Switzer Super Report

Issue 132, 1 November 2012

Cliffhanger

The US is gearing up for a cliffhanging end to the year, with the Presidential Elections set to take place on Tuesday. The winner will have a big bearing on how successful the Congress is at negotiating a new financial plan for the US economy, otherwise the country could be pushed off the fiscal cliff. I explain why in today's note.

Also in the *Switzer Super Report*, James Dunn analyses the recent NAB and ANZ results and compares their yields. And with China also set for a leadership change next week, JP Goldman takes a look at Shanghai stocks. Plus, we welcome Michael Heffernan, who answers the often-asked question of when to sell your shares. Enjoy the report!

Sincerely,

Peter Switzer

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Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
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Who's afraid of the fiscal cliff?

by Peter Switzer

There are always plenty of critical issues to worry about in this money-making game. However, it's the fiscal cliff in the United States that worries me most for my shorter-term trading actions.

There are heaps of big issues with a longer maturity date and that includes the China slowdown, the European debt/recession challenge, the overall US long-term debt problem and the timing of when the mining boom will really go bust.

To be frank, I think we'll muddle through most of these events over 2013 and stocks will go higher.

Blackrock's Bob Dole has tipped US stocks to rise 10% next year and Goldman Sachs is also on board with higher share prices.

By definition, both these influential market players mustn't be spooked by the approaching US fiscal cliff over the longer term and I think they are right. A solution has to come before January 1 and I'm sure it will, but there could be some huffing and puffing after the election that could worry investors until some 11th hour solution shows up.

What is the fiscal cliff?

The fiscal cliff is a description of what might happen to the US economy if existing tax cuts and spending measures disappear automatically on New Year's Day if Congress fails to agree on a new plan. The end-result would be an eradication of demand for the US economy, pushing it over a 'cliff' into recession.

This is because these mandated changes would cause a 19.6% increase in revenue to the US administration and a 1% cut to spending at a time when the economy still needs stimulus. Tax collected would go from 15.7% of gross domestic product (GDP) in 2012 to 18.4% of GDP in 2013, which is close to the historical average. This will look good on the books, but it will cause a recession!

So Wall Street will watch the Congress's arguments after the election like a Labrador eyes off a sausage at a BBQ! And if investors don't like the way things are going, stocks could be sold off.

On the flip side, if the negotiations are mature and sensible it could contribute to the end-of-year rally I'm expecting based on the belief that US politicians couldn't be so silly as to allow the economy to slump into recession.

Political analysts say the Republicans are in the box seat in terms of the Senate and so Democrats are likely to be more likely to be in a compromising mood after the election, but I'd say a Romney win in next week's poll would make for smoother negotiations over the fiscal cliff.

Right now the Democrats control the Senate, but it's a slim margin of 53-47 and of the 33 seats being contested 10 are held by Republicans and 23 are Democrat positions. Many of these are historically Republican having switched with the Obama wave of popularity at the last poll.

In the House of Representatives, the Republicans hold sway at 242-190. The Democrats are not expected to take the House.

My bet

In a perfect world for stock markets and the US economy, Romney would win and the Republicans would take both houses of government, which would mean this group of politicians would be responsible for pushing the economy off the cliff – and that would never happen.

Of course, there is something called a Presidential veto that KO'd a bill put forward by Congress, but I could not see Obama doing anything that would lead to the economy going over the fiscal cliff.

That's why I can't fall over or fall for this fiscal cliff fear talk.

My bet is that 'cliff anxiety' on top of ordinary company results could bring stocks down a small degree, which would be a buying opportunity, before another rally starts when Bing Crosby starts singing "I'm Dreaming of a White Christmas" in department stores across the USA.

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ANZ vs NAB: the results compared

by James Dunn

There is no doubting that the Big Four banks are hugely popular among Australian investors.

As at last year's annual reports, Commonwealth Bank (CBA) had 795,000 shareholders; Westpac (WBC) had 572,000; National Australia Bank (NAB) had 476,000 and ANZ had 443,000. The banks are core holdings for many retail share portfolios.

There is a very good reason for this: the banks have been strong generators of both capital growth and dividend yield. For self-managed super fund (SMSF) investors, the bank stocks are major generators of dividend flow.

NAB's full-year (FY) 2012 profit result yesterday showed why it is the weakest of the Big Four. NAB reported cash earnings of $5.4 billion, which was down 0.5% on the FY11 result. Net profit fell by 21% to $4.1 billion.

