is "exiting stocks" he told CNBC. Meanwhile, Northwestern University economist Robert Gordon in the USA is predicting a decade of low growth for the United States based on historical trends, while Mark Zandi, chief economist at Moody's Analytics, is tipping a strong 2013.

He expects a third stimulus package (quantitative easing three – QE3) to eventually come after the US Presidential election in November. He has 2014 at 4% growth and clearly isn't in the 'decade of low growth' camp.

US economic repair

Overnight we learnt that the Yanks grew their economy at 1.7% on an annualized basis in the June quarter – up from the 1.5% that was predicted before recent upward revisions. And once again, there was better US housing news with pending home sales up 2.4% in July, which took this important reading on the economy to a two-year high.

Also the Fed's Beige Book on the overall economy painted an improving snapshot with more jobs creeping into the picture.

For those who need to know, the Dow was up 4.49 points to 13,107.48 while the S&P 500 added 1.19 points to 1,410.49. So, is this the calm before the storm?

Line up

If the Europeans screw up, stocks will slide big time. If they deliver on expectations, there could be a small sell-off and this will be a buying opportunity. However, if they really surprise positively, then the rally that started on June 4 could be re-ignited, but then we will worry about a German court decision to give the European Financial Stability Facility – the key bailout fund – some more money. After that it will be the US

election and the ‘fiscal cliff’.

That said, I’m still punting on optimism and taking any sell-off as an opportunity because I invest long-term in great companies and especially when their share price looks like fantastic value.

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Iron ore slumps. Time to buy Atlas Iron?

by Charlie Aitken

I think the performance of the ASX200 was encouraging yesterday. It's not often that you see the Nation's major export commodity in free fall and the companies that mine that commodity in free fall, yet the benchmark equity index only lose three points. In fact, when you strip out the negative points contribution from the major miners (down nine points), the broader industrial market was higher again.

The Aussie dollar was also completely resilient to spot iron ore, as were 10-year bonds, industrial equities and non-iron ore resource stocks. Turnover on the ASX crept over $4 billion.

Iron ore downtrend

This continues a trend. Spot Iron ore has fallen 31.5% since June 22. In that period spot iron ore has only had six up nights. However, during that period the ASX200 has advanced 7.5%.

There is something a little weird about all this. Surely if this truly was the end of iron ore as we know it, the ASX200 would be under heavy pressure, the Aussie would be in free-fall and bond yields would be falling because Australia's budget surplus forecasts would be fanciful. Australian economic growth would also be being revised down sharply.

What I'm saying is the lack of asset class correlation of the spot iron ore price move, outside of iron ore equities, suggests this is an iron ore specific, short-term, game. In fact, all other commodities have been rising, increasing my suspicions about China Inc. manipulating the opaque spot iron price in a period of spot cargo tenders by one major producer. My point is that other Australian asset classes don't agree that it's all over for iron ore, in fact, they are pricing quite the opposite. Ditto the rest of the commodity complex in terms of global demand.

It will bottom

The conclusion I'm coming to is when spot iron ore bottoms, and that day must be extremely close with 60% of the industry losing money at these spot prices, the short-covering in major iron ore producers will drive the ASX200 into a new higher trading range. Hopefully this occurs as we concurrently jump the Jackson Hole hurdle this weekend.

I still think the 30-day ASX200 SPI futures charts look bullish, but to break out into a higher trading range it requires a rallying BHP (10% of the index). A rallying BHP can only occur as spot iron ore bottoms. That won't be today. Some Chinese stimulus wouldn't go astray either, but again, it's all inter-related. Even though I have been wrong in the short-term on big miners, we are about 20 odd days into my new bull Australian equity market call and so far so good.

