Switzer Super Report

Issue 121, 24 September 2012

Good vs Bad

There's no great rally news to report today, but Wall Street is definitely trying to defy gravity and I think it will be able to keep it up if the good run of news keeps showing up. But will it? I run over the things that could impact the market in today's note.

Also in the *Switzer Super Report*, what happens if your fund wants to borrow from two lenders? Or buy a property off the plan? Tony Negline talks about the grey areas in these transactions. Plus, we have our weekly broker wrap of Buy, Sell and Holds, and we also analyse the latest SMSF statistics to see where other funds are investing their money. Have a great week!

Sincerely,

Peter Switzer

Inside this Issue

Using two lenders and off-the-plan property
by Tony Negline
08

02 **What's looking good – and bad!**
by Peter Switzer
Can the run-up in stocks last?

04 **The broker wrap: FMG, ILU and WRT**
by Rudi Filapek-Vandyck
Here's what the stockbrokers are saying.

06 **Trustees get a little more defensive**
by Paul Rickard
Where other SMSFs have been putting their money.

08 **Using two lenders and off-the-plan property**
by Tony Negline
There are some grey areas in these types of transactions.

switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

Important information: This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. For this reason, any individual should, before acting, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice.

What's looking good – and bad!

by Peter Switzer

So the optimists have beaten up the pessimists and our portfolios are now up around 8% since the start of the year based on the S&P/ASX200 index. The index is now at 4,408.3 and is up 10.6% since the most recent low of 3,985 on June 4.

In the US, the Dow Jones index is at about 13,570 and near its all-time closing high of 14,164.53, but we are still a long way from our record close of 6,828.7 on November 2, 2007. These comparisons partly explain why I agree with Phil Ruthven of stats collector IBISWorld, who argues that there will be a big pop – over 40% – for our stocks when the worst of news is behind us.

Ready to run

I think that process is happening, though there are still challenges out there, such as China's recovery, the US election, the US fiscal cliff issue and what the Europeans get up to.

So far, the Europeans are playing ball. Over the weekend, there was some good news on the Spanish bailout front, which sent the German DAX up 0.84% and the French CAC 40 up 0.59%, which I like.

On the plus side, I like what an unusual index – the Baltic Dry Index (BDI)– is telling me. This is a forward indicator of world trade as it monitors shipping movements of dry-bulk commodities such as coal and grains and tells us something about industrial activity.

Earlier this year, the BDI was clobbered – plunging 56% according to CNBC. The good news is it has risen 14% in the past week! The index has been a good pointer for what is going on in China, but it's still early days. Even so, I like what I see.

On the flipside, there are suggestions the increased shipping activity could reflect a rush ahead of any potential Middle East showdown between Israel and Iran, which is becoming a topic of concern in recent times.

Here are some other things I like:

- The VIX or fear index is low at 14,
- Iron ore prices rose 14% in three days last week,
- The S&P 500 index in the USA is up 16.7% for the year to date, and
- The short-sellers are scared of the QE3 stimulus package, meaning they could be worried it just might work.

Against this I'm worried about:

- The US election,
- The US 'fiscal cliff', which might need a good election result and a compliant Congress to avoid calamitous results,
- Europe's handling of countries such as Greece and Spain remains a big question mark, and
- My biggest worry is China and the Shanghai Composite index, which has been very negative lately.

My main focus

Since May, the Shanghai Composite index has dropped from around 2,450 to 2,020 and while it kicked when Europe and the European Central Bank got their bailout act together, it has resumed its decline.

Now this could be ahead of a leadership change, but it has to be economic as well. I want to see the leadership change next month and some stimulation announcements. If that happens, I will be more relaxed, but China is now my main focus.

I think they won't let the bull team down, but I'm paid to be objective!

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Anyone should consider the appropriateness of the information in regards to their circumstances.*

