Switzer Super Report

Issue 136, 15 November 2012

Waiting game

I suspect the current market conditions are going to get worse before they get better. While the world is trying to wrap its head around how the US is going to negotiate its way past the fiscal cliff, uncertainty abounds in Greece with its struggling economy and austerity measures.

Even so, the current conditions are once again opening up some good buying opportunities and you should be keeping your eyes peeled for these. We highlight some of your options in today's report, including some high-yielding opportunities and a stock for uncertain times. Plus, we explain exactly what your employer should be paying you in super so you don't get cut short. Enjoy the report!

Sincerely,

Peter Switzer

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switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
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Buying opportunities ahead and why Buffett is wrong

by Peter Switzer

Another month and another challenge for investors and I suspect it will get worse before it gets better. However, I maintain my argument that this post-election, pre-fiscal-cliff-solution anxiety will create a buying opportunity ahead of a December rebound, which should roll into January.

And all of this underlines one argument of my favourite investor – Warren Buffett – which I disagree with. I will deal with that later.

Nearing the fiscal cliff

Wall Street has shed around 5% since Barack Obama took the prize in the US poll and now there are a collection of forces that make it easy for short-sellers and hedge funds to get a bit of action before some sort of settlement of the 'fiscal cliff' issues arrives.

However, there are other drivers hurting investor confidence right now, but I don't think any rival the fear generated out of the fiscal cliff. Right now Obama has made it clear that tax cuts must remain, but not for America's wealthiest, and this shows that even if the cliff is mastered, there could still be issues for markets, say if capital gains and dividend taxes are ratcheted up.

That said, I still will be punting that markets will spike on the cliff solution, just as they have fallen ahead of the negotiations, which both were predicted by Lance Lai and Gary Stone in this newsletter.

Don't forget Greece

On the other negative issues helping drive share prices down we have the Greeks waiting for debt help from the European Union after passing their budget, but there are protests daily with the economy contracting for a 17th quarter in a row! It is now 7.2% smaller than last year!

Across Europe there is unrest over austerity measures, but against that, company results have been pretty promising. Strikes in Spain and Portugal shut transport links across the Iberian Peninsula overnight and this didn't help European stock markets. However, these markets are also affected by the USA's fiscal cliff issues.

Not helping matters, oil prices spurted higher as tensions in the Middle East raised supply concerns after Israel launched a major offensive against Palestinian militants in Gaza.

Time to buy?

All of these make it sensible for shorter-term traders to take profit and wait for buying opportunity signs to kick in. Some US market experts are already buying now, but it could be too early and this is where I take issue with Buffett.

Sure I agree that you should be careful about news headlines when it comes to buying and selling shares, but sometimes headlines can help.

If a headline warns that a government is thinking about changing laws that could affect a company's profitability, then they are valuable alerts. A resignation of a great CEO being replaced by an unknown can be valuable.

Gary and Lance's warnings have been timely news items, which would have helped short-term players bank profit and I think news will be vital in working out when to buy into this pull back. News can be late, exaggerated or inadequate, but it has relevance – that's why this newsletter, website and service exists.

Of course, I select the companies in my portfolio on the criteria Buffett uses – quality companies, dividend payers, and great brand names with top management. But if Obama and the Congress drive down stock prices and Commonwealth Bank (CBA) ends up at $55, then that's the news I want to hear because I would want to be a buyer then!

Watch this space and I will break the news when Lance, Gary and yours truly are ready to buy.

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A stock to buy in uncertain times

by Geoff Wilson

On a recent trip to Greece, I met a woman who moved from Melbourne to Athens five years ago and found a job similar to the one she had in Australia.

There was one big difference: In Melbourne, she was paid $60,000 a year; in Athens, she makes the equivalent of $10,000.

Things are diabolical in Greece. Unemployment is over 25%, youth unemployment is over 54% and those who have jobs are scared to speak up to their bosses. Many I spoke to are trying to leave the country.

I asked people when they thought things would get better and was amazed at the universal answer – they believed there was no hope.

I also visited London, where the prevailing view was that it could take a decade to sort out the Europe's economic problems. In the United States, the re-election of President Obama has provided some stability, but the threat of the so-called 'fiscal cliff' – when mandated tax hikes and automatic spending cuts will deliver a big shock to the economy unless Congress can strike an agreement – is unsettling, to say the least.

Balancing act

Against this backdrop of great global uncertainty, a number of dynamics are positive for the Australian equity market.

The reduction in official interest rates in the past year has been good for investors in several ways. Since November 2011, the Reserve Bank has lowered the official cash rate from 4.75% to 3.25%.