Atlas Iron Ltd (AGO) – Buy

Atlas Iron recorded underlying net profit after tax (NPAT) of $72 million (compared with our estimate of $106 million), and was softer than expected due to differences in operating costs estimates. Revenue increased by 5% due to a 22% increase in iron ore exports for the year. Cash operating costs for full-year 2012 were $44.9 per tonne, and at the top end of guidance of $42-45/t. Atlas declared a final unfranked dividend of 3 cents per share, which was in line with our expectations. It had $400 million in cash as at 30 June.

We believe Atlas Iron can pursue its Horizon 1 growth option without additional debt. Based on comments from the conference call, we think there's been too much focus on Horizon 2's capex draining capital and funding requirements. Atlas's expansion beyond Horizon 1 could play out in many ways and could add significant value (i.e., staged developments, third

party access agreements etc).

We don't believe the market is factoring in Atlas Iron's relatively low risk Horizon 1 production growth to 12 million tonnes per annum (Mtpa) rates by the end of 2013. However, we think Atlas is likely to hold this discount until a rail solution for Horizon II is illustrated. We expect this solution to be announced over the next six to 12 months.

- Recommendation: Buy (unchanged)
- Price: $1.40
- Target (12 months): $3.30 (unchanged)
- Expected Capital growth: 99%
- Expected Dividend yield: 3%
- Total expected return: 102%

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How my stocks performed this season

by Ron Bewley

The August reporting season is just about over and the next won't be until February 2013, with only a few companies, including three big banks, reporting between the main seasons.

So it's a good time for me to take a month's holiday. Before I leave, I'm going through my whole portfolio, company by company, to minimise any action I have to take while I am away. And I've already arranged for an internet connection so I can keep in touch with my portfolio while overseas.

My defensive stocks

I have four defensive stocks: **AGL Energy (AGK)**, **Commonwealth Bank (CBA)**, **Cochlear (COH)** and **Westpac Bank (WBC)**.

By my exuberance measures regularly published on my website, the Utilities sector is fairly priced so, although AGK has run hard, I'm not worried. The two banks look strong, but I have this sector as being quite overpriced (but not dangerously so). I would be tempted to take a little profit from my banks if I were to be incommunicado on holiday (particularly if I needed cash for a pension payment), but I'm on hold. If they run much harder while I am away, I might act.

COH (Cochlear) is a favourite of mine. It had a recall for an ear implant late last year when I wrote about it for the Switzer Super Report. It has come back in price, but it's still not quite to its pre-recall level. Although analysts have it valued at less than its current price and their recommendation is 'Hold', I don't believe them. This is the only stock that I over-rule the analysts. I did a consulting project for them in the late 80?s and have followed them ever since. I did sell some when it got in the $80+ range in early 2011, but I bought back at $55!

So my defensives are covered – at least by my thinking.

My cyclicals

I wrote a fortnight ago about my mining services (Industrials sector) stocks: **Bradken (BKN)**, **Boart Longyear (BLY)**, **Emeco Holdings (EHL)**. They behaved beautifully (so far) this season. If I had more cash I would average down. I'm at the positive end of the China story, just as I was in late 2008 when these stocks got really hammered. I supported them then, and now.

My Energy sector stocks, **Santos (STO)** and **Woodside (WPL)**, got hurt in the last little while after so courageously climbing from their Spring 2011 lows. They reported well and I still back them. That leaves my Materials stocks. My one-man jury is naturally deliberating on this issue.

My Materials stocks are **Atlas Iron (AGO)**, **BHP Billiton (BHP)**, **Lynas (LYC)**, **Mount Gibson Iron (MGX)** and **Rio Tinto (RIO)**. I have no problems with BHP and RIO. There might be a lull in their performance but I bought these stocks on at least a five-year horizon, so a couple of questionable numbers change little for me. I argued very vigorously in the fourth quarter of 2008 and the first quarter of 2009 that China wasn't going away and backed my stocks. This time China is much stronger. Smaller miners such as AGO, LYC and MGX are a different proposition.

AGO reported yesterday and missed profit estimates, but reported well for the future. I don't have enough cash in my SMSF to buy more, but I'm sorely tempted to average down in my margin loan (which I have outside super).

