Switzer Super Report

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My crystal ball

Stocks are being pulled in all directions, recoiling on silly comments from US politicians one day and rebounding on good comments the next. So will they ultimately go up or down? You can find out in my note today in which I give my prediction for where the markets are headed as we close out the year and begin with the new. Plus I throw in a few stock tips.

Also in the *Switzer Super Report*, CSL has busted through $50 a share, but can it go higher? James Dunn takes a closer look at the biotech star. And as global conditions begin to improve and risk returns to the market, JP Goldman looks at the potential to tap the emerging markets at a relatively cheap price. Plus, we have seven tips for using a transition to retirement pension. Happy investing!

Sincerely,

Peter Switzer

Inside this Issue

Seven tips on Transition to Retirement pensions
by Andrew Bloore
08

02 **Five stocks and a crystal ball**
by Peter Switzer
My predictions for the end of 2012 and the New Year.

04 **Can CSL's success story continue?**
by James Dunn
Shares in the biotech star shot above $50 this week.

06 **Emerging markets looking cheap**
by JP Goldman
Should you invest in these two emerging market index trackers?

08 **Seven tips on Transition to Retirement pensions**
by Andrew Bloore
Read this before you jump on the bandwagon.

10 **Question of the week: trustee meetings**
by Jo Heighway
How often should I have a trustee meeting?

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Five stocks and a crystal ball

by Peter Switzer

As both the fiscal cliff and Christmas loom, I'd like to outline what I expect to happen as we head into year's end and then take a stab at 2013 for stocks. And I will throw in few stocks that a guy I respect is investing in right now.

Here's what I think will happen.

The fiscal cliff negotiations will send stocks up and down over the next two weeks, but before Christmas, there will be a settlement. This will lead to a rally that will spill over into January, which is good for stocks, and then sometime between March and May the market will have to work out whether this will be a "sell in May and go away" year.

History tells us that the first two years of a presidential cycle are the worst for stocks, but then spending increases in year three, often helped by the US Federal Reserve, and then year four is good for share prices as the November election bears down.

Will history repeat?

This year, the S&P 500 is up about 11% and the last two years have followed the historical script. Of course, history doesn't repeat like clockwork but has tendencies that give light to patterns – however, there are always out-years or out-cycles that can happen.

I think we are in an out-cycle because of the weirdness of the global economy in a post-GFC world. The US government can't play hard ball like other governments in the past or else it will cruel the creeping recovery, so I think stocks will go up this year.

Have a look at these 2013 forecasts for the S&P 500, which is now at 1,408. Bank of America Merill Lynch has it at 1,600, Deutsche Bank tips 1,500, S&P/IQ comes in at 1,550 and Canaccord Genuity has the highest at 1,650.

If the latter is right, the index will spike some 17% next year and even if we take the average of the four forecasts, then we get 1,575 and so the average rise would be 11.86%.

Locally, one of the country's best fund managers, Geoff Wilson of Wilson Asset Management also acknowledges the two bad years scenario in the US election cycle, but he thinks it will be an out-year. In addition, he thinks we will outperform with interest rate cuts crucial to turning businesses around.

Wilson admits to buying some big retailers on the strength of reconnaissance from retail businesses his institution surveys, though he admits it could be a short-term play. He reminds us that there is a record $1.6 trillion in deposits in financial institutions and some of this will eventually head back to stocks as rates fall.

What Wilson is buying

His improving economic outlook means he has bought **CSR (CSR)** and **Brickworks (BKW)**. In terms of the typical small caps, he chases the likes **Cash Converters (CCV)**, **Energy Action (EAX)** and **NextDC (NXT)**, which is seen as a takeover target (read A stock to buy in uncertain times).

"All the dynamics are perfect for the market to be stronger over the next six-12 months," he said.

He worries about international curve balls such as a revolution in Greece, which could ruin his optimistic view, but that says he is heavily into stocks and that's the kind of news I like to hear.

My story

Undoubtedly, there will be challenges next year, but I think improving economies – the USA, China and the Association of South-East Asian Nations (ASEAN) region – will offset the negative, which is Europe.

And if we can see some rate cuts at home create a lower Aussie dollar, then we could easily outperform Wall Street over 2013. That's my story and I am sticking to it.