The broker wrap: FMG, ILU and WRT

by Rudi Filapek-Vandyck

Changes to stockbroker ratings in the past week

Code	Company	Old Rating	New Rating	Broker
ACR	Acrux Limited	Neutral	Buy	RBS Australia
AGK	AGL Energy Ltd	Buy	Buy	Citi
FMG	Fortescue Metals Group	Neutral	Buy	RBS Australia
FMG	Fortescue Metals Group	Neutral	Buy	UBS
GNC	Graincorp Limited	Neutral	Buy	JP Morgan
ILU	Iluka Resources	Neutral	Buy	JP Morgan
MOC	Mortgage Choice	Neutral	Buy	RBS Australia
WRT	Westfield Retail Trust	Neutral	Buy	UBS
AGO	Atlas Iron Limited	Buy	Neutral	Macquarie
CSR	CSR Limited	Neutral	Sell	Citi
GRR	Grange Resources	Buy	Neutral	Macquarie
ILU	Iluka Resources Limited	Buy	Neutral	Macquarie
JHX	James Hardie Industries	Buy	Neutral	BA-Merrill Lynch
JHX	James Hardie Industries	Neutral	Sell	UBS
MAH	Macmahon Holdings	Buy	Neutral	RBS Australia
MAH	Macmahon Holdings	Buy	Neutral	Macquarie
MAH	Macmahon Holdings	Buy	Sell	UBS
SYD	Sydney Airport Holdings	Neutral	Sell	BA-Merrill Lynch
TPM	TPG Telecom Limited	Neutral	Sell	RBS Australia
WTF	Wotif.Com Holdings	Buy	Neutral	UBS

Source: FNArena

Downgrades to ratings by the eight brokers in the FNArena database continue to outweigh upgrades to the tune of 12 ratings reductions over the past week compared with eight increases. Total Buy ratings now stand at 44.79%.

Upgrades

Among the upgrades, the one stock to see more than one increase was **Fortescue Metals (FMG)**, with both UBS and RBS Australia upgrading it to Buy. RBS says Fortescue's securing of a new debt facility removes short-term funding issues, enough to justify a more positive rating in the broker's view.

Also upgraded was biotech **Acrux (ACR)**, with RBS suggesting there is now reasonable value in the stock at current levels following share price weakness post a profit downgrade announcement in August. RBS has moved to a Buy rating.

RBS also upgraded **Mortgage Choice (MOC)** to a Buy following a change in analyst covering the stock. The change has generated adjustments in price target and earnings estimates, while the broker also sees longer-term upside potential from recent acquisitions. An added attraction is Mortgage Choice offers an attractive fully franked dividend yield.

Citi upgraded **AGL Energy (AGK)** to Buy as the broker sees upside from the optionality in electricity retailing in NSW that the company has developed in recent years. The upgrade has no impact on Citi's earnings estimates or price target.

Westfield Retail (WRT) was upgraded by UBS to Buy on valuation grounds as the stock has underperformed in relative terms against the A-REIT index in recent weeks. UBS makes no changes to earnings forecasts or price target.

Both **Graincorp (GNC)** and **Iluka (ILU)** were upgraded to Buy by JP Morgan, the former on valuation grounds as the share price has fallen more than 10% since the recent edible oil assets acquisition. For Iluka, JP Morgan expects higher zircon prices to continue until at least 2015, which supports a solid earnings outlook for the company. Also positive is Iluka's strong balance sheet, good management and unique assets.

Downgrades

But Macquarie is less positive and has downgraded Iluka to Neutral as recent share price gains suggest limited valuation upside from current levels. Changes to commodity price forecasts resulted in Macquarie lifting its price target modestly.

Macmahon Holdings (MAH) was downgraded by three brokers, with RBS and Macquarie moving to Hold and UBS to Sell following a rather severe profit warning from the company. Earnings estimates and price targets for Macmahon received the chainsaw treatment across the market. Macquarie suggests a more cautious view on the company is now justified as the market will want some evidence with respect to the consistency of earnings before any re-rating occurs. UBS also sees an uncertain earnings outlook and suggests this risk is reason enough to exit the stock.

James Hardie (JHX) has also been downgraded by two brokers, BA Merrill Lynch moving to a Neutral rating and UBS to Sell. For UBS, the issue is value as the stock is viewed as simply too expensive at current levels, while BA-ML moves to a more cautious view as the current share price leaves little wriggle room for any earnings disappointment relative to expectations.

Among iron ore plays, both **Atlas Iron (AGO)** and **Grange Resources (GRR)** have been downgraded by Macquarie, this following revisions to the broker's commodity price forecasts. In the case of both, recent share price gains add weight to the downgrades.

Citi downgraded **CSR (CSR)** to Sell, reflecting the view non-residential and engineering work is likely to decline in coming years, impacting CSR's earnings, which are already under pressure from weak residential construction activity.

BA-ML has downgraded **Sydney Airport (SYD)** to a Sell. Solid traffic numbers for August and expectations this trend will continue are not enough to be more positive as the good news is already priced into the stock in the broker's view.

RBS has downgraded **TPG Telecom (TPM)** to Sell. Full year earnings for FY2012 were solid, but the earnings growth outlook for the stock isn't good enough in the broker's view to justify the stock's current premium to the sector.

For **Wotif.com (WTF)**, UBS has moved to a Neutral rating on news the CEO has resigned. This creates uncertainty in the broker's view, which limits the scope for any share price outperformance in the shorter-term.