The cash earnings is what bank analysts mostly look at because it is used as the basis for calculating earnings per share (EPS), return on equity (ROE) and dividends. But here the investor has to keep an eye on the 'one-off' items that are being excluded – the banks have a bad habit of filling this category to the gunwales, with NAB the worst offender, ANZ and CBA middling, and Westpac relatively lilywhite.

NAB

NAB's big problem is about $9 billion of troubled property loans held in its UK banking operation, which it took onto its own balance sheet earlier this year. Because of that, the bank had to swallow an increase of almost $800 million in its provision for bad and doubtful debts (B&DDs) to $2.6 billion, which marred a solid performance from its Australian banking businesses.

The UK losses will hurt NAB's net profit for a few years yet. That is the cost of repatriating most of its British commercial real estate loans to the parent balance sheet, which enjoys lower funding costs.

NAB's net interest margin – that is, the difference between interest income received and interest paid out – fell from 2.25% in FY11 to 2.11%. The bank managed to lower its costs by almost 2% on FY11.

ANZ

Now let's look at ANZ, where there was a lot to like about the FY12 result. ANZ boosted full-year cash profit by 6% to a record $6.01 billion, while reported net profit rose by a similar percentage, to $5.66 billion.

ANZ (as well as Westpac and CBA) has nothing like the lead in the saddlebags that NAB's UK headache gives the latter. ANZ was actually able to release $230 billion of provisions against B&DDs, and its bad debts charge only increased by less than 3%, to $1.21 billion.

ANZ did show signs of funding stress, with full-year net interest margins contracting by 11 basis points (0.11%). But on the plus side, revenue growth at 5% outpaced cost growth at 4%.

Dividends

But what most concerns SMSF investors is the dividend, and this was a good story. NAB lifted its full-year payout to 180 cents a share, up from 172 cents in FY11. ANZ lifted its full-year payment by five cents, to 145 cents a share from 140 cents.

The major banks are demonstrating that they can deliver solid dividend growth despite only modest profit growth. This should continue, because they

have strong and improving capital situations (in which they are the envy of their global peers), and they are certainly not stretched on their payout ratios: CBA paid out 74.3% of its profit in FY12, ANZ 66.8% and NAB 68.8%.

Westpac

Westpac reports its full-year FY12 results on Monday, November 5. The bank is expected to lift its cash profit by about 5%, driven mainly by retail banking. But the dividend situation will be most interesting because Westpac has the highest payout ratio of the Big Four at 82%. If return on equity comes under pressure, Westpac could struggle to maintain that level of payout – although the market consensus does expect the bank to lift its dividend next week, from 156 cents a share in FY11 to somewhere around 165.6 cents.

But let's cut to the chase for SMSF investors – the yields.

Comparing yields

Market consensus forecast expects ANZ to pay a dividend of 149.9 cents a share in FY13, rising to 157.6 cents a share in FY14. At a share price of $25.50, that places ANZ on a nominal yield of 5.88% for FY13, and 6.18% in FY14.

Market consensus forecast expects NAB to pay a dividend of 183.8 cents a share in FY13, rising to 189.5 cents a share in FY14. At a share price of $25.43, that places NAB on a nominal yield of 7.23% in FY13 and 7.45%.

As always, these yields have to be converted to the after-tax equivalent yields they represent for SMSFs making use of franking credit refunds.

An SMSF holding ANZ in accumulation phase is looking at an effective yield of 7.15% in FY13 and 7.52% in FY14. If the ANZ shares are held in pension mode, the effective yield to the fund is 8.35% in FY13 and 8.78% in FY14.

Similarly, an SMSF holding NAB in accumulation phase is looking at an effective yield of 8.80% in FY13 and 9.07% in FY14. If the NAB shares are held in pension mode, the effective yield to the fund is 10.26% in FY13 and 10.58% in FY14.

With term deposit rates at 4.8-5% and ten-year government bonds at 5.5%, these are simply outstanding yields for the level of safety implied.

The real yield

And it gets better. As I always stress, an SMSF has to assess the yield it receives on an asset based on what it paid for that investment. The after-tax yield received on an asset is 'the yield that you eat.'

The Big Four banks' track record of growing their dividend stream – let alone the accompanying capital growth they have generated – makes them truly magnificent assets to hold over the long term.

It is entirely possible that a lot of SMSFs hold bank shares that they bought for single-digit share prices in the 1990s. Because the dividends have increased over that time, the effective yields some SMSFs are receiving on the share dividend flow being paid to them in pension form are almost unbelievable.