MGX is different to me. Its problem has been the

balance of its board – too many members are seemingly very close to their Chinese customers for comfort – but it just rearranged its executive board and formed a new plan. The jury is out, but this looks promising – but it could go wrong. Would I hold it if I were to be in the wilderness? I will keep an eye on it from England.

Lynas (LYC) is a different story. Space precludes a detailed discussion, but the darling of 2011 has become the elephant in the room for late 2012. The main issue is if they will actually produce rare earths for sale from Malaysia. They had serious delays due to lobbying against environmental issues for six months to a year. The project has a green light but a capital raising might be necessary because of the costs of the delay. The world still needs rare earths for our high-tech world. I sold about half of my holding at prices from $1 to $2.50. Even with the price under $0.70, I would still make a tidy profit on this stock if I sold the rest now. I'm not overly confident, but the world's need for rare earths has not gone away. But I will watch this one too.

So I sold all of my **CSL (CSL)** and **Sonic Healthcare (SHL)** recently without regrets. I feel the market is on a big move up and cyclicals will do better than defensives. I've held all of my stocks for quite some time – most for more than five years! Of course, the amount of each I own varies over time and I don't have an equally-weighted portfolio!

Ron Bewley is the Executive Director of Woodhall Investment Research*.*

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90% in shares: the conservative approach

by Peter Thornhill

As we transitioned to full retirement, my wife and I decided to take charge of our future and opted some years ago to manage our own super. One of the primary reasons for this was to ensure that the assets reflected our very conservative nature – that is, 90% shares.

This may sound contradictory to many, but after 45 years in the financial services industry, I had learnt some very important lessons.

Outliving your super

The word 'risk' is bandied about, but many don't truly understand the investment risks associated with retirement. Leaving it to an industry that also doesn't understand it didn't appeal to us. Our primary risk is not losing money, but outliving it!

When discussing whether we could afford me ceasing full-time work, the consideration wasn't how much money we had, but how much income we needed. We looked at the three assets available – cash, property and shares – considered their income prospects, both present and future, and opted for shares.

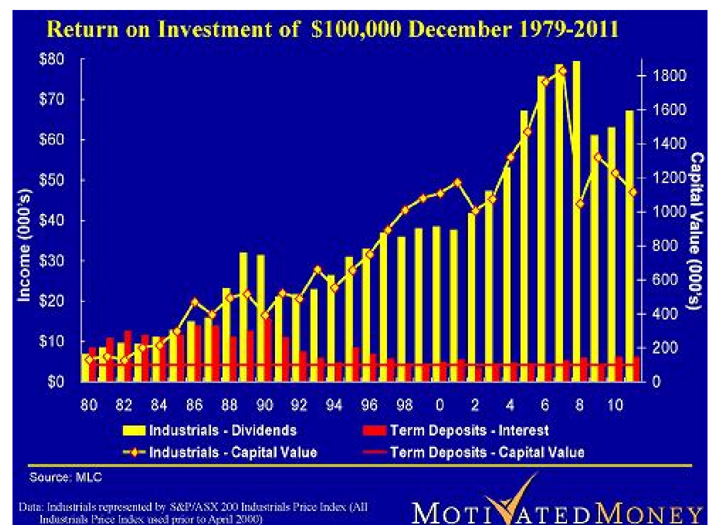
The income they generated would meet our immediate needs without having to rely on selling, thus maintaining the integrity of our asset base. Also, over the long term, I knew the dividends from a diversified portfolio of shares had and would grow in a relatively stable way; being linked to the productive efforts of the nation, they would be superior to the income from other sources.

Ten years on…

With more than a decade behind us now and the Global Financial Crisis (GFC) to add some spice, we can now look at our strategy being tested in real time.

As painful as it was to watch our portfolio almost halve in value, the income only dropped by 20%. As we held enough in cash to cover two years worth of pension withdrawals, we simply followed our parents' example who, when times were tough, simply tightened their belts.