Note: FNArena monitors eight leading stockbrokers on a daily basis. The eight experts are: BA-Merrill Lynch, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie, RBS and UBS.

Changes to earnings forecasts (EF) in cents per share

Code	Company	Previous EF	New EF	% Change	No. of brokers
KMD	Kathmandu	13.986	14.525	3.85%	5
GNC	Graincorp	100.443	103.543	3.09%	7
TPM	TPG Telecom	15.85	16.1	1.58%	4
QRN	QR National	21.075	21.288	1.01%	7
COH	Cochlear	281.325	283.125	0.64%	8
ORL	OrotonGroup	64.204	64.524	0.50%	5
REA	REA Group	75.086	75.443	0.48%	7
ANN	Ansell	107.584	107.909	0.30%	7
SPN	SP Ausnet	8.363	8.375	0.14%	6
ANZ	ANZ Bank	219.35	219.6	0.11%	8
PAN	Panoramic Resources	4.4	0.125	-97.16%	3
MAH	Macmahon	8.875	3.625	-59.15%	4
TEN	Ten Network	2.375	2.05	-13.68%	8
OSH	Oil Search	13.338	11.838	-11.25%	8
ARI	Arrium	17.85	16.183	-9.34%	6
FMG	Fortescue Metals	49.024	45.368	-7.46%	8
DJS	David Jones	20.175	19.238	-4.64%	8
MOC	Mortgage Choice	14.6	14	-4.11%	3
AAD	Ardent Leisure	12.767	12.3	-3.66%	5
CMJ	Consolidated Media	18.086	17.571	-2.85%	7

Source: FNArena

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Anyone should consider the appropriateness of the information in regards to their circumstances.*

Trustees get a little more defensive

by Paul Rickard

Self-managed super fund (SMSF) trustees became more defensive in 2011/12, with a marginal re-weighting away from shares towards cash, term deposits, fixed income and direct property, data from the Australian Taxation Office (ATO) shows.

The ATO uses data based on SMSF annual returns, so the June 2012 results will be subject to further revision as more funds lodge their returns.

Key asset class weightings and changes during the year

Asset	Jun-11	Jun-12	$ Change	Weighting 2011	Weighting 2012
Cash &Term Deposits	$121.5bn	$134.1bn	+ $12.6bn	28.70%	30.50%
Listed Shares	$135.3bn	$131.3bn	-$4.0bn	32.00%	30.00%
Business Property	$48.1bn	$50.8bn	+$2.7bn	11.40%	11.60%
Residential Property	$14.7bn	$15.6bn	+$0.9bn	3.50%	3.60%
Listed Trusts (Prop*)	$17.9bn	$18.1bn	+$0.2bn	4.20%	4.10%
Unlisted Trusts	$37.2bn	$37.8bn	+$0.6bn	8.80%	8.60%
Aust Managed Funds	$20.1bn	$21.5bn	+$1.4bn	4.70%	4.90%
Collectables	$0.7bn	$0.7bn	0	0.20%	0.20%
Offshore Assets	$3.7bn	$3.6bn	-$0.1bn	0.90%	0.80%
Other Assets	$24.2bn	$25.5bn	+$1.3bn	5.70%	5.80%
Total	**$423.2bn**	**$439.0bn**	**$15.8bn**	**100%**	**100%**

Source: ATO, Switzer Super Report

** Listed trusts, which are usually listed property funds.*

While the weighting by SMSFs to Australian shares dropped from 32% to 30% and on paper there was a reduction in funds, this occurred in a year where the S&P/ASX200 fell by 11.1%. Adjusting for this fall, there was actually a net inflow of new money into shares of approximately $11.1 billion.

Since July 1, the S&P/ASX200 is up by 7.9% – so the September quarter data is likely to show that this asset class is again the largest.

Another surprising result from the data is that despite most commentators agreeing that the Australian dollar is overvalued and heading below parity with the US dollar in the long run, trustees don't appear to be keen to look offshore for investible assets. In pure dollar terms, offshore assets fell from $3.7 billion to $3.6 billion.

For the first time, the ATO has analysed the collective fund data by median fund size and provided some insight as to how investing behaviour changes depending on the size of the fund.

The largest funds (with more than $5 million in assets) have the highest weighting towards listed Australian shares at 33%, and the lowest weighting in cash and term deposits (24%). While somewhat of a generalisation, the following conclusions can be drawn:

Small funds

- Less cash & term deposits
- Less listed shares
- Less business & real property
- Negligible collectables
- Negligible offshore assets

Large funds

- More cash & term deposits
- More listed shares
- More business property
- More unlisted trusts

During the 2011/12 financial year, the number of SMSFs grew by a net 35,300 (up from 28,000 in 10/11), taking the number of funds to 478,263. The average fund has 1.91 members, taking the total number of members to 913,500.

