Switzer Super Report

Issue 186, 16 May 2013

Much ado about nothing

Today in the *Switzer Super Report*, Paul Rickard gives us a run-down of all the SMSF-related budget issues, and stay tuned for Tony Abbott's response tonight.

We also have an analysis of the Big Four from James Dunn, and a sector rotation view from Ron Bewley - are high-yielding sectors overpriced? Our *Fundie's favourite* this week is NovaPort on Kathmandu - their opinion might surprise you.

Geoff Wilson suggests we should be following Warren Buffett's strategy and Tony Negline starts a series of articles on what you should be watching out for at the End of Financial Year in our EOFY special.

Also, don't forget you can follow us on Twitter at @switzersuper and @PaulRickard17.

Sincerely,

Peter Switzer

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Budget – mostly a yawn, with some benefits for downsizing

by Paul Rickard

For once, the Budget left superannuation unchanged and reconfirmed all the previous announcements. Here is a rundown of the changes coming up, plus two other budget announcements that may affect some readers (the abolition of the net medical expenses tax offset, and a pilot program to help senior Australians downsize from the family home).

Contribution caps

Legislation is currently before the Parliament to increases the concessional contributions cap to $35,000 for people aged 60 or over for the next financial year (2013/14), and for people aged 50 or over, from 2014/15. The expected concessional contributions caps are now as follows:

Age	2012/13	2013/14	2014/15
Under 50	$25,000	$25,000	$30,000
50 to 59	$25,000	$25,000	$35,000
60 and over	$25,000	$35,000	$35,000

There is no change to the non-concessional contributions cap of $150,000 in 2013/14.

Excess concessional contributions

If you make a concessional contribution in excess of the cap, from 1 July 2013, you will be allowed to withdraw the excess from your fund and have it taxed at your marginal rate, plus an interest charge.

Higher income earners to pay 30% tax on concessional contributions

Individuals whose adjusted taxable income exceeds $300,000 will effectively have their concessional contributions taxed at 30% (rather than 15%). This measure applies from 1 July 2012 – see Tony Neglines article for more.

Minimum pension payments go back up

Following the GFC, the Government reduced the minimum amount that needed to be taken as a payment from a super pension account balance. The concession has now ended, and from 1 July, the minimum pension payment amounts (as a percentage of the account balance) are:

Pensioner's Age	Minimum income payment
Under 65	4%
65 – 74	5%
75 – 79	6%
80 – 84	7%
85 – 89	9%
90 – 94	11%
95 –> +	14%

Super contributions go up to 9.25%

The super guarantee percentage increases from 9% to 9.25%. The maximum super contribution base increases to $48,040 per quarter (or approx $192,160 per annum). Technically, an employer is not obliged to make super contributions above this salary.

Low rate cap for lump sum payments

The low rate cap amount (the threshold at which the taxable component of lump sum payment may be taxable for some taxpayers) increases to $180,000, the untaxed plan and CGT cap amounts increase to $1,315,000.

Tax on income from pension assets

Announced on 5 April, this is the plan to tax the income earned on the assets supporting a pension.

The first $100,000 per member will be tax free, the amount in excess would be taxed at 15%. The scheduled start date is 1 July, 2014.

Although unlikely to ever be legislated, the Government has reconfirmed its intent to proceed.

Net Medical Expenses Tax Offset to go

Last budget, the Government tightened eligibility, halved the rate, and increased the threshold for the Net Medical Expenses Tax Offset. In 2012/13, if your adjusted taxable income was over $84,000 as a single (or $168,000 as a couple), a tax offset of 10% of medical expenses in excess of $5,000 was available. If your adjusted taxable income was under these levels, the tax offset was 20% on expenses in excess of $2,120.

Unless you have aged care or disability expenses, the offset will not be available in 2013/14 unless you lodge a claim this year, in which case you may also be able to claim for the last time in 2014/15. Where aged care or disability expenses are involved, the offset may potentially be available until 2018/19.

Seniors downsizing from the family home

Perhaps the most innovative announcement was the introduction of a pilot program to provide a means test exemption for age pension recipients downsizing from their family home. The idea is to remove the "loss of pension/pension entitlement" disincentive for seniors to consider more appropriate housing.

If the pilot goes ahead in July 2014, then up to $200,000 of the net proceeds from the downsize, which are then deposited into a special bank account, would be exempt from pensions means testing for up to 10 years. To qualify for the downsize, the family home would need to have been owned for at least 25 years, and the new accommodation could include a granny flat or retirement village, but not residential age care.

