Switzer Super Report

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Leave us alone

SMSFs are back in the news again. It looks like our outperformance and SMSF trustees' general happiness with their funds, is causing the rest of the industry some concern. Oh and add to that the fact that we're still getting the majority of super fund inflows.

Today in the *Switzer Super Report* we have Barrie Dunstan looking at the latest info about our sector, and why we are all so happy. Roger Montgomery examines a little known healthcare company with a salesforce to be reckoned with - LifeHealthcare - and Tony Negline reports on three big recent decisions by the regulators that may impact your fund.

Given the lackluster performance of some of the big insurers lately, our *Questions of the Week* today look at whether or not to hold onto IAG and/or QBE.

Sincerely,

Peter Switzer

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SMSFs a force to be reckoned with

by Barrie Dunstan

Contrary to many forecasts a decade ago, choice of super fund hasn't turned out to be a winner for retail funds or industry funds. Instead, self managed super funds (often derided as do-it-yourself operations), have become the dominant sector of the $1.7 trillion industry.

In fact, over the five years to June 2013, when superannuation's total funds grew by 42% (or $474 billion), SMSFs contributed the largest proportion of overall growth at 37%. According to the latest statistical overview from the Australian Taxation Office, this growth was far faster than industry funds (27%) or retail funds (17%).

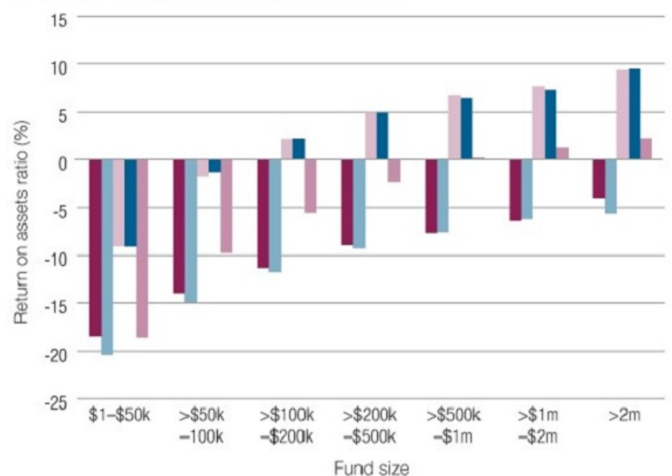
It's clear that the combination of the GFC's effect on returns, and the growing numbers who want control of their own funds, has been a major factor in the growth of SMSFs. In addition, lower expense ratios over four of the last five years, enabled SMSFs to outperform, on average, other APRA regulated funds.

There weren't any exotic investment strategies; SMSF trustees simply put their money directly into cash and short term deposits and Australian listed shares – a combination of safety and growth. In the two negative years of 2007-08 and 2008-09, SMSFs kept their losses to 2% to 5% less than APRA funds and matched the bigger competitors in two of the other three years.

Size does matter

The ATO's detailed figures show a direct relationship between the size of the fund and returns. Indeed, in 2010 and 2011, only funds with more than $100,000 of assets had positive returns. In 2012, on average only SMSFs with half a million or more had positive returns.

SMSF return on assets. by fund size



Source: ATO's Self-managed superannuation funds: A statistical overview 2011-2012

Similarly, all SMSF's overall operating expenses fell in each of the four years to June 30, 2011 – from 0.68% to 0.56% of assets – and remained stable in 2012. Again, bigger SMSFs did best: funds with over $2 million of assets averaged expense ratios of under 0.5% while funds with assets between $200,000 and $500,000 were around 1.5%.

Satisfaction guaranteed

As a result, SMSF members are the happiest fund members. Numbers from a recent Roy Morgan survey shows retail fund members were unhappy with their fund's performance in 2012-13. Retail fund members were only 45.5% satisfied with the financial performance of their funds (for the six months to August 2013). AMP was the poorest performer among the major retail funds and had only 39.1% of satisfied members – marginally better than 47.7% for CBA. However, nearly 71.6% of SMSF fund members were happy with their fund's performance.

