Switzer Super Report

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Welcome aboard

I have great news today with the Gillard Government backing down on expected raids on SMSFs. I've been screaming about this here, on my TV show and on 2GB because politicians need to know that they can't steal our super when they stuff up policy.

I also want to welcome James Dunn to our team. He is one of the country's best finance journalists, but unlike most, he is a real investor with skin in the game. Also Elizabeth Moran from FIIG Securities – a bonds and fixed interest expert – joins the Report. We are assembling the best group of experts in the country to keep you on top of your super and investments. Enjoy!

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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Would Warren Buffett buy QR National?

by James Dunn

A lot of people say they want to invest like Warren Buffett invests – but not many can.

That's not to say they can't make the same kind of investment decisions, it's just not many people can take the time horizon that Berkshire Hathaway, Buffett's investment company, can.

In November 2009, for example, in Berkshire's largest-ever deal, Buffett invested $34 billion buying Burlington Northern Santa Fe Corp., the second-largest railroad in the United States. Asked how long Berkshire Hathaway saw itself owning Burlington, Buffett replied that it was "a good asset for Berkshire to own over the next century."

Buffett described Burlington Northern as an "all-in wager" on the future of the US economy due to its status as the biggest carrier of food products like corn, and coal for electricity. It also moves imported consumer goods from Asia from the US West Coast ports at which they arrive. Buffett clearly sees the company as an indicator of the USA's economic health. At the time, he said he saw value in railroads as a "cost-effective and extraordinarily environmentally friendly way" to move goods.

US railroad companies are enjoying a mini-boom on the back of the demand for transport of crude oil out of the emerging shale areas such as North Dakota, where pipeline capacity falls well short of the burgeoning production. (You won't be surprised to learn that Buffett's Burlington Northern operation is up to its cabooses in this traffic.)

Australian rail

Railroads are not a major part of the Australian sharemarket, but they certainly hit the news last week with the deft sale by the Queensland government of more than half the 34% stake it held in railroad group QR National (QRN), which it floated on the stock exchange in 2010. The Queensland Treasury managed the noteworthy feat of selling just over 17% of QR National at a premium to the prevailing share price, when normally an 'overhang' of this size has to be offered at a discount – especially when the sale has been widely expected.

Without going into the mechanics of the deal, what would have jumped out of the financial pages at Switzer Super Report readers was the glowing reports of QR National as a growth prospect, based mainly on the movement of coal – mainly metallurgical, or steel-making coal – from mines in Queensland and New South Wales to end-customers and ports. Its largest customer is BHP Billiton.

QR National also moves other bulk mineral commodities (including iron ore) and agricultural products throughout Queensland, New South Wales and Western Australia, as well as general freight; and moves containerised freight throughout Australia. The company has only one meaningful competitor, in Asciano's Pacific National, but the critical difference is QR National's monopoly ownership of the regulated Queensland coal network track.

You can largely forget the freight operations, though. In effect, QR National is a huge bet on the China story – the demand for Australian coal and iron ore.

This is the story in which the stock was floated in 2010, at $2.55 a share. It has been a good performer, peaking at $4.03 in April this year, and even in the face of concerns over a Chinese slowdown – as the sick state of Europe and a tepid US recovery bite into demand for China's exports – the stock has only staged a mild retreat, to levels around $3.60.

Moving mainly steel-making coal, the driver for QR National's health is the gigantic urbanisation process

under way in China. In 2011, according to China's National Bureau of Statistics, China's urban population exceeded its rural population for the first time in the nation's history.

Growth potential

According to the Reserve Bank of Australia's economics group, China's urban population is expected to increase by 42% over the next two decades to about 70% of the total population by 2030.

By comparison, 90% of Australia's population already lives in urban areas and the US has an 80% urbanisation rate. This level of urbanisation is expected to continue to drive the demand for Australian iron ore and steel-making exports for decades to come.

There is no doubt that QR National will pick up on this growth – although there will be short-term air pockets for the share price. It has stood up fairly well lately, given that, for example, major customer BHP froze $50 billion of expansion projects in August; and wider market concerns about China can be starkly seen in the spot iron ore price falling by 36% in the September quarter (before pruning that quarterly fall to 22%.)