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Can CSL's success story continue?

by James Dunn

Clearly, the Australian government didn't have a clue what it owned when – in one of the first privatisations in this country – it sold the former Commonwealth Serum Laboratories through a sharemarket float in June 1994.

The government flogged the serum and antivenin maker – now known as CSL Limited (CSL) – off at $2.30 a share; a three-for-one share split in 2007 means that was effectively 77 cents a share. This week, CSL surged through $50 for the first time.

A success story

Australia's home-grown biotech star is unrecognisable from the company that was floated 18 years ago. Under the outstanding leadership of Brian McNamee (who will stand down in July 2013), CSL has become the world's second-largest blood products company and a world-class biotech business. CSL now has revenue of about $4.4 billion and more than 10,500 employees across 27 countries. It has significant manufacturing operations in Australia, the United States, Germany and Switzerland.

CSL collects blood plasma through the Red Cross and its own collection centres and uses it to make a wide range of medicines, the most important of which is intravenous immunoglobulin (IVIG, which is the chemical portion of blood that contains antibodies). This is used to treat immune deficiencies and inflammatory diseases. CSL's main IVIG products are high-margin products such as Privigen and Hizentra.

There are exciting indications that IVIG could be used to treat life-threatening conditions including multiple sclerosis and haemophilia. Another potentially large opportunity for CSL is the possibility that IVIG can be used to treat Alzheimer's disease.

CSL's main vaccine products are the flu vaccine and a human papillomavirus (HPV) cervical cancer vaccine, Gardasil, which is licensed to Merck (as Gardasil) and GlaxoSmithKline (as Cervarix). CSL was one of the companies that the world health authorities turned to in 2009 when a vaccine was needed for the H1N1 strain of swine flu.

Growth potential

At $50, CSL has delivered float subscribers a capital gain of 6,390%. But original CSL shareholders have also received $8.275 in dividends: that makes the total return 7,468%. The dividend flow has paid for the original shares more than ten times over.

Ordinarily, a stock boasting a dividend yield of less than 2%, franked to a single-digit percentage, would not be a suitable candidate for a self-managed super fund (SMSF) portfolio. But CSL is something different: it is one of Australia's few global industrial players and a 'growth' stock in the true sense of the word.

For example, in its life on the stock market under the lead of CEO Brian McNamee, CSL has delivered total shareholder returns of more than 25% a year – and most of that has come from the share price.

CSL has also rewarded shareholders with $5.4 billion worth of share buybacks since October 2011.

In fact, given the defensive nature of the biotech business, CSL is that rarest of combinations – defensive global growth – in the one stock.

Profit upgrade

This status was reiterated this week when CSL came out with a profit upgrade. After reporting net profit after tax of just over US$1 billion last financial year,

CSL had forecast a 12% rise in profit in 2012-13, but it told the market on Tuesday that its profit lift would be more like 20% once exchange rate effects are taken out. (Starting in the 2012-13 financial year, CSL will report in US dollars to better match its global peer group). The shares jumped almost 8% on the back of the upgrade.

The improved outlook for CSL is a salutary lesson on why it is sometimes wise to ignore the professionals. Prior to this week's upgrade, at least one broker, Citi, downgraded CSL from neutral to 'sell,' on the basis of the high price to earnings (P/E) ratio (22 times expected FY2013 earnings) and low dividend yield (2% on expected FY2013 dividend) – but against that, CSL has staked out the basis for why it should still be considered a growth stock.

CSL has a very strong balance sheet – it has no net debt – and while SMSF proprietors should base their portfolios on strong dividend flows, CSL is one of the very rare cases where the dividend flow is secondary. In fact, the reason for the poor level of franking – due to the fact that almost 90% of earnings come from outside Australia – is the big plus for this company.

The bottom line

CSL has built a hugely strong position in the area of medicines derived from blood plasma, and economies of scale magnify the benefits of its low-cost production. Gardasil is going better than expected, and the uplift in royalty income was a major factor in the earnings upgrade.

In a weak economic environment, the defensive qualities of 'big pharma' come to the fore, and that is certainly the case for CSL. When added to the high promise of its intellectual property portfolio in applications like Alzheimer's, you have a case for growth that more than justifies a role as a core holding for an SMSF portfolio.

And if you've got it – don't sell it.