Little wonder, then, that SMSFs are the big winners

from fund members' switching products, according to the Roy Morgan Superannuation and Wealth Management Report. Several banks (the NAB and ANZ) were net losers from switching while rivals gained slightly: CBA got 3.1% of switches and Westpac picked up 1.7%. But SMSFs were the biggest gainers with a net 9 % of super fund switches.

Anecdotally, many SMSFs are created as members near retirement and opt for simplicity in their fund and safety in their investments. These strategies worked in the post-GFC recovery, although there may be a hidden danger in some portfolios.

Diversification needed

Over the difficult last five years, the ATO says there has been an increase to 14% in the proportion of SMSFs holding all of their investments in just one asset class. That might work when the stock market returns 15%, but we know the market returns can fluctuate wildly.

Similarly, bank term deposits were fine when rates were high single digits but, if current levels continue for another year, many funds (especially any paying tax) will struggle to beat inflation.

The percentage of funds using borrowings to leverage returns from property have risen – though not by as much as critics imagine. At the end of 2012, only some 3.7% of SMSFs had borrowings, accounting for just over 1% of total assets. Although even a small number relying on leverage to increase returns may, belatedly, find it a risky practice, that's hardly a number to create alarm.

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A good-value medical opportunity in LifeHealthcare

by Roger Montgomery

The number of Initial Public Offerings (IPOs) certainly heated up in the second half of 2013, and it seems that the pipeline of floats could be just as voluminous in 2014.

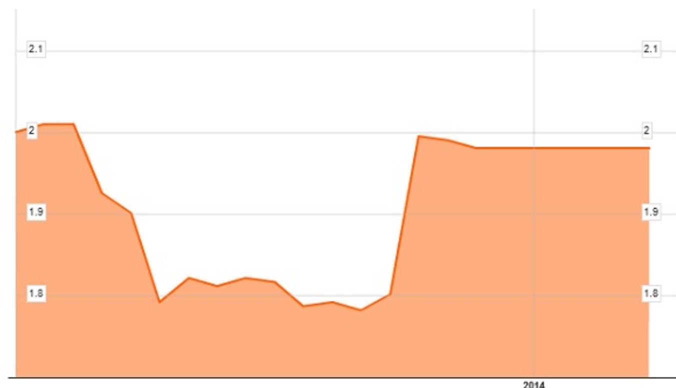
Despite the extraordinary demand – on occasions we heard that it was six to 10 times the supply – the share prices of several IPOs are trading at or below their issue prices. This may present a favourable opportunity for investors wishing to enter selected companies they initially missed out on.

A medical opportunity

LifeHealthcare (ASX: LHC) is one float Montgomery Investment Management participated in. A microcap, it is currently trading at $1.96, a tiny discount to its $2.00 per share issue price. In recent weeks a number of institutions, including IOOF, Investors Mutual, Renaissance, AMP, Watermark and Northcape, have all announced a substantial shareholder position of greater than 5% of the 42.5 million shares on issue.

LifeHealthcare is a distributor of high-end medical devices in Australia and New Zealand, and we believe it is a high quality business with very solid prospects for growth. Half of the company's revenues are derived from the distribution of implantable devices such as spine and joint prostheses. The remaining products in its portfolio include non-implantable devices such as surgical instruments, and capital equipment such as ultrasound machines.

LifeHealthcare (LHC)



Source: Bloomberg

The company services global medical device manufacturers without direct distribution in Australia. These suppliers either cannot achieve scale, or do not have access to Australia, and are willing to pay a margin for the local distribution. LifeHealthcare has done very well with this arrangement, with EBITDA to revenue margins approaching 20%, and an after tax return on equity that is forecast to hit 20%.

A strong sales force

Montgomery typically shies away from distribution businesses as they generally find it difficult to differentiate themselves from their competitors. But LifeHealthcare's competitive advantage shines through in the form of its sales force.

The LifeHealthcare sales force must have an intimate knowledge of the prostheses and the devices they supply, while building lasting relationships with their surgeon customers. When a surgeon becomes comfortable with a piece of equipment, they are more likely to continue their relationship with the supplier – as any changes may require considerable training and adjustment time. This dynamic can translate into sticky revenues.

LifeHealthcare has grown the number of surgeons in

its network from 52 in 2010 to 83 in 2013, and has increased the annual revenue per surgeon by 41% over this period.