QR National brought out a full-year profit for 2011-12 of $441 million, a 22% lift on the previous year, and ahead of analysts' consensus expectations by about the same proportion. It is a solid performer, every way you look at it.

SMSF potential?

But is it a self-managed super fund stock? No, for two main reasons.

The first is, you are probably already gaining Chinese exposure through BHP or Rio Tinto. Holding QR National would cannibalise that to some degree.

The second reason is the yield – or lack of it.

QR National is expected to pay a dividend this financial year of 8.5 cents, with the same again in 2013-14. At $3.62, that is a princely nominal yield of 2.3%. The yield is so low because QR National reinvests most of its profit, and has large capital spending needs (it will spend about $1 billion this financial year.)

Even worse, there is no franking because the cash tax paid by QR National is minimal, due to capital allowances available for current, past and anticipated capital expenditure. As a result, tax payable by QR National is expected to be minimal. Unfranked dividend flows and SMSFs are not really compatible.

The bottom line

The stock does have a growth story, but the paucity of yield is the deal-breaker. Even Buffett, who wants to sit on Burlington Northern for 100 years, is unlikely to be enthused about the 1.6% yield it offers him in the meantime.

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Fears for China's economy are overdone

by Ron Bewley

For the first time in well over a year, we are not anxiously awaiting news each morning from the US and Europe on the state of the economy and bailouts. While the US economy is sluggish and Europe is worse, all the cards seem to be on the table. Stimulus packages are in place and there are no major meetings scheduled for the coming months. But, just as the western world seemed to be restoring order, markets now have the jitters about China.

A new story?

It doesn't seem reasonable to manage an Australian equity portfolio without having a well-defined opinion on China. On the face of it, it seems ridiculous that earlier this year most people here and in China were talking in terms of a boom in China lasting a decade or more – and now it's all is over for many of the same people! Did they wake up one morning and look out the window to see a stockpile of steel and totally reverse their opinions? What is more likely, in my opinion, is that the story of an end to the boom in China has arisen to replace the US and Europe stories now that those issues have largely been resolved.

The fear about China got going mid-year when a Purchasing Managers Index (PMI) came in at 48.1 (The HSBC 'flash' index) and a reading below 50 signifies the economy is doing worse than normal.

Many misread this statistic as implying a contraction or a recession in China. As the journalist Michael Pascoe wrote, and citing Reserve Bank Governor Glenn Stevens for support, 48.1 just means industrial production running at a bit less than the 14.8% average of recent years. The official PMI is now up to 49.8 – about as close as you can get to the 50-mark that separates better than normal to worse than normal. The Secretary to the Treasury came out last week saying the boom was not over. So how did the story get going?

In the news

A Deloitte Access Economics report came out and said the China boom would be over in 2014. Again it was Michael Pascoe who point out last year they were predicting it would end in 2013 so this was in fact an extension of the boom! It turns out Access seemingly has always had a relatively negative view on China. But the price of iron ore did fall rather dramatically.

After hovering around $130 to $140 per tonne for a year or more, prices fell sharply to below $90. However, as many markets often do, there was a bounce back to just under $110. Seemingly any company associated with iron ore or its exploration got hit hard, but many of those companies' share prices bounced back by 25% and more since the first panic.

The real story

There is no doubt China's economy is in transition from a government-led infrastructure economy to a consumer-driven economy. This has been a stated aim for some time and, after all, the western world economies are consumer driven. The PMI data for China services support the success of this transition.

In hindsight, there was a bit of over exuberance in following resource stocks, but I believe this bump in the trend will vanish as phases two and three of the boom take over.

Markets rarely travel in straight lines for long. When trends seem to end, as the China story did in 2008 and 2012, the dip can be savage, but a bounce back and renewed growth can emerge.

China did report big new infrastructure programmes over the last one or two months and it pumped over US$50 billion into the finance sector to aid liquidity. But the once-a-decade handover of government leadership in China starts in a few weeks. Wouldn't it look good for the new team if it rescued the economy and reinstated the growth we had all been expecting in recent times?

I think during 2013, this glum view of China will drift away and the new leadership team will look in control. I am holding on to my resource stocks.

Ron Bewley is the Executive Director of Woodhall Investment Research.