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Bumper bank season for the Big Four

by James Dunn

May is interim reporting season for the major banks: half-year results for NAB, Westpac and ANZ, whose year ends in September, and a third-quarter "trading update" from CBA, which reports on the more usual June 30 full-year timing.

It is always a closely watched group of results, and this year was no different. And the banks came through with flying colours, with their best interim profit season yet. The combined half-year profits of the Big Four came in at a record $13.4 billion, up 7.2%.

Big Four's profit machine rolls on

Analysts reckon that puts the Big Four on track for a combined full-year net profit haul of more than $25 billion.

This year, on the interim results, the Big Four's return on equity averaged 16.1%, compared with 15.5% in the second half of 2012 and higher than most of their overseas peers – although matching the average of other major Australian companies.

In both 2011 and 2012, the Big Four Australian banks were ranked the most profitable in the world, according to the Bank for International Settlements (BIS). But to put the headline profits in context, they achieved this with pre-tax profits equal to 1.2% of their assets.

Not only have the banks been highly profitable, they have been a significant driver of the overall stock market performance.

CBA recently dethroned BHP Billiton as the biggest single component of the S&P/ASX200 index (although it is smaller in market capitalisation) and was responsible for almost 18% of the 644 points the index gained in the year to April 10, according to an attribution analysis published in the Brisbane Times. Westpac was almost as big a driver, ANZ and NAB generated just over 9% of the index's gains between them – meaning that the Big Four banks were responsible for more than half of the index's gain.

Search for yield ends in bank haven

This has been driven by strong overseas and domestic interest in the banks' high-yielding dividends and earnings growth. In a low-interest-rate world, share investors cannot get enough of the alluring yields of the Big Four Australian banks.

The average dividend yield for the banks is running at almost one full percentage point – or almost one-quarter higher – than the average yield of the S&P500 index.

The yield is virtually the first thing investors want to look at. For example, ANZ reported a strong interim, with cash profit after tax surging by 10% to $3.2 billion (banking analysts prefer to focus on the cash earnings which excludes one-off items, discontinued operations and non-cash accounting items: cash earnings is used as the basis for calculating earnings per share, return on equity and dividends). But what really impressed the market was that the bank lifted its fully franked interim dividend by 11%, to 73 cents a share.

Westpac also came out with a strong interim result, lifting cash profit by 10% to $3.53 billion, but that was only an entrée to the four cent boost to the interim fully franked dividend, to 86 cents a share, augmented by a 10-cents-a-share special dividend, also fully franked.

In contrast, NAB could only lift its half-year dividend by three cents (3.3%) to 93 cents a share fully franked. Cash profit growth came in lower than this, at 3.1%.

There is no doubt that the Big Four Australian banks are outstanding businesses, being an oligopoly that dominates their home market, with an effective government guarantee behind them. They remain some of the highest-rated financial institutions in the world, at AA-. With comparatively low cost-to-income ratios, surplus capital and conservative loan provisions, the big Australian banks are cushioned to a significant extent from pressure on their earnings if the local economy enters a modest downturn.

They are certainly not identical: Westpac is the most domestically-focused of the four; ANZ earns 20% of its revenue from its Asian operations; NAB is still hamstring by its troubled (but improving) UK businesses; while CBA has a powerful retail and business banking franchise, and dominates home lending with a 27.2% market share.

Bank shares still pay more than the banks themselves

But for most investors – particularly SMSFs – the main attraction of the banks is yield.

Market consensus forecast expects ANZ to pay a dividend of 167.4 cents a share in FY14. At a share price of $29.98, that places ANZ on a nominal yield of 5.58%.

An SMSF holding ANZ in accumulation phase is looking at an effective yield of 6.78% in FY14. If the ANZ shares are held in pension mode, the effective yield to the fund in FY14 is 8%.

For CBA, the consensus is looking for 365.9 cents a share in FY14. At a share price of $72.65, CBA is trading on a nominal yield of 5.04%.

Our SMSF in accumulation phase is thus earning an effective yield of 6.12% in FY14. In pension mode, the equivalent yield is 7.2%.

For NAB, the consensus dividend expectation for FY14 is 197.6 cents a share. At a share price of $33.07, the market has NAB on a FY14 yield of 5.97%. For an SMSF in accumulation phase, that equates to 7.26%, while for an SMSF in pension mode, the yield swells to 8.53%.

