Switzer Super Report

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Dividend strategy

Most of you by now would know that my strategy in recent years has been to buy good quality dividend-paying companies on the dips. This is still my main game, particularly with so much uncertainty still around, and I explain why in today's note.

Continuing this theme, George Boubouras names the stocks in UBS's Australian Core Equity Income Portfolio, and Paul Rickard answers a reader's question about a strategy of buying bank stocks for dividends. Plus, with the recent foreign takeover offer for Graincorp, James Dunn takes a look at your investment options in Australia's shrinking agribusiness sector. Enjoy your read!

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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Wanted: rational Americans

by Peter Switzer

Wall Street was down again overnight and the S&P 500 is now below an important testing level of 1,420; it's sitting on 1,408, which should have some resistance, but if it falls, 1,400 is the next big one. So are we in the calm before the storm?

I think we could see 1,400 breached because US company reporting season hasn't come in as we hoped – that is, better than expected. Instead, it has come in as you would have expected given the terrible run of economic data we saw over the September quarter.

Also remember that both the European Central Bank (ECB) and the US Federal Reserve have increased their money supplies and they did this because they were worried about their economies.

Since then, my reading of both economic results and stock market movements all suggest that we are heading in the right direction, provided it's not towards this US fiscal cliff!

The main threat

Congress needs to agree on new fiscal measures as the country once again reaches its debt ceiling. If this can't be done, automatic tax hikes and spending cuts will kick in, which is something the economy isn't ready for.

I really don't like resting my market forecasts on the logical behaviour of Americans and especially those who populate the US Congress. I'm hoping like hell that whoever wins the US election will have a Congress that supports him. If we get a stalemate like we saw in August and September last year, we could see a 20% slide in stocks.

This means the US election is really important for our portfolios. Let's be optimists and imagine the poll goes our way and the new president and Congress can negotiate some softer fiscal measures to reduce the budget deficit and the country's towering debt; stocks will head up. However, if the reverse happens, stocks will fall from the outset after the election if it's perceived that a stalemate is coming.

Even if an outcome results before New Year, which is when the fiscal cliff would be triggered, the market would still give up plenty ahead of a resurgence in stocks triggered by an agreement.

My bet

With Cup Day looming, I'm a betting man. Regular readers know I started talking up stocks as soon as China promised to start spending big after Lehman Brothers failed. Since 9 March 2009, stocks have been the place to be, despite their average performance.

The punting strategy has been to buy good quality stocks that pay great dividends and to buy in the dips. I wouldn't change that strategy, but I would prefer if I didn't have to endure another 20% crash in stocks.

With Spain getting close to asking for a bailout and China showing it is on the improve, all we need now is the Americans to behave like rational, intelligent citizens of the world and we could be off to the races next year!

Gee, I hope that's not asking too much.

P.S. If you want proof of an improving China, the HSBC Flash Manufacturing PMI reading, while in shrinking mode for 12th months in a row in October, showed that actual output was at a three-month high. Better still, order books were the best they have been since April! This is a great sign of a recovering Chinese economy.

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Investing in what's left of Australia's agribusiness

by James Dunn

There would not be an SMSF investor unaware of the growth story in China, and the other big emerging economies of the world, not just in Asia, but in South America and Africa.

China's demand for Australia's raw materials to feed its massive industrialisation and urbanisation plans is one of the major investment 'themes' of our time – for very good reasons. Most people are well-positioned to tap into this theme: let's be honest, all you have to do to benefit directly from this economic force is to hold BHP and Rio Tinto.

But what about the other side of the China story – the 'soft' commodities demand?

Feeding the people

As China industrialises, its population is not only moving to urban areas – more Chinese now live in cities than in the countryside – it is rising up the income-per-capita scale. And as people move up the income scale, they also ascend the protein scale, eating better-quality, more protein-rich food.

Australia has long held ambitions to become the 'food bowl' of Asia, providing high-quality food to the 3.2 billion affluent and middle-class people projected to be living in the Asian region by 2030, mostly in China, India and Indonesia. As Agriculture Minister Joe Ludwig put it in July: "Australia produces enough food to feed a nation three times its size, our food system is safe and stable and there are many new opportunities to export more food to Asia."

Ludwig was releasing a draft of a food security plan focused on increasing Australia's exports and capitalising on the growing demand for food worldwide, which is expected to increase by 80% by 2050.

Sounds like a perfect theme for an SMSF – profound economic changes that will take many years to play out.

But there are some major drawbacks, chief among them that investing in soft commodities in Australia is very different to investing in mineral and energy commodities.