About 65% of members joining new funds are under 55 years of age.

Only 8.4% of all SMSFs have three or four members. This is somewhat surprising, given the potential advantages of bringing adult children into the fund and pooling the contributions to reduce the overall running costs of the SMSF, and perhaps more importantly, the horrendous fees that young people with small superannuation balances can face with industry or retail funds.

The full ATO report can be accessed at www.ato.gov.au/content/00332225.htm

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Anyone should consider the appropriateness of the information in regards to their circumstances.*

Using two lenders and off-the-plan property

by Tony Negline

There are two common 'grey' areas that self-managed super funds (SMSF) come up against when looking to borrow and these involve off-the-plan property purchases and borrowing from two different lenders. But the recent release of some Tax Office minutes have clarified a few issues.

SMSFs can borrow under what's called a Limited Recourse Borrowing Arrangement. These sorts of arrangements are also referred to as Super Gearing, however this name isn't used as much as it once was.

While LRBAs have been around since July 2007, they are still relatively new and this means new complex issues are emerging all the time.

Many of these problems revolve around property purchases. Such transactions involve an intricate mix of trust law, property legislation (which varies from State to State), super legislation and finally, Federal and specific State tax legislation.

Off-the-plan property purchases

When using an LRBA, a super fund borrows to buy an asset, which is held in a Holding Trust whilst the loan remains unpaid. There are strict rules limiting the ability of an SMSF to 'replace' an asset purchased under an LRBA.

Off-the-plan property purchases differ from normal properties because the asset doesn't physically exist when the contract is initially signed. Therefore, with off the plan purchases there is one description of the asset during the development phase and then another description once it has been completed and has been strata titled.

An obvious concern is the notion that the change in property title between the payment of the initial deposit and settlement might imply that the asset has been 'replaced' compared with its original condition.

The recently released minutes of the June 2012 meeting of the National Tax Liaison Group Superannuation Technical Committee have cleared up some of these fears. The Tax Office said that "provided the substance of what is being acquired under the LRBA … has not changed, such a change in the description will not, of itself, result in there being a different asset being held on trust under the LRBA…"

This is a commonsense outcome.

Two lenders

Sometimes a super fund runs into a circumstance where it wants to use two different lenders. For example, the LRBA might involve a third party lender (like a bank) and a related party lender (that is, the super fund borrows from its members, their relatives, or an employer of a member that contribute to the fund). One lender might provide finance for the initial deposit and the other lender might provide money to settle the transaction.

Under the legislative provisions that govern LRBAs, there's no restriction on the number of borrowings that make up these arrangements. This means that a trustee merely needs to meet all the relevant requirements of the LRBA provisions.

One tricky aspect of having more than one lender is the issue of security. Under the LRBA rules, a lender's security is limited to the asset bought with the borrowed funds, so other assets in your fund are protected in the event of a default. But in the event of two defaults with two lenders, which lender would take priority in being able to recover their money first? This will come down to the loan documentation.

If these practical issues can be sorted out, then the super laws won’t stand in the way of two lenders being possible.

Other problem areas

Finally, one mistake many trustees make concerns their existing super fund trust deed.

The LRBA lender is the dominant party and the lender’s solicitors might only review the deed just prior to a transaction settlement. This means any changes they want to your trust deed will have to be completed very quickly because it may not be possible to postpone settlement. A simpler approach would be to have your trust deed checked before you enter into an LRBA.

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Anyone should consider the appropriateness of the information in regards to their circumstances.*

The Week Ahead

Australia
Tuesday 25 September: Financial Stability Review
Tuesday 25 September: Reserve Bank speech by Assistant Governor Guy Debelle
Thursday 27 September: Financial accounts (June quarter)
Thursday 27 September: Job vacancies (August)
Friday 28 September: Private sector credit (August)

Overseas
Tuesday 25 September: US home prices (July)
Tuesday 25 September: US Richmond Fed index (September)
Tuesday 25 September: US Consumer confidence (September)
Wednesday 26 September: US New home sales (August)
Thursday 27 September: US Economic growth (Sept quarter)
Thursday 27 September: US Durable goods orders (August)
Thursday 27 September: US Pending home sales (August)
Friday 28 September: US Personal income (August)

Did you know?

You can look up a list of SMSF administrators and trust deed providers on the Switzer Super Report website, helping you to compare your options. Just visit the Service Providers link on our homepage.