- **Today's opening price:** $50.05
- **Consensus target price:** $51.71, with a bias to the upside

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CSL Limited (ASX code CSL) stock price performance

JP Goldman

Emerging markets looking cheap

by JP Goldman

Many investors have heard of emerging markets, but what about the 'BRICs'? This sub-set of emerging market countries covers four powerhouses of global growth – Brazil, Russia, India and China – and both the emerging markets and BRICs have established equity benchmarks behind them: the MSCI Emerging Markets and MSCI BRICs indices, which are tracked by two iShares exchange-trade funds listed on the Australian market (ASX codes IEM and IBK, respectively).

Are the BRICs better or worse investment option compared with the broader emerging market for local Australian investors? And what is the outlook for emerging markets in general?

BRICs vs Emerging Markets

A BRICs focus might be better suited to higher risk-seeking investors because its index performance is more geared to the lesser developed, large emerging-market economies. Indeed, China dominates the BRICs' index, accounting for 40% of its market capitalisation followed by Brazil with 30%. The other 30% of the index is broadly shared equally between India and Russia.

By contrast, China accounts for around only 15% of the emerging markets index due to the inclusion of the relatively more developed industrial Asian nations of South Korea and Taiwan, which make up about 15% and 10% of the index, respectively. All up, the BRICs only account for around 40% of the broader emerging markets index.

The other difference between the two indices is sector composition. Due to the greater importance of Korea and Taiwan, the emerging market index has relatively more exposure to information technology and relatively less to financials and energy.

Country & Sector	Shares (%)	
	IEM	IBK
China	16	40
Russia	7	15
India	7	15
Brazil	12	30
Taiwan	10	-
Korea	15	-
South Africa	8	-
Financials	24	30
Energy	13	23
Materials	12	10
Info Tech.	14	5

Performance

How have each performed? As an investment, emerging markets were the place to be during the roaring energy and commodity price boom in the decade prior to the global financial crisis (GFC). But emerging markets fell harder during the GFC as commodity prices fell and investors adopted an indiscriminate 'risk off' attitude.

Led by China, emerging market equities bottomed earlier than the developed world in late 2008 and began a period of solid outperformance for around two years. But relative performance has since trailed that of the developed markets.

The BRICs index has been more volatile on the upside and downside, but it has largely tracked the performance of the larger emerging-market benchmark. China's market has been especially weak of late, and while other emerging markets have bounced higher over the past year, China's market

remains in the doldrums.

In Australian dollar terms, these indices have also broadly underperformed the S&P/ASX200 index since mid-2009 – not helped by relative strength in the Australia dollar.

All up, earlier hopes that emerging market economies could 'de-couple' from the woes in the developed world have not been fully borne out in recent years. It turns out emerging markets still rely on foreign capital inflows to support sentiment in their local market, and this capital can prove fickle in times of crisis. Emerging markets also still rely fairly heavily on exporting to the developed world.

What's more, emerging markets have had their own problems to deal with. Relatively stronger economic growth – as in China and Brazil – has made them more inflation prone, resulting in less accommodative financial conditions. India has struggled with a slowing in economic reform, while political and energy price risks still afflict Russia.

The outlook

The good news is that the period of emerging market underperformance has left the emerging markets appearing fairly cheap and potentially well positioned to perform as risk returns to global markets. Slowing exports and policy tightening has slowed economic growth and inflation in many emerging markets to a point where policy makers are beginning the process of easing earlier policy tightness.

At a price-to-forward-earnings ratio of 10, the MSCI emerging markets index is trading at the lower edge of its range for the past two decades. Compared with developed markets, the earnings outlook for emerging markets is also stronger while the price-to-earnings (PE) ratio is now trading at a 15% discount. While the PE discount has been greater in periods prior to the global financial crisis, developed markets are now in a notably weaker position than they were back then.

The emerging markets through the IEM and IBK ETFs provide good diversification options as investors begin to feel comfortable re-entering riskier investments.