Lower borrowing costs stimulate a pick-up in economic activity. The cuts are positive for sharemarket valuations because lower interest rates mean higher price-earnings ratios. Lower rates on savings products also force those in bank deposits to look to equities for better returns – six months ago, average term deposits paid around 6% interest; now they pay a little over 4%.

The Reserve Bank left interest rates on hold this month, but the benefits of the cuts already made will continue to be felt.

What to buy?

In times of global upheaval, I look for stocks I believe will perform well regardless of wider trends.

NEXTDC Ltd (ASX code NXT) establishes, develops and operates data centre facilities in Australia, where companies can remotely install their IT and communications equipment. The centres offer reliability, convenience, security and in some cases lower costs than internal storage.

At Wilson Asset Management, we believe the demand for data centres will continue to increase. NXT is well positioned to benefit from this growth. They have centres operating in Brisbane, Melbourne and Canberra and plan to open in Sydney and Perth by the end of next year.

NXT was founded by Bevan Slattery, who set up Pipe Networks, which was eventually taken over by TPG Telecom. It has a strong management team, headed by the recently appointed chief executive, Craig Scroggie.

The company is currently making losses, but as the new data centres open and space is filled, this will become a highly profitable business. Its capital position will be strengthened by the spin-off of the first three data centres into a listed property trust,

scheduled to be completed by the end of the year.

This move will release capital to fund the new centres in Sydney and Perth. We believe NXT has sufficient cash to reach break-even in 2014 and grow strongly thereafter. Its growth will not be reliant on global or domestic investment dynamics.

Disclosure: WAM Capital and WAM Research, listed investment companies managed by Wilson Asset Management, are investors in NXTDC Limited.

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NEXTDC (NXT) stock price chart

Two simple ways to beat the market

by James Dunn

Self-managed super fund (SMSF) proprietors looking to get an edge on the stock market can look within it at the two largest listed investment companies (LICs), Australian Foundation Investment Company (AFIC) and Argo Investments Limited.

To many investors, LICs are the tortoises of the sharemarket. But that is not necessarily an insult: in fact, the LICs do a very good job of their stated mission, which is compounding share price rises and dividend income to generate long-term capital growth.

AFIC, the largest LIC on the Australian Securities Exchange – it is capitalised at $5 billion – was founded in 1928 by the JBWere group, while the second-largest, Argo Investments ($3.9 billion) was founded in 1946 in Adelaide by a group of stockbrokers that included Sir Donald Bradman.

Both AFIC and Argo specialise in managing portfolios of large-cap stocks. They have been solid performers against the market – although, like the market, they have taken a hit over the last three to five years.

For example, over the 20 years to the end of September 2012, Argo's gross net tangible assets (NTA) figure has appreciated by 10.9% a year, versus 9.8% a year for the S&P/ASX All Ordinaries Accumulation Index. For its part, AFIC compares itself to the S&P/ASX 200 Accumulation Index (because it holds a smaller number of stocks in its portfolio): over the 20 years to the end of September 2012, AFIC says its gross NTA has appreciated by 11.4% a year, compared with a 9.9% a year gain for the S&P/ASX 200 Accumulation Index.

The NTA figure, which is the market value of the fund's share portfolio divided by the number of units on issue, is the best measure of the performance of the LICs. The NTA tells you the dollar amount of the portfolio's value that 'stands behind' each unit.

Each month, the LICs will quote two NTA figures, one gross, one net of capital gains tax that may arise should the entire portfolio be liquidated (they are required by current accounting standards to do this.) As most LICs are long-term investors that don't intend to sell their portfolios, the gross NTA is the figure to use.

For self-managed super fund (SMSF) investors, LICs are an excellent way of holding a stock that delivers instant diversification and a decent shot at outperforming the market return.

LICs vs managed funds and ETFs

When investors are paying upwards of 1% a year for an actively managed fund, not beating the index is a problem.

This point was recently reiterated with the release of the mid-year 2012 S&P Dow Jones SPIVA Australia scorecard. This research measures the performance of active fund managers against S&P's main market indices such as the S&P/ASX 200 accumulation index.

In the equity funds category, over the 12 months to the end of June, the index outperformed 72% of active share fund managers. Over three and five years, the proportions of funds beaten by the index were 72% and 81%, respectively.

That is why ETFs and index funds, which at least give the market return, and cost one-quarter of that, have grown in popularity.

Where LICs fit into this discussion is that they are actively managed vehicles – but they charge as if they were passive.

LICs are closed-end investment vehicles: this means

that after the initial capital raising, the shares trade at a price set by the market. No new money comes into the fund unless new shares are issued or through a dividend reinvestment plan.