In those sectors, the obvious picks are world-class companies like BHP Billiton (BHP), Rio Tinto (RIO), Fortescue (FMG), Newcrest Mining (NCM), Woodside Petroleum (WPL) and Santos (STO). But in the soft commodities, the Australian sharemarket has shown a bad habit of losing its biggest candidates – and with a takeover bid announced this week for the country's largest grain merchant, Graincorp, that sorry trend is in danger of continuing.

Takeover targets

First it was ABB Grain, the former Australian Barley Board, picked off the sharemarket by Canadian agribusiness giant Viterra in 2009. That was followed into Canadian ownership by AWB, the former Australian Wheat Board, bought by Agrium in 2010.

Now it is the turn of Graincorp (GNC), handed a $2.8 billion takeover bid by US agribusiness heavyweight Archer Daniels Midland (NYSE: ADM).

Unfortunately, that leaves a fairly small group of agribusiness stocks, which, while ticking all of the boxes in many respects in terms of their business focus, leave a lot to be desired from the viewpoint of an SMSF investor.

Your choices

Take Australian Agricultural Company (ACC). In business since 1824, AustAg is Australia's largest

beef producer, managing a herd of more than 680,000 head of cattle, which it runs on 1.1% of Australia's land mass. AustAg is transforming itself from a cattle grower into a globally focused vertically integrated producer, building a state-of-the-art meat processing facility near Darwin. The company is very well-positioned to take advantage of rising global demand for high-quality beef, particularly from Asia.

But the pertinent fact is that AustAg has not paid a dividend for the past three years, as it restructured its operation and paid down debt (the board is targeting a dividend in the 2013 financial year). That is not an SMSF stock. Shareholders of rural services company Elders (ELD) are in the same boat.

The fertiliser businesses, Incitec Pivot (IPL) and Nufarm (NUF), are often considered agribusiness exposures, but 60% of the former's business is explosives – fertilisers gets smaller as a proportion of the company every year – while Nufarm has still not lived down the 18 months of hell it gave shareholders in 2008-10 as it made profit downgrade after downgrade, breached market disclosure rules and got sued by its own investors.

But the sector is not a total dead loss for yield-oriented investors – as SMSFs should be.

Chasing yield

The stand out looks to be Hobart-based Ruralco (RHL), which operates through a national chain of businesses that specialise in rural merchandise and services: its CRT (Combined Rural Traders) brand is the largest network of independently owned rural stores throughout Australia. Ruralco is essentially a buying group for its independent trader members: think of it as the rural services equivalent to IGA supermarkets.

I'm using the dividend expectations of RBS Morgans' Belinda Moore, whom I consider one of the best agribusiness analysts in the country. She is expecting Ruralco to pay 22 cents a share in FY2013 and 24 cents in FY2014. At $3.36, that places Ruralco on a nominal fully franked yield of 6.55% in FY2013, which equates to after-tax yields of 7.93% for an SMSF in accumulation mode and 9.32% in pension phase.

For FY2014, Ruralco is on a prospective nominal yield of 7.14%, or 8.66% for a fund in accumulation phase and 10.16% if the dividend is funding a super pension. That is starting to look more like it!

Admittedly, Ruralco is an indirect exposure, as it sells goods and services to Australian farmers to enable them to do what they do. If you want a high-yielding stock that actually exports soft commodities to Asia in its own right, Warrnambool Cheese & Butter (WCB) generates 50% of sales exporting dairy products to Asia.

Moore expects Warrnambool Cheese & Butter to pay 15.56 cents a share in FY2013 and 17.12 cents in FY2014. At $3.82, that places the stock on a nominal fully franked yield of 4.07% in FY2013, which equates to a yield of 4.94% for an SMSF in accumulation phase and 5.8% in pension phase. The FY2014 numbers are: a nominal yield of 4.48%; SMSF in accumulation mode, 5.43%; and pension-paying super fund, 6.38%.

Does size matter?

The problem is that these are small stocks. Ruralco is capitalised at $185 million; Warrnambool Cheese & Butter is not much bigger at $211 million; while Warrnambool's rival, Bega Cheese (BGA) – which is also highly leveraged to increasing dairy consumption in Asia – is larger, at $273.4 million.

Because it keeps losing its large stocks, the agribusiness sector falls away quite quickly in size: this means that investors are constantly forced to go further down the risk curve than they perhaps might have liked. Then there is the inescapable fact that as agricultural producers, and service providers to the agriculture business, these stocks are prone to climatic effects and fluctuating commodity prices.