Lastly, Westpac is expected to pay a dividend of 186.3 cents a share in FY14, which prices the stock, at $31.67, on a yield of 5.88%. For an SMSF in accumulation phase, that is equivalent to 7.15%; in pension mode, the shares are effectively yielding 8.4%.

With five-year term deposit rates at the very same institutions running at 4.5 – 4.6% and 10-year government bonds trading at 3.3%, these are outstanding yields for the level of safety implied.

Valuations looking stretched – to some eyes

But there is one big problem – many in the market believe the Big Four banks are expensive for now, in an economy where credit growth in the medium term looks likely to be modest at best.

Investment bank UBS, for example, says the Big Four are in “bubble” territory, all trading at about 14.9 times earnings. UBS says ANZ and CBA are a sell, while it has a “neutral” rating on NAB and Westpac.

In contrast, Citi reckons the banks deserve to trade at a premium, and rates ANZ, CBA and Westpac as “buys.”

If it takes two different views to make a market, those two big global brokers certainly differ on the banks.

As for NAB, it is not exactly friendless: Deutsche Bank rates it a “buy,” Macquarie has it as “outperform” and JP Morgan recommends an “overweight” position. Switzer Super Report expert Paul Rickard also supports this view, mainly on a relative valuation basis compared to the other three banks.

There is the possibility of having your nice expected yield eroded somewhat by falling share prices if the bubble view does play out, but you can certainly make a case on yield grounds for buying the Big Four banks, with NAB’s higher yield reflecting the higher risk as it runs down its UK exposure.

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Fundie's favourite - NovaPort on Kathmandu Holdings

by Alex Milton

How long have you held the stock?

NovaPort Capital's portfolios have held Kathmandu (KMD) since its IPO in November 2009.

What do you like about it?

Kathmandu is a vertically integrated apparel retailer with a history dating back to 1987. The investment appeal for NovaPort Capital is based on four key factors.

Source: Bloomberg

First is its focus on the outdoor, travel and adventure segments of the retail apparel sector. These are some of the faster growing segments based on an increasing consumer appetite for travel experiences and desire to take on a healthier approach to lifestyle.

Second, while it does retail some third party products, as a vertically integrated company, Kathmandu designs and manufactures its own range of products. This gives the company the ability to respond to changes in consumer preferences, whereas some local competitors don't have that flexibility.

Third, store rollout driven by network growth as it expands from New Zealand to Australia has given Kathmandu a meaningful earnings driver in what has been a difficult retail environment since the GFC.

Lastly, and very importantly, Kathmandu owns its brand. Unlike a range of retailers that face the dual headwind of increasing online migration and a strong Australian dollar (offshore shopping), a customer cannot buy Kathmandu product online from anyone other than Kathmandu. This gives the company protection against a structural challenge currently impacting the sector.

How is it better than its competitors?

Its edge over many competitors in the sector stems from a combination of brand ownership, an in-house design and product development team, and established offshore manufacturing relationships. This enables Kathmandu to manage key earnings levers such as inventory range, volumes, quality and pricing in an environment where many competitors are beholden to global suppliers to varying degrees.

What do you like about its management?

In assessing management teams, NovaPort seeks out boards and managers who take a longer term view in the execution of business strategy, even though at times it may come at a cost to short-term performance. While the stock is currently trading at all-time highs, Kathmandu has, in the past, posted results below expectations.

Whether this has been from higher than expected levels of investment, or a reluctance to reduce costs (such as advertising spend) in order to bolster short-term earnings, we believe these have been the right calls from our perspective as long term shareholders.

What is your target price on the stock?

Continued store rollout, increasing portion of sales from the online channel, expansion of product range and likely improvement in consumer sentiment as interest rate cuts work their way through the economy, underpins our price target of $2.80 per share.

At what point would you sell it?

Maturation of the store rollout potential, as well as high sales per square metre, based on close to optimal product ranging would be signals to us that the upside to valuation at that point in time is limited. The potential to hold the shares from that point onwards would, most probably, rest on success in driving online sales, thereby taking market shares to levels above expectations.

How much has it added to your overall portfolio over the last 12 months? Where do you see the value?

Kathmandu is a relatively liquid stock so achieving our desired portfolio weighting has not been hampered by stock scarcity. Its share price is up over 100% since June last year making it one of our top 10 portfolio contributors over that period. Nevertheless, despite this share price appreciation, Kathmandu still trades at a material discount to highly regarded peers. For NovaPort, the upside from here will likely come from a re-rating by the market, as it becomes more comfortable with the company's reliance on three key selling periods to generate earnings (Christmas, Easter and Winter sales).