This makes LICs very different to unlisted equity trusts, which are open-ended investment vehicles: at any time a new investor can buy new units in the trust, which are priced at the prevailing NTA. The unlisted equity trust manager has to invest new money coming in; and conversely, sell shares to meet investor requests to take money out of the fund.

LICs do not. The fund manager gets to take a long-term view on their investment portfolio. All managers advertise that they do this – but the structure of the LIC means that they really can.

Performance

This ability can have a very material impact on investment performance. For instance, William Spraggett of Bell Potter – probably Australia's leading analyst of LICs – reckons the larger LICs outperform unlisted equity trusts by about 1.6% a year. (Spraggett compared the domestic equity LICs he covers to about 700 unit trusts with performance figures in the Morningstar database.) Considering that the big LICs focus on the large-cap stocks – where arguably the market is materially more efficient, and outperformance harder to achieve – this is a very pertinent statistic.

And for that performance, Spraggett says Argo Investments charges investors an indirect cost ratio (ICR) of 0.18% a year; AFIC charges 0.19% a year.

On yield grounds, the big LICs are solid performers, but not spectacular. Looking at 2011-12 dividends, Argo paid a dividend of 26 cents last year, while AFIC paid 21 cents. At a share price of $5.75, Argo is priced on a historic nominal yield of 4.52%. At $4.73, AFIC shows a trailing yield of 4.44 per cent.

The dividends are fully franked, which means that an SMSF in accumulation mode is earning 5.5% on Argo shares and 5.4 per cent on AFIC. In pension mode, these yields are augmented to 6.4% for Argo, and 6.3% for AFIC.

These are not as lucrative as bank yields, for example, but for a less-volatile, diversified portfolio, they are very solid income contributors.

Pricing

There is one other feature of LICs that investors must grasp, and that is that the share price of a LIC can and will fluctuate around its NTA figure. What this means is that when the price is less than NTA, investors can buy an interest in a high-quality, well-diversified share portfolio for less than the cost of establishing that portfolio themselves. The reverse also applies, and an LIC's share price can exceed the prevailing NTA.

The LICs' NTA figures come out each month, but Spraggett models the figures on an intra-day basis: at present, he has AFIC trading at a 2.8% premium to its NTA, while Argo is valued by the sharemarket at a –2.1% discount to its NTA.

Traders on the market can make money on the fluctuations of the LICs' share prices compared to their stated NTA figures, but that constantly shifting balance should not concern SMSF investors.

The bottom line

However, that slight discount – and a touch better yield – indicates that Argo is a better bargain at the moment. But both Argo and AFIC should be considered highly effective and cheap ways to capture the long-term total performance of the sharemarket, over an extended period of time.

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JP Goldman

Four high-yielding investment options compared

by JP Goldman

Investors seeking steady returns and good yields in the share market have had new investment opportunities open up in recent years with the advent of exchange trade funds (ETFs). In this column I have regularly reviewed different investment themes and money making opportunities with the local ETF sector, ranging from sector rotation to international exposure.

ETFs strongest benefit is their relative cost. For a fraction of the cost of most actively managed funds, investors can get exposure to indices that track established benchmarks such as the S&P/ASX 200 (State Street's STW) or S&P/ASX 300 (Vanguard's VAS). Their management expense ratios are 0.29% and 0.15%, respectively.

We've also looked at so-called 'strategy based' ETFs, such the suite of high-dividend-yield products available. For only a fraction more in management fee, these ETFs aim to select stocks from within the large cap and most liquid end of the market that are most likely to produce reliable and above-average dividend yields. Ideally, such ETFs might produce capital returns broadly in line with the market over the long-run, though with the added benefit of a higher dividend yield. As such, these products are well suited to investors seeking regular tax effective income.

Four main options

So much for the theory. It's been just over a year since I last reviewed the high-yield ETF sector. In that time there's been no new players enter the market, meaning we still have four providers: State Street, Vanguard, iShares and Russell Investments.

Back then I suggested that "overall, my choice of ETF for relatively conservative and income needy investors would be Vanguard's ETF. While this is the newest ETF, it's backed by a fund that has been operating for the past ten years… it's also the cheapest high-income ETF and has relatively greater defensive qualities given its higher weight to consumer staples rather than financials."

Which one should you buy?

How have these investments fared?

As seen in the table below, Vanguard remains the cheapest ETF with a management expense ratio of only 0.25%, though the others (with the possible exception of Russell) are not much more expensive. Russell has the oldest high-dividend ETF and retains the most funds under management (FUM) – though the other funds have increased FUM and market share relative to Russell over the past year. Measures of liquidity – such as bid/offer spreads and market depth – have improved to fairly good levels for all these ETFs.