If Graincorp were to stay on the ASX, it would at least offer a $2.8 billion exposure offering a 4.1% nominal yield in FY2013 and 3.52% in FY2014. But it probably won't: investors will be hoping for a nice bidding war to ensue to generate the bulk of their returns. (That attraction of takeover appeal is certainly present in Warrnambool Cheese & Butter, too.)

The bottom line

SMSF investors who really want to invest in Australia's farming sector – and get a decent yield while they're at it – are at this stage probably limited to Ruralco, or Warrnambool Cheese & Butter. These are well-run businesses, offering good investment access to the China story – more direct in the case of WCB – with their only real negative being that they are small in size.

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Why a bond is not like a term deposit

by Gavin Madson

We continue to receive questions from readers about the fixed-income asset class, and this week I will address a common one: why would I buy bonds when I am getting high returns from my term deposits?

This is a great question, and the answer shows how with a little bit of knowledge about fixed income, you can customize your investment portfolio to best suit your needs – which is what self-managed super funds (SMSFs) are all about.

Allocating your assets

First, I think it is worth stating that all investment portfolios should have an exposure to 'cash', through a term deposit, an on-line high interest account, or both. However, because of the historic structure of the bond market in Australia, people have tended to think of fixed income as only being term deposits. This has led to very lopsided asset allocations in most investment portfolio's, reliant heavily on equities, with term deposits making up the rest. This structure proved largely disastrous for people approaching or in retirement when the Global financial Crisis (GFC) hit and has more recently been highlighted a risk of economy-wide instability by highly-respected commentators including Ken Henry, David Murray; and Lindsay Tanner.

In order to reduce risk, they suggest bonds. Bonds represent a 'middle road', offering more stability for both capital and returns than equities, whilst offering the possibility of (depending on the bond) stronger returns than term deposits.

Term deposits vs Bonds

In recent times, term deposits have offered fantastic returns driven by a change in banking regulations and external funding trends, and investors have enjoyed the benefits. However, term deposits are very much a one-size-fits-all solution.

Term deposits lock in a fixed return for investors over the deposit period and at the end of the period you get the full amount of your deposit back. Term deposits have a very rigid structure including penalties if, for some reason, the investor needs to access their cash before the maturity date.

Bonds offer more flexibility to investors, allowing them to better match their specific requirements. Some bonds offer a fixed return, much like a term deposit, so investors needing to lock in their income may chose to focus on fixed-rate bonds, whilst other bonds offer a 'floating' rate of return, so the returns move up and down with an underlying benchmark, much like a variable home loan, though in this situation you are receiving the floating amount, not paying it.

These bonds may be more suitable for investors who's income needs will more closely follow interest rates, rather than be locked into a long-term fixed rate. Remember, whilst rates may be falling at the moment, inevitably, they will begin to rise again.

Inflation-linked bonds

A third type of bond is an Inflation-Linked Bond (ILB), these bonds return a specified rate above inflation, so investors concerned about inflation eating into their nest egg, may chose to invest in these.

ILBs see both the capital and the income move with inflation. If you lock away a term deposit for a longer period like five years, when the deposit matures you will only receive your original investment back, so you may, in a low interest rate environment, have effectively lost capital when you take inflation into account. When an ILB matures, the capital has increased by the rate of inflation, so you get your

original investment back, plus an amount reflecting the effects of inflation. Inflation-linked bonds are the only pure protection against inflation available to investors.

Equity hedge

Bonds can also be used to offset the effects of the equity markets. When the economy slows, as it is currently, equities generally underperform and interest rates are cut. When this happens, the capital price of fixed-rate bonds increases – this is in part why fixed government bonds last financial year had a 24% return, and is why professional super fund investors include government bonds in their investment mix.

In future weeks I will look at the capital structure and how it works because understanding this can offer opportunities for stronger returns.

As mentioned, term deposits are offering great returns currently, for example, a five year Big Four bank term deposit is returning around 4.50%, while a comparable senior bond from a Big Four bank is returning 4.00%.

However, if you move slightly down the capital structure, to a Big Four subordinated bond, you can boost your return to 5.75%. Am I comfortable with the risk of a Big Four bank subordinated bond? Yes. Would I prefer to earn 1.25% more for my fixed-income investment? Yes. And this is just one of the reasons a little bit of fixed-income knowledge is essential for any SMSF manager.

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My quality high dividend strategy

by George Boubouras

Following the October rate cut, cash rate futures are now pricing in a rate of 2.50% by March 2013. At these levels, lower cash rates and bond yields remain supportive for quality dividend strategies, even before the franking.