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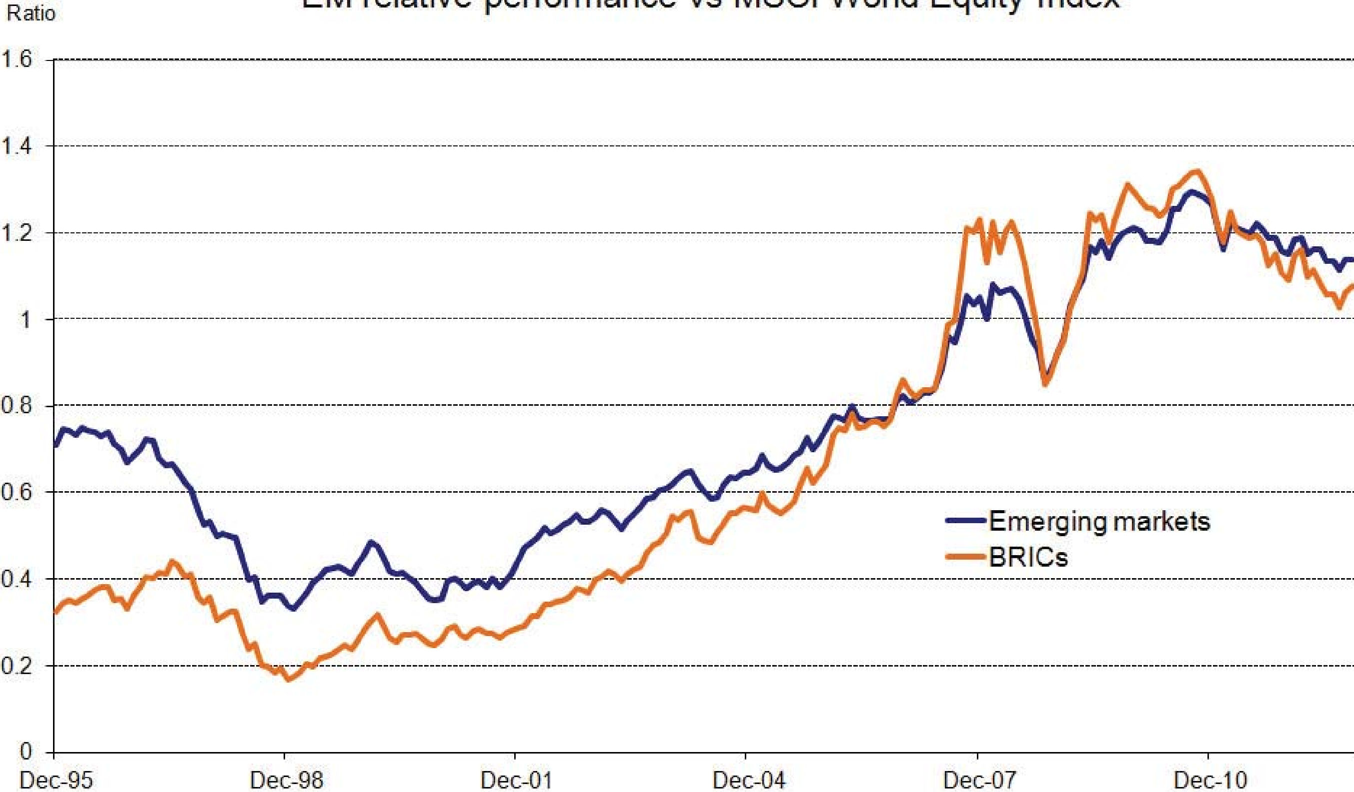
EM relative performance vs MSCI World Equity Index
Ratio
1.6
1.4
1.2
1
0.8
0.6
0.4
0.2
0
Dec-95
Dec-98
Dec-01
Dec-04
Dec-07
Dec-10
Emerging markets
BRICs

Seven tips on Transition to Retirement pensions

by Andrew Bloore

Transition to retirement strategies are popular among DIY super trustees because they allow you to access your superannuation while still working, and when combined with an income swap strategy, there are some attractive tax benefits.

Transition to retirement (TTR) allows you to reduce your work hours by supplementing your wages with super pension income, providing you with a financially stable alternative to retiring permanently after attaining preservation age.

Two ways to use TTR

There are two key ways in which a transition to retirement pension can work:

A member may choose to continue working on a part-time basis, using part of their super to supplement their income instead of having to retire permanently from the workforce simply to access their superannuation;

Or

A member may choose to establish an effective salary sacrifice agreement with their employer whereby the member directs a portion of their pre-tax salary as additional contributions to superannuation, while at the same time accessing a TTR pension. This TTR income swap strategy has some attractive tax benefits.