Just as an example, it was possible to have bought Westpac for as low as $3 in 1992, after the bank had suffered badly in the 1990-91 recession. Admittedly that would have been considered a brave buy at the time, but 20 years down the track, not only do you have a share worth $25.40, but more importantly, you have a share expected to pay a dividend of about 165 cents a share when it reports on Monday.

Let that sink in – our 20-year Westpac holder is looking at a nominal yield of 55%.

If the shares are held in an SMSF in accumulation mode, you can bump the effective after-tax yield up to 67%. And if the SMSF is paying a pension, those original Westpac shares are generating a yield of 78%.

Of course, inflation has to be factored into that equation, but the point is that time and the ability of well-run companies to increase their profit and dividend payout consistently can throw off yields that seem incredible. The old saying that "if a yield looks too good to be true, it probably is" holds true in

virtually all circumstances, except this one scenario of long-term dividend growth in the cream of Australia's industrial companies.

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Deep value in Shanghai stocks as index slides

by JP Goldman

Back in May this year I reconsidered the Chinese outlook, noting that Shanghai equity prices had fallen to reasonably cheap levels while the economy was continuing to defy dooms-day predictions that it would suffer a hard landing.

I did not suggest a bottom in China stocks was yet in place, but I warned readers to keep an eye out for a potential change in trend.

Five months on, what has changed? We're still watching and waiting. The economy is holding up while the stock market has become even cheaper and this suggesting a great investment opportunity is at hand once investor confidence improves and the economy stabilises.

The slowdown

Although the Chinese economy is still avoiding a hard landing, economic growth has nonetheless continued to slow, keeping investors nervous. Annual growth in national output slowed to 7.4% in the September quarter – the weakest since the depths of the global financial crisis and marking the seventh consecutive quarter of easing growth.

And the latest manifestation of this economic slowdown was a build-up in iron ore inventories due to weaker steel demand, which led to a sharp slump in iron ore export prices faced by Australian miners. In late September, iron ore spot prices touched a low of US$90 per tonne compared with highs around US$150 earlier in the year.

Adding to investor concerns is the fact Chinese authorities have remained reluctant to simply pump their economy with major new infrastructure projects as they did in late 2008 during the Global Financial Crisis (GFC). Some analysts suggest political leaders have been too distracted by a one-in-a-decade power transition that is set to resolve itself soon. If so, we might expect a swathe of new stimulus plans to be announced once the new leadership is firmly in place by early next year.

More likely, however, is that China's leaders remain less worried about the economy than many international observers and have not felt the emergency stimulus measures of 2008 are justified as the global outlook is far less dire. What's more, given the fact the 2008 stimulus helped spark a property bubble, China is more circumspect about how it supports its economy this time around, preferring more targeted measures to boost regional infrastructure and consumer spending rather than re-encourage excessive property speculation in its major coastal cities of Beijing and Shanghai.

Levelling out

Indeed, earlier this year China announced an official target of only 7.5% growth in 2012 – the economic data has since been broadly in line with this objective.

Many analyst suggest the economy is close to stabilising, meaning annual gross domestic product (GDP) growth will stop decelerating and level out at around current mid-7% levels. Data released for September provide tentative support for this view, with a lift in a key manufacturing index and stronger-than-expected retail sales and industrial production growth.

As for spot iron ore prices, they've recently bounced back to around US$120 a tonne due to some cutbacks in inefficient China iron ore production and a whittling down of excess inventories by steel producers.

The bottom line

As for the share market, the downtrend still remains in place. The Shanghai composite index touched a low of around 2,000 points in late September, and has since bounced higher – but prices remains well below their 200-day moving average and have yet to make a series of 'higher lows' and 'higher highs' that are needed to mark a new uptrend.

That said, valuations are even more compelling. The price to forward earnings ratio (Forward PE, which is the market share price divided by the expected earnings per share) for the China MSCI index fell to 6.2 as at the end of October – broadly equal to the lowest levels seen over the past few decades. Indeed, it was around these PE levels that the market bottomed in late 2008 and also during the turmoil of August 1998.

The market's measure of forward earnings is turning down, but the decline is more gentle than in 2008 – consistent with a soft landing. And note, due to very cheap valuations (as now), falling forward earnings in late 2008 and early 2009 didn't stop the Chinese market rebounding strongly once confidence in the economy was restored.