The chart of my portfolio below is worth a thousand words. The dividends, during the 1980's and 1990's, whilst I was still working, were being reinvested. When I quit the industry in 2000, it was simply a matter of redirecting the dividend stream from reinvestment to pension mode.



Then the GFC hit. Two years later and our income was almost back to where it was before the GFC, although the portfolio value still hasn't recovered fully.

The importance of never having to rely on cashing your asset base to provide income can't be impressed enough. Too many retire with too little, too early and leave themselves exposed to the disaster that is cashing in when prices have retreated.

By focussing only on the income and not the prices of

our shares, we have avoided much of the angst associated with the GFC. Also, as longevity appears to be a genetic advantage that we enjoy, I need to be sure that the asset base remains intact and the income stream continues to grow for the next few decades.

I have watched as my parents, in-laws and many of their peers were reduced to living totally on the old age pension because they had initially relied on bank deposits in what they thought was the 'safe' option. The nail in the coffin as far as I was concerned was watching as the two respective family homes were sold as neither widow (the husbands having pre-deceased their spouses) could afford to maintain them.

As the probability is that my wife will survive me, we will continue to invest solely in shares – the conservative option – as I'm determined that she will live with dignity.

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Ask the auditor: the top 5 questions SMSFs ask

by Jo Heighway

As an SMSF auditor, I get asked a lot of questions, but these are the five most common:

1. Why do I need to keep records?

The rules applying to SMSFs require trustees to keep and maintain appropriate records for at least five years!

The best advice I can give is to communicate regularly with your advisor and auditor so that you know the types of records that they want you to keep (ask in advance!). This saves you from holding onto things that you don't need or having to chase up records months or even years after transactions happen.

2. Can my SMSF buy this asset?

When you are looking at making any investment with your SMSF money, you need to first make sure your super fund trust deed allows the investment, and secondly that there are no rules within the legislation that would prohibit the investment.

Be extra careful if you are thinking of transferring or selling personal investments into your SMSF. For example, residential rental property can't be transferred into your SMSF, so ask before you act.

And don't forget to review and update your fund's investment strategy any time you' re making a new investment.

3. Can I have this insurance in my SMSF?

It makes sense to have life insurance policies paid from your SMSF as the premiums are deductible and can be paid out of your compulsory SG contributions. Many other insurance policies including TPD and income protection can also be paid from your SMSF.

It is very important that the owner of the insurance policy is the Trustees of your SMSF. Never pay personal insurance policies from your SMSF bank account as this will cause a breach of the rules. New policies in the name of the super fund are the safest way to go.

4. Why do I need an audit, can't the ATO do that?

SMSFs by law are required to have an independent audit of their financial statements and compliance with superannuation law every year. The auditor needs to be an approved SMSF auditor, and from 1 July 2013, they will need to be registered with ASIC.

Who you appoint as auditor of your fund is your decision and it's important to know who your auditor is and what their qualifications are. You should also be clear on what relationship the auditor has with your advisors to be confident it truly is an independent audit.

There are many benefits to having an annual audit and it is very different from the experience you may encounter with an Australian Taxation Office (ATO) audit. The fact is the ATO doesn't have the resources to audit every fund, so they rely heavily on approved auditors to assist them in educating Trustees and focusing attention on only the worst cases.

Read: Why an audit can be the best thing for your SMSF.

5. I've contributed too much into my super fund, what do I do now?

It's very important to get proper advice from an SMSF specialist if you think you have contributed too much. Excess contributions tax can be extremely costly, so it's worth paying for advice.

There are situations where your contributions can be refunded – such as if you are over 65 and haven't met the "work test", or where you have made a single contribution that exceeds your non concessional contribution cap ($150,000 or $450,000, depending on your age).

Contributions received in June also provide some planning flexibility using a strategy that defers allocation of the contribution until July.