The key benefit comes from moving current super benefits from the accumulation phase – an environment where income or earnings are taxed at 15% – in to the pension environment, where earnings are exempt from tax.

Four benefits of a TTR pension

Supplement income – Work fewer hours and supplement part-time income by commencing a transition to retirement pension so that you are able to maintain your current lifestyle.

Maximise your super – You can still keep contributing to your super as you are still working while using a transition to retirement pension. This will include the 9% Super Guarantee and salary sacrifice.

Tax effective income - Income received from a TTR pension is favourably taxed compared with your earned income. If you're aged 60 and over, the pension income is tax-free and if you're between 55 and 59, it is taxed at your marginal tax rate and receives a 15% tax offset.

Flexibility - If your circumstances change, you can stop this type of pension and revert to simply accumulating your super.

Is a TTR pension right for you?

A TTR pension may be suitable if you're aged between age 55 and 64, still working, want to supplement your income, or want to boost your super and save tax.

These seven points will help you decide whether or not a TTR pension will suit your circumstances.

Seven tips for using a TTR pension

1) Under a TTR strategy, you can access no more than 10% and no less than 4% of your super account balance in any one year.

2) Before beginning a TTR strategy you should make sure you have accumulated enough super to last for your full retirement – remember, we are all living for longer.

3) Income from a TTR pension is assessed as income for social security purposes. Some people may be better off not commencing a pension if social security entitlements are more important. Alternatively, for some commencing a pension that replaces salary and wages may improve social

security entitlements under the income test as it will be treated more favourably due to the tax exempt amount.

4) Accessing large lump sum amounts under a TTR pension is restricted until age 65 or the until the earlier of an individual permanently retiring from the workforce before age 60 or resigning from a position while aged between 60 and 65 years.

5) The maximum amount that can be directly contributed from your salary to superannuation is $25,000 per annum (includes salary sacrifice and Superannuation Guarantee).

6) An effective salary sacrifice arrangement allows more superannuation monies to be accumulated for retirement. Salary sacrifice super contributions are taxed up to a maximum of 15% rather than a client’s marginal tax rate (which could be up to 46.5%, including the Medicare Levy).

7) Income from the TTR pension (when over age 60) won’t attract tax because it’s not counted as assessable income. Therefore your employment income won’t be pushed into a higher marginal tax bracket by your pension income.

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Question of the week: trustee meetings

by Jo Heighway

Q: *How often should I have a trustee meeting where minutes are required for compliance? How often should the investment strategy be reviewed?*

A: I would highly recommend trustees meet at least annually and document that meeting in written trustee meetings. In fact, there is no legislative requirement for a minimum number of trustee meetings per year, so it really depends on how many trustees there are and how often more significant decisions need to be made that might require a majority to agree.

Major decisions such as decisions to commence paying benefits, appoint an auditor, make significant investments, welcome new members for example may be of great assistance at audit time in demonstrating trustee approval of major events.

At times, minutes greatly assist us as auditors to know what the true intentions were at the time transactions occur. So being active in holding meetings and documenting minutes is a great way to be proactive in your role as trustee.

Meeting minutes should be kept as simple as possible. A document that states the name of the fund, the date of the meeting, who attended and what was discussed is all that is required. Many SMSF administration software providers include standard meeting minutes in the software, or seek assistance from your accountant or adviser who can help provide you with a useful template.

The investment strategy of the fund is usually reviewed annually by most trustees, unless major investment decisions are made part way through the year, in which case the strategy should be updated at the time the decisions are made rather than investing outside the strategy and fixing it at year end.

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Did you know?

Term deposit rates continue to come in, with three-month to five-year rates now all below 5%. You can compare the latest term deposit rates using our interest rates table on the Switzer Super Report website.

Did you know?

On Tuesday, the Reserve Bank of Australia (RBA) will meet for the very last time this year. Will we get a rate cut for Christmas? The monthly inflation gauge and retail sales figures out Monday may give us some clues.

Plus, there's a host of other major economic data out next week, with building approvals and the current account figures out Tuesday followed by economic growth data on Wednesday and employment figures on Thursday. The economic growth and employment figures will be out after the rates decision, so let's see if the RBA makes the right call.