Regarding timing for the next move, the market has effectively pencilled in a November Cup Day rate cut. The theme is simple enough, rates globally and domestically, are staying lower for longer. Cash returns will clearly be lower in 2012 compared with 2011 as term deposit rates continue to migrate lower.

A quality dividend strategy

Investors need to look to diversify portfolios across income-generating assets as term deposit rates continue to fall. Within the equity asset class, a focus on a quality dividend strategy across the defensive sectors aims to deliver an attractive income stream. This is generally a core strategy for retail investors.

Dividends provide an income stream that is often underestimated. In the last decade, dividends have accounted for an average of one-third of total equity returns. Dividend payments are a good surplus when stock prices are rising by providing capital protection while at the same time allowing investors to benefit from rising share prices. In sideways trending or declining equity markets, however, the dividend payment can act as a support. This explains why investments in stocks that offer high yields can be seen as defensive and less risky.

It is important not to forget the benefits through time of franking credits. For investors who are able to take advantage of franking credits, this could add an additional 1-1.5% to portfolio returns (note, at UBS Wealth Management we target closer to 2.0% franking for our retail dividend strategy portfolios).

Constructing a dividend strategy portfolio

Table 1 goes through some basic filters when constructing a dividend strategy portfolio. This should be used to build a core strategy. Depending on an investor's risk appetite, they could add more risk. When determining companies to add to the Core Equity Income Portfolio, some of the metrics UBS Wealth Management consider include:

- A dividend yield above that average yield of the ASX 200, and above the 10-year bond yield;
- A lower-than-market beta value. The portfolio has a beta of 0.8. This implies the sensitivity of earnings are less leveraged to future economic cycles vs the broader ASX200 market;
- A dividend coverage ratio above 1.00;
- Generally, the company should have a market capitalisation of over $500 million.

(See Table 1)

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Code	Company	Sector	Market Price $	P/E 12e	Yield 12e %	Franking % 12e	Grossed Up Yield 12e %	Market Cap ($m)
AMP	AMP	Financials	4.67	13.8	5.68	-	5.68	13,519
CBA	Commonwealth Bank	Financials	57.35	13.0	6.05	100	8.64	90,912
CCL	Coca-Cola Amatil Limited	Consumer Staples	13.60	16.1	4.65	100	6.65	10,362
DUE	Diversified Utility & Energy Trusts	Utilities	2.03	12.5	8.12	-	8.12	2,297
NAB	National Australia Bank	Financials	25.96	10.1	7.36	100	10.51	58,222
TAH	Tabcorp Holdings Limited	Consumer Discretionary	2.84	15.0	5.28	100	7.55	2,088
TLS	Telstra Corporation Limited	Telecommunications	4.06	13.2	6.91	100	9.86	50,519
TTS	Tatts Group Limited	Consumer Discretionary	2.82	18.2	4.97	100	7.10	3,952
WBC	Westpac Banking Corporation	Financials	25.36	12.4	6.86	100	9.80	77,663
WES	Wesfarmers Limited	Consumer Staples	34.75	16.2	5.55	100	7.93	40,368
WRT	Westfield Retail Trust	Financials	3.06	15.7	6.38	-	6.38	9,346
					6.17		**8.02**	

Data Sources: IRESS, UBS WM **All Data priced as at: 24 October 2012**

Question of the week: bank dividends

by Paul Rickard

Q: What is your opinion on buying ANZ, WBC or NAB shares at the current price to hold for around 13 months, and in doing so, pick up the three dividends that will be paid? My calculations put the returns at around 12% to 14%, including franking credits.

A: This strategy is fairly popular for those investors, particularly SMSFs, who are seeking a high tax-advantaged running yield, and are comfortable with their assessment that there isn't a lot of downside price risk on major bank shares. Over the 14-month holding period, the after-tax income return is in the order of 12% to 14%, which provides some protection for a downward movement in the share price.

How does the strategy work?

Purchase shares in ANZ, NAB and/or Westpac before they go 'ex-dividend' in the second week of November, and receive three dividends (payable in Dec 2012, July 2013 and December 2013), then sell the shares in late December 2013/early January 2014.