It's very important to ensure all contributions have been appropriately classified (concessional or non-concessional) and appropriately allocated to the right person. Many excess contribution cases I see are simply caused by the wrong assumptions being made in the preparation of SMSF financial statements and no one has asked the right questions about what was actually intended.

Have you got a question for Jo? Click here to submit it.

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SMSFs can't borrow money, except...

by Andrew Bloore

Regardless of the lender, super law prohibits SMSF trustees from borrowing money or maintaining an existing loan.

A transaction will be considered borrowing if:

- there is a temporary transfer of an asset from a lender to a borrower; and
- there is an obligation or intention to return the temporarily transferred asset to the lender.

The legislation states that the asset borrowed must be money, although the borrower may provide an asset (or other money's worth) in satisfaction of their obligation or intention to repay the lender.

The fine print

There are three strict exceptions to the borrowing rule.

1. To fund a payment to a beneficiary

This enables the SMSF to undertake a temporary loan to make a payment to a beneficiary, which the trustee is required to make by law or by the SMSFs governing rules, and which the trustee wouldn't be able to make without the borrowing. The borrowing period must not exceed 90 days and the total amount borrowed must not exceed 10% of the value of the SMSF assets.

2. To cover settlement of certain securities transactions

The purpose of the loan is to enable the trustee to cover the settlement of a transaction for the acquisition of certain securities. Examples include listed shares, units in a unit trust, bonds and debentures, futures and forward contracts, swap contracts, rights or options over these securities and foreign currency. The loan period must not exceed seven days and the total amount borrowed must not exceed 10% of the value of the SMSF assets. Importantly, at the time the relevant investment decision was made, it was likely that the loan would not be needed.

3. Allowing the SMSF to acquire an asset under certain limited recourse borrowing arrangements (LRBA)

This is a complex piece of legislation which allows the SMSF to borrow to acquire a single acquirable asset that is held in a holding trust so that the trustees acquire a beneficial interest in the asset. The trustee has a right to acquire legal ownership of the asset by making one or more payments after acquiring beneficial interest, and the rights of the lender (or any other person) against the trustee in connection with the borrowing and other charges are limited to that asset only. Acquirable assets are any assets that an SMSF is permitted to acquire under general super law.

There are specific rules around the holding trust, what constitutes a single asset, in which circumstances assets can be replaced, and whether assets can be repaired or improved.

What is and isn't 'borrowing'?

Examples of circumstances that are classified as borrowings:

- Loan of money, either secured or unsecured
- Margin lending accounts
- Bank overdrafts
- Sale and repurchase agreements

Examples of circumstances that are not classified as borrowings:

- Contracts for difference (CFDs)

- Installment purchase agreements with immediate use of assets
- The liability of an SMSF to pay benefits to members as they fall due
- Arrangements under which expenses are paid on behalf of the SMSF trustee by any person where reimbursement is immediately sought from and made by the SMSF
- Normal commercial delays in the payment of expenses incurred by an SMSF trustee

The borrowing prohibition extends to granting a charge against an asset of the SMSF. This includes a mortgage, lien or any other encumbrance. Therefore, an SMSF can't use existing assets as security for any dealings.

The borrowing exceptions are strict in application, and breaking these rules could result in civil and criminal penalties, and may jeopardise the complying status of the SMSF.

With respect to LRBAs, it's imperative that the arrangement is set up correctly to avoid unnecessary tax and duties when the asset is transferred to the SMSF. It's prudent to seek advice on these structures from your financial planner or SMSF adviser.

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Did you know?

Gold fell to US$1,656.76.10 an ounce overnight from US$1,666.10 yesterday, consolidating within its new US$1,650-US$1,676 range. Holdings of gold ETFs continued to rise, hitting a fresh record at 71.65 million ounces.

ANZ analysts expect range-restricted trading as the weekend's macro policy and data risks approach.

Don't miss this!

Switzer Financial Planning 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.