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Listen to Buffett – this too will end

by Geoff Wilson

In recent months I have written about the developing bubble in (perceived) safe, high yield securities. Unfortunately this month I find my self more concerned than ever.

US interest rates have been at unprecedented lows for what is now a prolonged period of time, despite the US experiencing a gradual economic recovery, and investors are starting to herd. The flow of funds to relatively higher-yielding investments has become a torrent. Junk bonds in the US are trading at all time lows against government treasuries and the Dow Jones is at all time highs.

The Australian market is behaving in sync. Stocks that pay high dividend yields, and are perceived to have pricing power in their business model, are trading at, or close to, all time highs.

The bubble that brought on the GFC has now been replaced by a different bubble, but one that is equally dangerous. As Rene Rivkin used to say, every boom busts, we just don't know when.

Wise words from Warren Buffett

My mate Nige has just returned from Omaha for the annual Berkshire Hathaway meeting, where investors from all over the world meet to listen to the wise words of Warren Buffett and Charlie Munger. They consistently reiterated their view, that we are in unchartered territory in regards to monetary policy, and they do not know how the US will ween itself off the QE drug or bring its budget into line.

They made it clear that finding good value was difficult and they are accumulating cash and waiting for the inevitable fall in asset prices, when they again will buy enthusiastically.

As Warren often says, the time to be fearful is when others are greedy and the time to be greedy is when others are fearful. In Australia we will see something like $500 billion in bank term deposits roll off this calendar year.

Those investors will probably be surprised at what they get offered (by their bank) to reinvest and many may go hunting elsewhere for more attractive returns. Even the ASIC Chairman, Greg Medcraft, is trying to get ahead of this bubble by warning investors to be sceptical of investment yields that appear to good to be true. With higher returns comes higher risk. The attitude that even blue chip stocks, such as our banks, Telstra and Woolworths, provide bond-like stability is just not right, so beware of treating them thus.

Trends tend to travel further in both directions than common sense and value suggest they should, but that's the human component of markets and they won't change. There is no telling how, or when, this rush for yield will end but end it will, and we will be doing our best to insulate our investors from the fallout by not being in the overpriced areas of the market.

Election gambit

The Australian Federal election, of course, is around the corner, and the political experts are suggesting the Coalition will win convincingly. Whichever party wins, they will find themselves with a very weak budget position and the odds suggest, to me, that higher taxes and lower spending are likely to be a signature of the next term.

Markets may stage a relief rally on a change of government or may indeed price it in before the event, given the likelihood of the outcome. Either way, it is not an issue we are too concerned about at this time.

While interest rates are the key driver of asset prices globally right now, ultimately, stock markets need earnings growth to really maintain rising share prices. In Australia, we are seeing little evidence of this. The risk of share prices moving ahead of earnings is becoming more acute with every step up in the market.

At this time, our market is in a very unusual environment where good economic news leads to a market sell-off, as happened on 9 May, when better than expected unemployment numbers were announced. The market is being fuelled by the expectation that interest rates are going lower and investors will continue to drive the high-yielding stocks ever higher.

Our bull market is leading to a bubble in high-yielding stocks, we have no way of knowing how and when it will end, indeed it appears to be moving higher before it ends, but end it will.

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Time to rotate into the resources sector

by Ron Bewley

From time to time, investors should consider whether they have allocated the 'right' amount of their equity funds across sectors. Data on market capitalisations are shown in the second last column of the following table for each of the 11 major sectors of the ASX 200. That is, say, the value of stocks in the energy sector is 5.5% of the value of the whole ASX 200. 'Index huggers' – who want behaviour in their investments to as closely as possible match that of the index – should try to match these market capitalisation weights.