Forecast dividends and payment dates are as follows:

Bank	Final 2012	Interim 2013	Final 2013
ANZ	79c	68c	82c
	19-Dec-12	1-Jul-13	18-Dec-13
NAB	90c	94c	93c
	18-Dec-12	Jul-13	Dec-13
Westpac	84c	85c	87c
	20-Dec-12	Jul-13	Dec-13

To qualify for the dividend to be paid in December, the shares must be purchased before they go 'ex-dividend'. Ex-dividend dates are:

- ANZ: 8 November
- NAB: 9 November
- WBC: 9 November

Income returns

Assuming a 14-month holding period, approximate gross and after-tax forecast returns (in accumulation and pension) are as follows:

Bank	Share Price	Gross Dividend	Gross Return	Return in Accumulation	Return in Pension
ANZ	$25.60	$2.29	8.90%	10.80%	12.80%
NAB	$25.90	$2.77	10.70%	13.00%	15.30%
Westpac	$25.27	$2.56	10.10%	12.30%	14.50%

The forecast returns above are for 14 months, so on an annualised basis, they are going to be slightly lower.

Be careful of …

You need to be cognisant of the '45-day holding rule' in relation to being eligible for the imputation credits, so you are more likely looking at a 14-month holding period rather than 13 months. Further, share prices do adjust downwards when they change from 'cum-dividend' to 'ex-dividend'. When you come to sell the shares late in December 2013 or early 2014, some part of the final 2013 dividend may already be reflected in a lower share price.

Also, factor in transaction costs, calculating the brokerage on both the buy and sell legs.

The bottom line

If your medium-term outlook for bank shares is positive, there is quite a lot to be said for this strategy. The 12% to 14% after-tax income return provides quite a deal of downside protection on the share price falling.

On paper, NAB would appear to be the stock to go for. However, there are good reasons why NAB is consistently the cheapest major bank stock on a price

to earnings ratio (PE) basis and it why pays the highest dividend yield – I don't think this is going to change in the short term. I would be more inclined to consider Westpac.

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The benefits of spousal super splitting

by Andrew Bloore

If you're married, a super splitting strategy is worth considering because it may help maximise your retirement benefits and provide an avenue to creatively share them.

This strategy is particularly effective if there is an age gap between you and your spouse.

How it works

Since 1 July 2007, super benefits have been paid tax-free after the age of 60. This means you no longer have to consider accessing two separate reasonable benefit limits (RBLs) and the advantage of two-rate thresholds remains only for members who are aged between 55 and 60 when they receive their super benefit. So why would people still consider splitting super with their spouse?

The answer is simple. By using a super splitting strategy with your spouse, you may be able to increase age pension entitlements, access more tax free income sooner, or enable spouses to top-up their super when they experience employment breaks.

Increase your age pension entitlements

The older spouse may qualify for a higher age pension.

By splitting super with a younger spouse, you can shield assets from Assets Testing, which may qualify you for a higher age pension entitlement. Assets held in super by pensioners and allowees who are between 55 and age-pension age are exempt under both the Income and Assets Test.

Access tax free income from age 60, sooner

Suitable for a couple where one spouse is aged 60 or over.

In the case of a couple with one partner aged 60 or more, splitting contributions to the older spouse may enable earlier access to tax-free income. This is because super benefits are paid tax free after a person reaches the age of 60 and retires.

This strategy can help increase the total income a couple is living off simply through splitting their contributions to the older spouse. The younger spouse splits their contributions with their older partner, who, once they reach 60-years-old, can access these additional contributions tax free and earlier than the younger spouse. This may benefit the couple by effectively reducing their overall assessable income.

Top up your spouse's super

Use this if your spouse has less super than you or needs to cover relevant insurance premiums.

Most couples have significantly different superannuation balances due to different work patterns.

Women in particular often experience breaks in their employment through child bearing and therefore their superannuation also experiences a break from ongoing contributions. In this example, a spouse can help balance the situation through super splitting, adjusting for the time when the mother has not been earning an income.

Another benefit of super splitting is that if insurance is held through a spouse's super account, splitting contributions to that spouse can then be used to fund ongoing insurance premiums, regardless of whether that spouse is contributing to super or not. There is also the option of taking out additional cover without worrying whether benefits will exceed concessional tax limits.

A super splitting strategy may also be of particular benefit to low income or non-working spouses by allowing them to control their own super and have their own income in retirement.

Some legislative risk

Though super splitting is still a relevant strategy, as with all superannuation legislation there is a risk that the rules could change in the future under this or a new government.

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If you're looking for someone to help administer your DIY super fund or prepare your trust deed, take a look at the Service Providers directory on the Switzer Super Report website. It includes a list of providers plus a comparison table of the key costs.

Don't miss this!

Tom Keenan, director of iShares, explains how one investment product that trades like a stock can give you the benefit of the movements in an entire index or index sector. Watch it on SuperTV.