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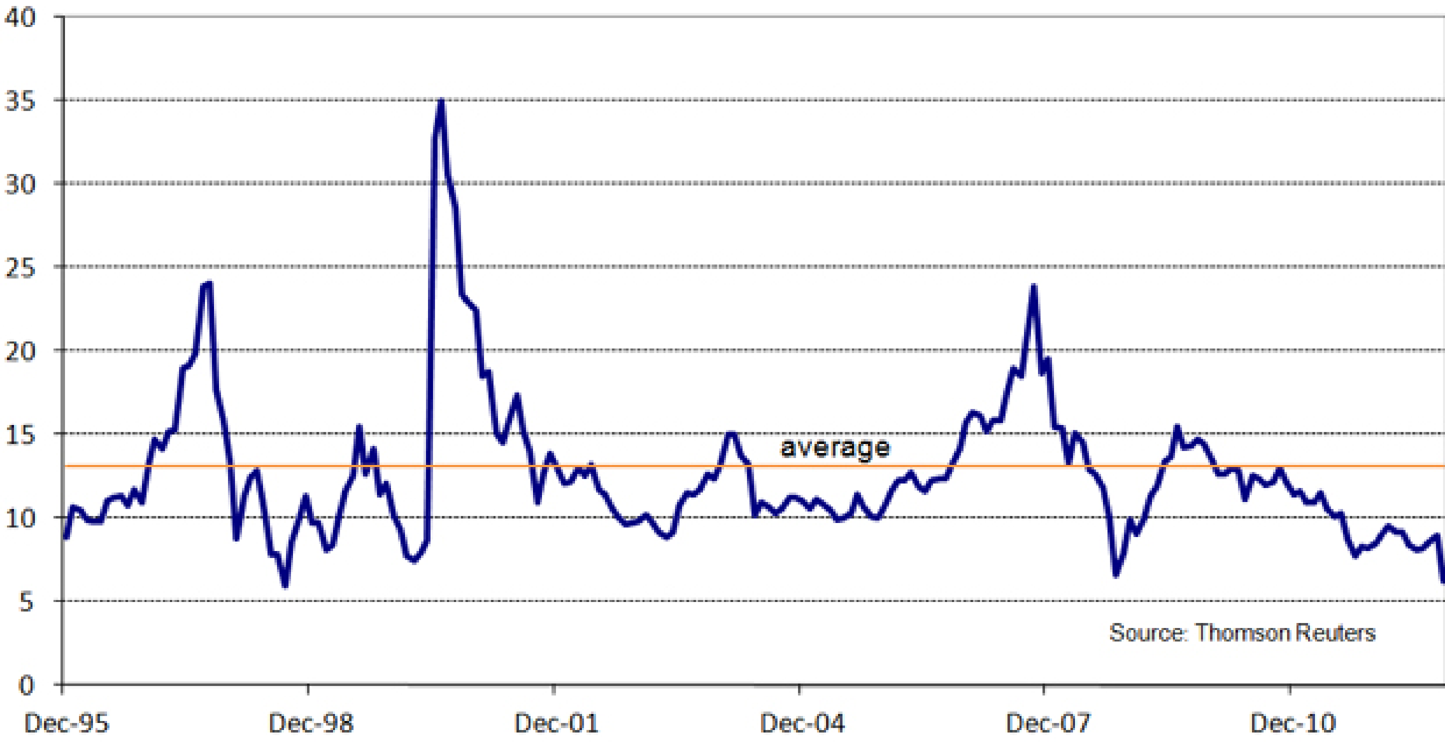
China MSCI Forward PE Ratio
40
35
30
25
20
15
10
5
0
average
Source: Thomson Reuters
Dec-95
Dec-98
Dec-01
Dec-04
Dec-07
Dec-10

When to cut your stock losses and sell

by Michael Heffernan

One of the most difficult decisions for investors is when to sell shares.

For instance when shares have seen a very substantial increase, some investors might like to take profits, as they believe that the share price will fall – other investors might take the opposite view and decide to let the share price run.

Similarly when share prices fall, many investors believe that the share prices will turn around and they don't want to be in the position of selling at the bottom.

Indeed, some investors have a reluctance to sell any shares at a loss.

But the key element to grasp here is that if share prices have declined, then the investor has made a loss – whether it is crystallised or not makes no difference. The fact is, a loss is a loss.

In this case, investors must look at whether they would be better off in some other stock rather than waiting for the stock that they are currently holding to turn around.

Expressed in another way, if the shares which were in the loss-making situation were sold, and other shares (which the investor judges to be sound and with good prospects) were purchased in their place, and those latter shares increased while waiting for the original shares to turn around, the investor is better off by moving out of the loss-making shares and into the replacement shares.