Sector analysis

Sector	P/E ratio		Forecast yield	Forecast cap. gain	Consensus rec.	Exuberance	Market capital	Adj. cap. gain
	historical	forward						
Energy	18.0	15.1	3.9%	20.7%	2.40	0.8%	5.5%	19.9%
Materials	13.8	10.5	3.3%	27.4%	2.21	-11.0%	17.2%	38.4%
Industrials	17.1	14.6	4.1%	15.7%	2.67	0.6%	6.1%	15.1%
Discretiona	18.7	15.8	2.6%	16.8%	2.46	8.5%	5.1%	8.2%
Staples	19.1	17.8	4.3%	7.4%	3.11	5.1%	8.6%	2.4%
Health	22.7	20.2	2.3%	11.7%	2.75	5.7%	4.6%	6.0%
Financials	14.3	13.5	5.4%	5.3%	2.76	8.8%	39.0%	-3.5%
Property	16.8	16.0	5.1%	4.8%	2.76	9.8%	6.2%	-4.9%
IT	19.4	17.1	3.3%	12.7%	2.69	4.5%	0.6%	8.2%
Telco	16.6	16.1	5.5%	2.9%	2.97	11.3%	5.4%	-8.4%
Utilities	17.3	16.0	5.4%	8.3%	2.66	2.1%	1.8%	6.3%
ASX 200	15.6	13.9	4.5%	11.7%	2.66	3.8%	100.0%	7.8%

Source: Woodhall Investment Research and Thomson Reuters Datastream; data to close 13 May 2013

Depending on which stocks the investor chooses to represent each sector, the investor's fund will evolve away from these index weights with market movements, and rebalancing from time to time might be desirable. Of course, strict adherence to such rebalancing means that good sectors are being penalised by selling off outperforming sectors to prop up the underperformers. Some latitude in following sector weights is, therefore, highly desirable.

Sector preference

An investor who wants to try to outperform the index needs to take positions on some or all sectors. For most of this financial year it would have been a great benefit to have been 'overweight' in the high yielding sectors of financials, property, telcos and utilities. Not only did these sectors provide good yields, they also happened to have strong capital growth, as funds migrated from term deposits to higher-yielding assets.

I contend that there is little (if any) prospect for further capital growth in these sectors as higher prices would drive yields down below that which investors need to compensate them for the additional risk they are taking on over term deposits.

Last week was a stellar week for materials stocks – including BHP, RIO, miners and some building products companies – as this sector's sub-index grew by 8.4%, and energy stocks grew by 4.8% over the week. Perhaps unsurprisingly, the prices of these stocks started slowly this week. But is it time to get into these and other non-high-yielding sectors?

Rational or irrational exuberance?

As can be noted from our table, all of the forward price-to-earnings ratios (P/E) are lower than the historical. From these numbers alone, it is not clear whether prices are too low or earnings forecasts are too high. At Woodhall Investment Research we analyse lots of company-specific data from brokers to arrive at forecasts for sector capital gains over the following 12 months and a measure of 'exuberance' or mispricing.

For example, we are predicting a capital gain of 5.3% for the financials sector (including the big four banks) fundamental (or fair price) but we have priced the sector as over-priced by 8.8%. As a result we need to (approximately) subtract the exuberance from the growth forecast to get an estimate of -3.5%. While the forecast yield is 5.4% (or about 7.5% including franking credits) the combined total return (growth plus yield) is marginal. However, investors who

bought at lower prices are facing a very nice yield and do not need to worry about short-run mispricing behaviour.

Taking this approach to analysing the statistics in the table, energy and materials stocks are looking really good. This is the position I took on Switzer TV on March 19 and April 30 - and elsewhere.

But, of course, there are many risks involved in these and all sectors. Expected return is only one component of good decision making. Industrials, including mining services companies, were badly hit in 2012/13 to date but are also starting to rebound. Their prospects are also good by our measures.

Consumer staples stocks (such as Woolworths and Wesfarmers) were highly overpriced earlier in the year by our measures, and without the yield to back up such overpricing. When Coca Cola Amatil reported a profit downgrade last week, sector mispricing fell to more reasonable levels. In our thinking, any exuberance measure above 6% is cause for some concern unless another story – such as yield – backs up the mispricing.

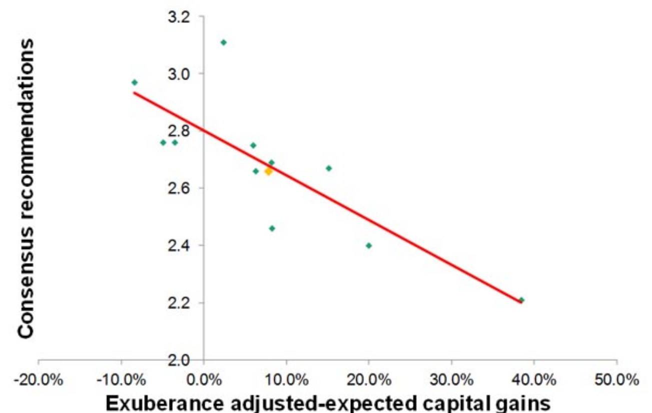
Consumer discretionary stocks (such as David Jones and Myers) have the next to lowest projected yield and a worrying degree of overpricing. The weaker dollar might help this sector but its prospects do not look good by our measures. Health and IT are in the middle ground.