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Why bonds are attractive for SMSFs

by Elizabeth Moran

I am delighted to be contributing to the *Switzer Super Report* as I'm passionate about spreading the word about bonds.

Because of its complexity, many investors are unsure about the fixed income asset class (which includes bonds), which is huge and on a global scale – five times the size of the global equity market! My aim initially is to get you up to speed on this market, while at the same time discussing opportunities to buy and sell.

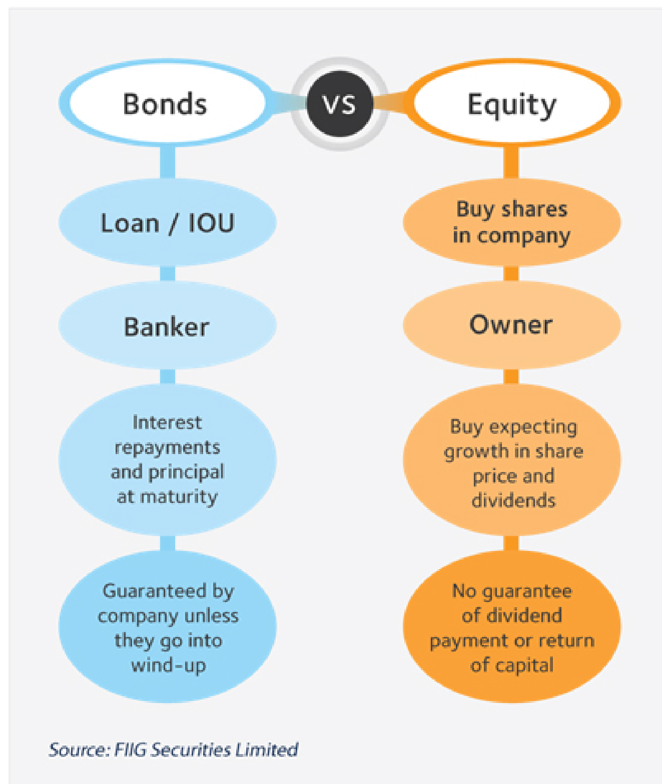
Fixed income includes investments such as At Call Accounts, Term Deposits, Bonds and Hybrids. I expect all of you will have an At Call Account or a Term Deposit, but it's worth taking the time to understand other securities available as they have unique properties that can help you achieve your investment goals.

So, how do bonds differ from shares?

Bonds are simply a loan from you – the investor – to the government, company or bank who issues the bonds. Importantly, they are a contractual agreement and as such, the issuer of the bonds must pay interest (known as the coupon) when it's due and principal according to the terms of the agreement. In that way investors who purchase bonds know what their income will be and in most cases know when they'll receive their capital back (see Figure 1 below).

So, bonds have that certainty of income and capital repayment in contrast to shares (equity) where dividends can be cut and the price of shares can fall, meaning investors can never know their return until they make the decision to sell.

Figure 1.



Bond investment is altogether different than equity investment. Since a bond is a legal agreement and the company issuing them must make coupon and principal payments, investors' primary focus is the ability of the company to survive. *It's much easier to choose a company that you expect to survive than one which will grow.*

Leighton: stocks or bonds?

Take Leighton Holdings as an example. They've made some poor tender bids that have cost the company and it's been forced to revise profit forecasts. The share price has been a roller coaster (the share price high in the last 52 weeks was $26.65 and low $14.71 with a last trade of $17.24). Yet the company is supported by a significant amount of pending work. It is somewhat easier for an investor

to judge whether Leighton is likely to survive based on the strength of its order book than it is to predict what will happen to the share price.

Over the past 12 months, Leighton's share price fluctuated by 45% from its peak to its low. Over the same period, Leighton's senior

Australian dolla fixed rate bond price peaked at $107.58 and its low was $105.07, showing a price movement over the same period of just 2.3%. Much of the reason for Leighton's bond price movement was due to lower interest rates and had nothing to do with the perceived risk of the company.

The bottom line

In summary, bonds provide a consistent return and with capital repayment at maturity (in the vast majority of cases). The fact remains that bonds are lower risk and display less volatility than shares.

Leighton's bond is a fixed-rate bond maturing in July 2014 and is currently trading at a premium of $107.08 per $100 face value. The yield to maturity (which incorporates the loss of face value as the bond will only repay $100 at maturity) is 5.30%. However, the running yield is much higher at 8.87% and this high income stream will appeal to some investors.