Selling discipline

One way to alleviate investors anxiety about loss making shares is to have a selling discipline and to follow two fairly simple moves. The first is that when the share price is going up, investors should let the share prices run; the second is to cut your losses.

The real question then becomes how does one cut ones losses – what is the discipline.

My experience is that a reasonable selling discipline is that if the share price falls by 15% from its most recent high point, then investors should sell the shares no matter what.

In this way, one can always limit oneself to losing no more than 15% on any share transaction. Even more advantageously, one can actually lock in profit by using this discipline (that is, if the share price has risen above your purchase price before falling 15% below its high point, it may still be above your purchase cost).

My experience also indicates that more often than not when share prices fall by 15% from their most recent high point, the share prices tend to fall even further. When selling the shares once they drop 15% below their most recent high point, one should look for opportunities to buy other stocks, which one expects on reasonable assumptions to show an increase.

However, it is important to be alert to a situation where after the share has been sold, the share price starts to turn around and increase. In such a situation the investor should be ready to buy back into that particular stock.

The recovery

Examples of stocks that have declined substantially and then recovered a little would be our major resources stocks, BHP Billiton (BHP) and Rio Tinto (RIO). If one had sold either of these two stocks when they fell 15% below their high point, then one would have had ample opportunity to buy back into each of

them when they eventually did show signs of stabilising and turning around. As the share prices of both BHP and Rio have fallen considerably more than 15% over the past year, the selling strategy would have paid handsome rewards.

More specifically, if one had sold BHP and Rio shares back in February or March of this year at around $38 and $66 each respectively, and transferred the proceeds into any one of the major banks, one would be substantially in front at the moment.

As of now, the four major banks have all increased by between 11% (NAB) and 27% (WBC) so far this year whereas BHP and Rio have actually shown very little overall movement as at November.

Stick to it

In summary, if one does opt for this 15% selling strategy, investors should stick to the discipline absolutely.

If an investor tries to finesse the disciple and say, “well there are no reasons why the stock should have fallen, its prospects look good, so I will hold on,” my experience again has shown more often than not (but not necessarily on every occasion) that the share prices tend to drop even further.

Importantly, it should be remembered that this strategy is a ‘more often than not’ rule, that is, it may not work all the time, but on average, I have found that it will work to your benefit more than it will work to your cost.

Michael Heffernan is a Senior Client Advisor and Economist at Lonsec Sharebrokers.

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How the new SMSF audit rules affect you

by Andrew Bloore

DIY super fund auditors will soon need to pass tougher standards in order to be approved to operate and it's important you're aware of this change so that you can make sure your annual audit remains compliant.

The Government recently announced the introduction of a new registration process for self-managed super fund (SMSF) auditors as part of its Stronger Super reform package for Australia's superannuation system. If an auditor fails to meet these requirements, any audit they complete for you won't count.

What does this mean for your fund's auditor?

The registration process will commence from 31 January 2013, with mandatory registration required by 1 July 2013 for all SMSF auditors wishing to continue SMSF audits after this date. Subject to transitional arrangements, registration will require auditors to meet the following criteria:

- hold a tertiary accounting qualification that includes an audit component or have successfully completed study in audit as part of a professional accounting body program;
- meet a fit and proper test;
- hold appropriate professional indemnity insurance;
- have 300 hours of SMSF audit experience in the three years prior to registration; and
- pass a competency exam.

Why are these new requirements important?

Given the level of taxation concessions provided to complying super funds and as auditors play a crucial role in the regulation of the SMSF sector, it is necessary that SMSF auditors have a high standard of competency.

The annual audit and the new registration process will provide assurance to the Government and the general public that SMSFs are complying with the super laws.

The new regulations will raise the standards of SMSF auditor competency and ensure that there is a set of minimum standards that apply across the entire sector.

Your role

As an SMSF trustee, it's crucial to ensure your fund is audited annually by an approved auditor. You must appoint an approved auditor at least 30 days before the due date of the SMSF return. Upon appointment, you can expect a letter of engagement from the approved auditor, explaining the scope of the proposed audit.

The approved auditor is required each year to examine not only the fund's financial statements but to also assess the fund's overall compliance with super law. As an SMSF trustee, you have to ensure that you provide your fund's approved auditor with any documents they require to conduct the audit.

An approved auditor will request a letter of representation from a fund's trustee before they commence an audit of the fund. The letter is a statement from the trustees that SMSF trustees are of the belief that the financial statements are a fair representation and that the fund complies with super law. Your auditor will provide you with an audit report before the lodgement date of your fund's annual return.