But do our measures compare with those of others? Thomson Reuters supplies the broker forecasts of dividends and earnings of companies we use in our analysis. They also provide a 'consensus recommendation' for each company, which we aggregate into sector recommendations – which are shown in our table. These recommendations are on a scale of one for a buy to five for a sell. Of course the averaging of recommendations over brokers and companies within sectors, means that the extremes of one and five are almost impossible to attain.

Comparison analysis

To give this process some clarity I have plotted the sector recommendations against our exuberance-adjusted capital growth forecasts in Chart 1. Each green diamond represents a sector and the yellow diamond is the index. The red line is a line of best fit through the data on the 11 sectors.

Chart 1: Relationship between recommendations and growth forecasts



Source: Woodhall Investment Research and Thomson Reuters Datastream data to close 13th May 2013

Two sectors stand out. The diamond at the top, which is consumer staples, and the sector at co-ordinates 8.5% and 2.5 (well below the red line), which is consumer discretionary. I take this lack of concordance between the two approaches to add an additional layer of risk to both sector forecasts.

So my conclusion is that it might be time to move some funds from high yield stocks to resources stocks – leaving a bit more room for cash-on-the-sidelines to take the place of those funds migrating from high yield.

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Make sure your employer gets super contributions right

by Tony Negline

For the next few weeks, we'll review some of the super contribution issues and then look at year-end tax issues for your SMSF.

Concessional contributions cap

All employer contributions – even those that can't be claimed as a tax deduction – are counted towards your concessional contributions cap.

This year, for everyone, the cap is $25,000. (See Paul Rickard's article above for potential changes to this cap in coming years.)

Taking into account the rules mentioned above, if you run your own business via a company, then your employer contributions above the cap are tax deductible.

You might decide that receiving a 30% tax deduction in your business and paying 46.5% tax on super contributions above your cap is worthwhile. Before making this decision I suggest you receive good advice from your business advisers. The answer you reach might be different if you will have to pay the higher income earners additional super tax, which comes into play this financial year.

Salary sacrifice agreements (SSA)

If you have an SSA with your employer, then you need to make sure your employer makes contributions when they've agreed to make them. There are a number of excess contributions tax cases where employers have made contributions later than agreed and this has caused an employee's cap to be breached and tax penalties have been applied.

We discussed SSAs in much more detail in June last year.

Timing of contributions

If you want a tax deduction for your super contributions, then you need to make sure the contributions are made on time.

If you want to claim your employer contributions as a tax deduction this year, then you need to make sure those contributions are in your super fund's bank account by 30 June (which is a Sunday this year).

If you intend to use online direct debit facilities or B-Pay, then remember that delays can occur, particularly over weekends.

You are taking an unnecessary risk performing an electronic transfer on 28 June (Friday) and expecting the transaction will be completed by the following Sunday night.

Also, if you intend using a cheque just before 30 June to make contributions, then I suggest you bank this cheque after that date. It's possible that the bank could place this money into the wrong account before 30 June, which would cause you to lose your tax deduction. This unfortunate event has occurred to at least one taxpayer.

Next week

We'll walk through the rules and procedures for claiming a personal contribution as a tax deduction.

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Question of the week – can my SMSF part-own my farm?

by Tony Negline

Question: *We are considering purchasing a farm on which we would live (residential area less than two hectares) and would require 10% of the purchase price to be funded by our SMSF and 90% by ourselves (part cash and part debt). We would pay rent to our SMSF at market rates for the 10% of the land. Would this be allowable? We will be running a primary production business as recognised by the ATO.*

Answer: Thanks for the question.

As you're running a genuine business then it would seem that the super fund would own business real property, which it can lease to a related party.

You will want to make sure the super fund's interest in the property is very clear on the property's title.

Also, you should make sure the lease agreement between the super fund and yourselves is a good arm's length agreement that doesn't give you, as farmers, anything over and above what a third party would receive. You can read more about arm's length transactions here.

If you wanted to be really careful, you should consider getting an ATO SMSF specific advice about your circumstances.

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Did you know?

Do you want to know what I really think about Tuesday night's budget? Check out my views on the Sky News Business Budget 2013 special here.