While the capital loss may make the bond less attractive, investors are still willing to buy the bond to lock in the fixed rate for the defined period, especially given recent interest rate cuts and lower prospective term deposit rates.

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Six reasons why property is a great SMSF asset

by Chris Gray

You may have the ability to buy property inside your SMSF, you may even have reviewed the risks and strategies that you could undertake to ensure it's done effectively. But when it comes to deciding where to put your money, many asset classes will be vying for your attention.

So how does property compare?

Back in August 2011, John McGrath wrote briefly about the benefits and pitfalls of property in Super for the Switzer website. So with all respect to John, I would like to further expand on his points and add a few that I believe are key to what makes property an outstanding asset class.

Six reasons to invest in property

1. Safe and stable – Property is one of the few asset classes where even the banks are willing to lend the vast majority of the value of the asset. This is because they generally view property as a very low-risk, steady investment. Prices do not fluctuate as wildly as they do in the stock market, and the market value of property in general is quite consistent. This can be a great comfort for those of you who wish to sleep well at night.

2. Long-term development – Due to the nature of SMSF's being "self-managed", the tendency to want to tinker in the allocation and performance of the fund can be quite high. Property does not lend itself to such tinkering. The market is far more long-term and great for investors who don't have nerves of steel to weather the ups and downs of the stock market.

3. No margin calls – Unlike borrowing to buy shares, borrowing to buy property is not subject to unexpected margin calls. Again, much of this is due to the fact the value of Australian property rarely fluctuates more than 10% over a long period of time. The market is resilient and profitable enough that banks don't feel the need to continually assess whether they need a "top-up" from the owner.

4. Higher degree of leverage – The power of leverage allows you to control a lot of money with very little outlay. This means gains (and losses) can be achieved in much shorter period of time. There are very few investments as safe and accessible as property that allow such a high degree of leverage, resulting in a return on investment that can far exceed any comparable investments.

5. Control – If you wish to increase the value of your share portfolio, it can be very difficult to directly influence the value of the company itself. With property however, and SMSF property is no exception, you can undertake renovations and improvements that can lead to an increase in the value of that asset. There are, however, strict rules surrounding these improvements if you plan to borrow the money to make them, so pay close attention to the rules.

6. Negative gearing – Many do not consider an SMSF as a vehicle for negative gearing. Yet there is a portion of tax paid (15%) within the Super Fund that can still be offset against any losses that might occur from a shortfall between the rent and the loan repayments. This can effectively result in the tax inside your super fund being reduced to almost zero.

Watch out for these

Property is not all plain sailing of course, and like any asset class, it has it's disadvantages. Here are a few you will need to consider before leaping in.

1. High entry costs – Given the large deposit required to purchase property, access to property investment can often be prohibitive for many. It is

higher again inside SMSF's due to the need to have additional funds for diversification into other areas in order to reduce risk.

2. Maintenance costs – Although you can't control the value of your shares like you can with property improvements, you don't have to repair them either. Ongoing maintenance and repair costs may need to be undertaken with property in order to keep it at a serviceable level as time passes.

3. Longer selling periods – For those of you with your finger on the trigger, equity and bond markets can be a fluid and easily transferable asset to acquire or release depending on the opportunity. Not so with property. Selling a poor performing property can take months and could jeopardize your financial situation if it wasn't allowed for.

4. Captured profits – Shares can be freely bought and sold within an SMSF, moving from one fund to the next in search of better profit performance. Again, not so with property. Any equity gains that occur from growing property values are trapped within the fund and can't be leveraged into further investments.

Despite these considerations, many investors feel the positive aspects play a much more important role in the outcome of their investment, especially when considering long-term growth and the low levels of risk associated with property. With careful selection and proper management, many of the pitfalls can be easily reduced or avoided altogether, leaving you with a solid level of performance that can last for years to come.

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An SMSF strategy involving the kids

by Andrew Bloore

Younger entrants into the self-managed super fund (SMSF) market continue to grow, with 34.1% of new members under the age of 45 years, the latest ATO statistics show. The main reason for this growth could be the inclusion of adult children as members of family SMSFs.