According to the Australian Taxation Office (ATO), a fund's auditor is required to:

- provide the fund with an audit report before

the due date of the SMSF annual return;
- bring to the ATO's attention, and the attention of the fund's trustees, to any concerns about the fund's financial position or its compliance with the super law;
- report to the ATO any certain contraventions of the super law that they may identify during an audit.

If the fund's auditor identifies a contravention of the super law, the trustees will need to take immediate steps to rectify the contravention.

Who can be an approved auditor?

Super law defines an approved auditor of an SMSF as any of the following:

- a member of CPA Australia Ltd
- a member of the Institute of Chartered Accountants in Australia
- a member of the National Institute of Accountants
- a member or fellow of the Association of Taxation and Management Accountants
- a fellow of the National Tax and Accountants and Accountants Association Ltd
- an SMSF specialist auditor of the SMSF Professionals' Association of Australia Ltd
- a registered company auditor
- an auditor-general of the Commonwealth, a state or a territory.

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Question of the week: bank accounts

by Paul Rickard

Q: *I have about $10,000 cash in my SMSF bank account and it seems that to get the higher interest rate, there is always a minimum deposit of $50,000. Can you suggest options? Alternatively, can I borrow that money and pay interest to my SMSF?*

A: I'm somewhat surprised by the question as most of the targeted accounts offered by banks for SMSFs have eliminated minimum deposit requirements. Perhaps you are using an older style account, or with a bank that hasn't yet understood the needs of SMSF trustees.

As the following table shows, there are several banks that don't require a minimum opening deposit. Further, most of the banks pay interest on the whole balance (that is, on every dollar). If there is a 'magic' level at which you move from a low rate to a high rate, this appears to be $10,000 rather than $50,000. Westpac (WBC), Commonwealth (CBA) and Bank of Queensland (BOQ) have products structured on this basis, although the former operates a 'two product account' and technically, you could get the higher rate on a deposit of any size in their savings account. (See table on next page.)

Finally, you can't borrow money from your SMSF (and pay it interest). This would be constituted as a 'loan from the fund to a member or relatives of members of the fund' and this is forbidden under Section 65 of the Superannuation Industry Supervision Act. Contravention of this section would leave you liable to civil penalties – so please don't go there.

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SMSF bank accounts

Bank	Product	Minimum to Open	Standard Interest Rate	Special Interest Rate
Bank of Queensland	BOQ Super Savings	Nil	0.00% up to $9,999; over $10,000 4.55%	0.70% bonus for 4 months for new a/c (over $10K)
Commonwealth Bank	DIY Super Cash	$10,000	0.01% up to $9,999; over $10,000 3.25%	n/a
National Australia Bank	NAB Cash Manager	$5,000	2.75%	n/a
St George/Bank of Melbourne	DIY Super Saver	Nil	3.40%	1.1% bonus for 4 months for new a/c (1.2% BOM)
Westpac	DIY Super Solution	Nil	3.45% on Savings a/c, 3.25% on Working a/c > $10,000	n/a
ING	SMSF Cash	Nil	3.50%	1.5% bonus for 6 months for new a/c
RaboDirect	DIY Super HISA	Nil	4.30%	1.16% bonus for 4 months for new a/c
UBank	USaver SMSF	Nil	4.46%	0.70% bonus in month of no withdrawal

**Interest rates and conditions current as at 29 October, 2012.*

Don't miss this!

Tuesday is gearing up to be one massive day. Not only is it Melbourne Cup Day, but it's also the next Reserve Bank of Australia monetary policy meeting and many market pundits are expecting a cut.

All that will be followed by the Presidential Election in the United States!

Craig James, the chief economist at CommSec, expects the RBA to shave 25 basis points off the official cash rate, taking it down to a low 3%.

"It is by no means a clear-cut decision, but the relatively high Aussie dollar, global risks and conservatism of consumers and businesses argue the case for lower rates," says James.

The decision will be announced at 1430 AEST, half an hour before the race gets under way in Flemington. The US Presidential Election coverage will unfold overnight.

Did you know?

Australian online retail sales jumped by 23% in the 12 months to September, but while online retail is growing, the overall level is still modest compared with traditional sales, a National Australia Bank survey showed.

Online retail sales totalled $12.1 billion in the past year, equivalent to 5.5% of the traditional store retail sales.

However, NAB found that the growth rate for online retail sales continued to outperform traditional sales, which increased by 4% in the same period.