Generally, we like businesses that receive a "higher share of wallet from a growing customer base". LifeHealthcare's forecast revenue for fiscal year 2014 of nearly $90 million is only a fraction of the addressable $6 billion Australian and New Zealand market, which is forecast to grow at 6% annually.

Acquisition plans

We understand that LifeHealthcare's CEO, Daren McKennay, is on the lookout to acquire smaller distributors in Australia and possibly Asia. The successful introduction of new devices by LifeHealthcare's suppliers could add further growth.

While the company has bright prospects, there are a number of risks that investors should consider. If the global manufacturers decide to market directly to hospitals, this will significantly impact the viability of LifeHealthcare's distribution model. To mitigate this risk, LifeHealthcare signs exclusive long-dated agreements with suppliers. The contract with its largest supplier, which comprises 30% of its revenues, is set to expire in 2018.

LifeHealthcare must also continue to effectively manage its core asset – its salesforce. While management believe staff are adequately compensated and incentivised, any attrition could be a considerable drain on the company's position.

We believe LifeHealthcare may earn 18 cents per share and pay out 13 cents per share in dividends in fiscal year 2014. At the recent share price of $1.96, this places the company on a prospective price to earnings multiple of 11 times with a dividend yield of 6.6%. While the company's share price has generally traded at a small discount to its $2.00 issue price since its float in early December 2013, this may present an opportunity for investors who initially missed out.

Of course, we encourage all investors to conduct their own research and seek personal, professional advice before making any investment decisions.

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SMSFs square up for battle

by Penny Pryor

As David Murray embarks on the government's review of the financial services sector this year, expect a lot of noise from the competing sectors of the superannuation industry.

It got off to an early start this week with an opinion piece by Paul Howes, national secretary of The Australian Workers Union, in *The Australian Financial Review* on Monday.

Property – friend or foe

Howes argues that the investment by SMSFs in property is fuelling a bubble. However he ignores the fact that the majority of SMSF property investment is in commercial property – 77% – and the total exposure by SMSFs to residential property represents just 3.5% of all assets.

Also Switzer Super Report director, Paul Rickard, points out that borrowing by SMSFs represents just over 1% of total sector assets, and he objects to the loose comparison made to the impact of negative gearing in the article.

"SMSF property purchases are not about negative gearing," he says.

Graeme Colley, director technical and professional standards, SMSF Professionals Association of Australia (SPAA), also stresses that the majority of investment in property by SMSFs is in commercial property.

"We don't really think it's going to fuel any bubble, particularly in the residential side, because most people put their business property in their fund for really good reasons," he says.

A survey recently completed for SPAA by CoreData Research, to be released at the SPAA conference next month, has also just found that while many SMSF trustees may talk to their advisers about property, they don't actually go ahead with investments in that space.

"Our perception last year was there was a lot of noise but not a lot happening," Colley says.

"That seems to have been born out by the surveys that have been done by CoreData."

One thing the larger funds forget when it comes to their criticism of property purchases in SMSFs, is the complex process that trustees actually need to go through to get loans approved by banks. Banks are extremely cautious, loan to value ratios are higher than ordinary home or investment purchases, and the process can take months.

"It is too complex to put your geared property through superannuation, and it's expensive," Colley says.

Industry gears up for battle

Some years ago, the superannuation space was dominated by the battle between industry and retail funds following choice of super fund legislation in 2005 that allowed many members to switch between funds.

Given the huge popularity of SMSFs, the battlelines have now moved, and the larger funds are, rightly, concerned by outflows to SMSFs (see Barrie Dunstan's article today for more on this trend).

Colley says there will be significant lobbying from all sides of the industry this year, as a result of the Murray Review.

"Industry super funds are leading the charge because they are threatened by SMSFs," Paul

Rickard says, and points out that the Australian Financial Review neglected to mention that Paul Howes is also deputy chair of the AustralianSuper Trustee Board.

But the regulators are paying attention. On Monday, Media Super was forced to pay a penalty for not accurately representing the costs and benefits of its funds in a comparison it made to SMSFs in member communication.

“There has been so much criticism about SMSFs last year from the bigger funds, at least this was a little bit of compensation,” Colley says of the ASIC decision.