ETF costs and liquidity

ETF Provider	Listing Date	ASX Code	MER (1)	FUM ($Am) (2)	Av. Bid/ Offer (3)	Depth ($Am) (4)
iShares	09-Dec-10	IHD	0.30%	$98	0.26%	$0
Russell	14-May-10	RDV	0.46%	$114	0.23%	$0
State Street	24-Sep-10	SYI	0.35%	$52	0.21%	$0
Vanguard	26-May-11	VHY	0.25%	$56	0.19%	$0

(1) management expense ratio (2) funds under management in Australia (3) average % spread between best bid & offer price (4) average dollar value of 5 best bids & offers.
Source: ASX ETF Monthly Report October 2012, ETF Provider websites.

Sector exposures – reflecting the respective methodologies of these providers – remains similar to last year, with a generally higher than market weight to the financial sector. As we noted last year, Russell's ETF is the only one that invests in listed property, while iShares tends to underweight financials so as to provide investors greater diversification to other sectors. Vanguard is also relatively underweight financials, with the major difference made up with a larger overweight to

telecommunications.

Sector break down

ETF Provider	ASX Code	Financial ex-A REITs	Industrials	Consumer Staples	A-REITs
iShares	IHD	20%	18%	7%	0%
Russell	RDV	45%	5%	11%	7%
State Street	SYI	53%	7%	10%	0%
Vanguard	VHY	40%	15%	12%	0%
S&P/ASX 200	**STW**	**31%**	**7%**	**9%**	**7%**

Source: ETF Provider websites.

In terms of performance over the year, all have managed to produced a higher than market average dividend return. Capital returns have also been above average, reflecting the market preference for high yielding sectors in the past year – such as financials – rather than materials or consumer discretionary stocks.

These sector performances appear to have especially hurt the performance of iShares' ETF given its higher weight to materials, and aided the performance of Vanguard (despite an underweight financials exposure) due to the strong performance of telecommunications.

Recent Price Performance: 11-Nov-11 to 13-Nov-12

ETF Provider	ASX Code	Yield	Price	Total
iShares	IHD	4.7%	-0.6%	4.2%
Russell	RDV	5.7%	2.3%	8.1%
State Street	SYI	5.5%	5.6%	11.1%
Vanguard	VHY	6.1%	6.7%	12.9%
S&P/ASX 200	STW	4.2%	1.9%	6.1%

My pick

Overall, on the basis of both relative cost, liquidity and performance, the Vanguard ETF still remains my most favoured. Given its solid performance over the past year, my call last year so far remains vindicated.

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Question of the week: death benefits

by Tony Negline

Q: *In a two member SMSF, where each is the declared beneficiary of the other and each has approximately 50 % of the assets in the fund, upon the death of one member, can the other member retain the funds in the SMSF or must they be paid out?*

If they need to be paid out, is there a time limit to this? And what if the funds aren't liquid e.g. property assets or term deposits?

A: Before getting into the nitty gritty of the questions, I should point out that in my response I'm going to assume "declared beneficiary" means that each has a Binding Death Benefit Nomination (BDBN) in favour of the other person. (Remember your Will has no impact on how benefits are paid out of your super fund.)

I'm also going to assume both members of the super fund are eligible to receive the other member's death benefit. That is, they are deemed to be a dependant.

So can the death benefits be left in a super fund, or must they be paid out?

The simple fact is that something must be done with the member's death benefit – it can't remain in the fund indefinitely 'unpaid'. They must be either paid as a lump sum or remain within the fund and be paid as a pension.

What happens with a member's benefits very much depends on the terms of your fund's trust deed and what any completed BDBN says.

If your SMSF has an old trust deed – because you haven't regularly updated it – then it might only allow death benefits to be paid out as lump sums and may not permit a member to complete a BDBN.

However, don't assume that a newer trust deed will automatically have these provisions.

The death benefit can't stay in the super fund in the accumulation phase and can't be added to the surviving member's existing accumulation phase benefit. However, benefits may be able to stay in the fund if they are being used to pay a pension. Over time, they will cease to be the deceased member's assets and become the remaining member's super fund assets.

Is there a time limit on lump sum death benefits?

Before answering this question, I need to mention that trustees have to act in the best interests of the beneficiaries at all times and to the exclusion of all personal considerations.

If the terms of the trust deed are quite clear and there is no dispute as to who will receive these benefits and how they will be paid, then there is no justification for any delay in payment. Most of us wouldn't accept any delay from a retail super fund and the same principle applies for SMSFs.