Bringing adult children into the family SMSF can help preserve and create family wealth. Some of the benefits are:

- there will be more money within superannuation to invest;
- it may be cheaper to aggregate all superannuation, therefore providing an overall total fee saving; and
- having children as members of a family SMSF may enable parents to teach them about the importance of saving money in super to fund their own retirement.

The only difficulty including children into the family SMSF is that you are limited to having only four members. This could pose a problem for large families because only two children would be allowed with Mum and Dad, comprising a maximum of four members only. This number doesn't look like it will change any time soon. The Super System (Cooper) Review recommended that the limit of four members shouldn't be increased and the Government agreed that it is still appropriate.

Family business

Including children as members in a family superannuation fund may be appropriate when a high valuable asset such as the family business premises is held in the fund. The family business premise could remain in the family SMSF through generations, provided of course that there are other assets in the fund to pay retirement and death benefits when necessary. This strategy is often referred to as the 'intergenerational transfer of assets'.

How does it work?

When business assets are passing from one generation to the next outside of super, the transfer may give rise to capital gains tax (CGT) and stamp duty obligations. By holding the property in a family superannuation fund with the parents and their adult children as members, as the parents cease working and contributing to the fund (subsequently commencing pensions), their children's ongoing Super Guarantee contributions into the fund result in a change in the respective proportion of account balances , and consequently the ownership of the underlying assets.

Ultimately, the parents' accounts will be completely eroded by pension payments and the assets of the fund will be represented entirely by the member's accounts of the next generation. Whilst it's a slow process, the property will have effectively been transferred from one generation to the next in circumstances which are unlikely to give rise to the imposition of CGT or stamp duty.

When considering whether or not to include children in a family SMSF, it will also be important to ensure that all members have appropriately considered how to deal with the benefits when a member of the SMSF passes away. The importance of estate planning must therefore be considered to ensure that the end wishes of all members are adhered to by the children.

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Should my SMSF really invest offshore?

by Paul Rickard

Q: *Our SMSF is 95% in pension phase. Our investments are now all in Australia, as investing overseas has currency risk and we do not get the benefits of any franking credits. Previously, we had a mediocre to poor experience investing overseas with some managed funds, such as Hunter Ethical & Platinum Japan. We are now exposed overseas only through Australian companies such as BHP. What is wrong with this as a strategy?*

A: There is nothing wrong with this strategy per se – it really depends on your fund's investment objectives and investment time frame.

That said, it is worth recapping on why investing offshore will make sense for many funds:

- The Australian sharemarket is incredibly narrow, dominated by financial and resource companies – we simply don't have the IT companies such as Google, Apple or IBM; the pharmaceutical companies like Pfizer, Merck or Johnson & Johnson; or the industrial conglomerates like GE;
- The range of investment opportunities must by definition be so much bigger overseas. As a developed nation with a mature economy, the growth opportunities available in Australia are limited compared with those available where the consumer/services markets are growing or the economies developing; and
- Portfolio research (which studies how different asset classes perform in relation to each other – in other words, their correlation) substantiates investment in offshore assets in accordance with a fund's return and risk objectives.

The downsides

One downside clearly is the currency risk, which is arguably as important a consideration as a view on the offshore asset price. Understanding whether your investment is 'hedged' or 'unhedged', and if the latter, the timing for potential entry and exit are critical factors. And, there is no dividend imputation available. This is a system that is unique to Australia, and for funds in pension, it is pretty hard to beat the after-tax income returns from high quality Australian companies paying fully franked dividends.

Is BHP or RIO a substitute for investing offshore?

While they have substantial operations and sell most of their production offshore, I'm not sure they are a real substitute. Arguably, they are a substitute for that part of the world economy that depends on manufacturing growth – how they benefit from growth in the other sectors like services or technology is less clear. They are not the next Apple, which is now the largest company (by market capitalisation) in the world!

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Did you know?

Switzer Super Report subscribers can send their superannuation question to us on our Ask & Tell page.

Don't miss this!

If you missed the special video on Future investment trends, produced by futurist Craig Rispin for the *Switzer Super Report* last week, now's a good time to catch up. Craig names the first of the three Rs of future investment trends and he'll be naming the remainder in the coming weeks.