Problems paying a death benefit promptly due to liquidity

All super fund trustees have to establish an investment strategy and the super legislation demands that in framing this strategy, trustees have to consider their fund's liquidity requirements including expected cash flow needs.

If an SMSF trust heavily invested into illiquid assets, which cause a delay in the payment of death benefits, has the trustee adequately taken into account their fund's likely cash flow requirements? Have they acted in the best interests of all their beneficiaries?

We don't know enough about this case to answer definitively, but my hunch is no to both questions.

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Is your boss paying you the right super?

by Andrew Bloore

While most employers do the right thing when paying their employees' super contributions, some make their payments late and in a few cases, not at all.

In 2011-12, the Australian Taxation Office (ATO) received 19,440 complaints from employees about 13,399 individual employers regarding unpaid superannuation. But while employees are likely to spot if they haven't been paid their super at all, considerably less would recognise if their super payments were falling short of the mark, so it's important to understand what you should be receiving.

How much should you receive?

The superannuation guarantee (SG) scheme requires all employers to provide a minimum level of superannuation support in each quarter for their employees. At present, the minimum level of support is generally 9% of ordinary time earnings, although this amount will gradually increase to be to 12% by 2019-2020.

The ordinary time earnings of an employee is the lesser of:

- The total of the employee's earnings for ordinary hours of work and earnings for over-award payments, shift loading and commission (but not including lump sum payments on termination of employment for unused annual leave, unused long service leave or unused sick leave), and
- The 'maximum contributions base' for the period. For 2012/13, this is $45,750 (indexed annually) for each quarter.

This means that an employer's liability to make SG contributions for each quarter is limited to 9% of $45,750, even if an employee's ordinary time earnings for the quarter exceed that amount.

Example

For example, if an employee's ordinary time earnings in a quarter is $75,000 ($300,000 ÷ 4 = $75,000), the employer only has to pay $4,118 (9% x $45,750 = $4,118). Therefore, over the course of the year, $16,472 ($4,118 x 4 = $16,472 pa) in concessional contributions would be contributed into their super account based on their approximate ordinary time earnings for the year. This amount falls well short of their $25,000 concessional contribution cap for the year.

The actual level of superannuation support provided in respect of each employee is measured on a quarterly basis, that is the three month period commencing 1 July, 1 October, 1 January and 1 April.

The SG scheme applies to all employers in respect of their full time, part time and causal employees with only limited exceptions. In general terms, an 'employee' is a person who is paid a salary or wages in return for work or services rendered, and who receives payment for work under a contract that is wholly or principally for that person's labour. The 'employer' is the person liable to make the payment.

The SG charge that is imposed if the employer fails to make sufficient SG contributions is based on the employee's salary or wages for the quarter.

Sacrifice into superannuation

Because the SG legislation doesn't prescribe how the minimum level of employer contributions for employees is to be funded, contributions made by an employer after an employee enters into a salary sacrifice arrangement may be an acceptable way for an employer to fulfil its obligations.

Choice of fund

As well as providing the required level of SG, employers must also give their eligible employees a choice as to the fund into which their SG contributions are paid. If the employee fails to choose, or chooses a fund that cannot be used by the employer, the employer may choose the fund.

As an employee, you may initiate the choice process by giving your employer a written notice proposing a particular complying super fund or your employer must give you a standard choice form and thereby initiate the choice of fund process.

Your employer must act on your choice of fund.

It is important to note that you may not be eligible under the SG to choose a super fund if for example you work under a state industrial award, a federal industrial agreement such as an Australian workplace agreement (AWA), if you are in a particular type of defined fund or if you have reached a certain level in a defined benefit fund.

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The week ahead

Your self-managed super fund needs a written investment strategy and the super laws require you to review this regularly. When creating your strategy, you'll need to take certain issues into account, such as how much money you'll need in retirement, your risk profile, the types of assets that suit your needs and the needs of the other members in the fund, how to weight these assets, how quickly you can access the assets if needs be, and if relevant, how long you have until retirement.

You can find out more about creating an investment strategy on the Switzer Super Report website, as well as an example strategy to help get you on your way.

Did you know?

For those in Sydney, Paul Rickard and myself will be presenting a seminar on the benefits of self-managed super funds (SMSFs) , with the first of two seminars kicking off tomorrow.

Friday 16 November: Grace Hotel, Sydney CBD, 12.30pm
Wednesday 21 November: Easts Rugby Union Club, 6.30pm

Tickets at $20 each or $25 for a couple.

To book your seat, please visit switzer.com.au/SMSF or phone 1300 794 8937.