“Maybe the larger funds need to be a little bit more careful when they start attacking other sectors.”

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How to buy international shares

by Penny Pryor

Once the domain of institutional investors and high-end clients only, international direct investing is becoming much more accessible to the retail investor.

Yes, the brokerage fees are a little high, there are offshore tax issues and no franking credits, but international markets offer you opportunities and a level of diversification that is impossible to achieve by investing in Australian equities alone.

(Barrie Dunstan wrote about the importance of including international shares *in your portfolio late last year and in June we covered* funds that offer good international exposure *if you don't like picking the stocks yourself.)*

Darren Moglia, head of broking, products and sales at Westpac Online Investing, says that the US is the most popular of international markets they offer, with major sectors being financials, industrials and technology.

"Some of the major tech stocks [traded are] things such as Apple and Google, which are very popular," he says.

Most brokers report that less than 1% of their clients' trades are in international companies, but that number is steadily growing.

Brian Phelps, CommSec, general manager of distribution, business and private banking, says they reached their financial year target for international accounts by January and had 500 new international accounts opened in the last six weeks alone.

He says: "93% of revenue comes from the US markets. Apple is our largest holding and has been for some time".

Cost

There is brokerage cost, which varies widely between brokers and markets. As a general rule, the bigger and more liquid a market, the cheaper it probably is to access.

But brokerage cost isn't the only fee you need to take into account. Some online brokers charge what are sometimes called inactive account fees.

Because they use an external provider to help them out, like Pershing in the US, there will be custody fee of anything between $US63 (Westpac Online Investing) to $USD68 (CommSec) per annum if your account is inactive.

CommSec says they also charge clients trading non-US markets a $2 monthly holding fee.

Saxo Capital Markets' head of sales Stephen Luu, says they don't charge anything in addition to their brokerage fees.

There will also probably be a foreign exchange fee of less than a percentage point to convert any income or capital gains made back into Australian dollars as well. However no brokers specified this when we asked about additional costs, so make sure you clarify this before you sign onto a broker.

Click here for a table of costs from major brokers but check with their websites to see if there have been any changes before you commit.

Tax

On income from the US, such as dividends, tax is usually deducted and withheld at a rate of 15%. You will generally be able to claim an offset in Australia for the tax that has been withheld.

However, if you haven't completed the W-8BEN form

– a form from the US Department of Inland Revenue which certifies you're not a US resident – extra tax will be deducted, so make sure you complete this before you start trading.

"Whenever they open accounts, normally the brokers should inform the client they need to complete the W-8BEN," Stephen Luu adds.

"If they fail to complete that form, we don't allow them to trade the US."

This form can also cover you for other markets, if your broker uses an international partner like Pershing.

Dividends and franking credits

The main reason that many investors give for not investing overseas is the lack of dividends and franking credits. Obviously franking credits are only available in Australia, but some institutional investors say this should not be a primary reason for investing.

"You shouldn't invest in [something] because of franking credits. That shouldn't be your method of investing…it is just a slight benefit," Chad Padowitz, chief investment officer of international fund manager Wingate Asset Management, says.

The SMSF investor, with their income focus, obviously has a slightly different take but what is interesting is that many international companies are increasing their dividend payouts.

"I think [growing] dividends are going to be a big focus of US markets," founder of Morphic Asset Management, Jack Lowenstein, says and cites US banks as an example.

"I think they [US banks] are over capitalised…they will actually edge up their dividends."

Apple is another example. Its recent $US17 billion debt raising has drawn criticism, but the tech giant raised the capital to pay dividends to share holders and keep them happy.

Investment strategy

Finally, once you've made the decision to invest offshore, as an SMSF trustee, if your fund hasn't invested in international markets before, then you need to include your reasoning behind why you want to do it and how you're going to do it in your investment strategy.

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Three important super issues you need to know about

by Tony Negline

As we head into a new year, it's a good idea to take stock of what has been happening in the super world over the past few months, and in particular, the past few weeks.

This week I want to discuss three developments to superannuation that occurred during the Christmas and New Year period and which should not be ignored by SMSF trustees.

Higher income earner's super tax

This super tax on high-income earners was announced in the budget of 2012 by the then Labor government. However the tax legislation (Division 293) did not receive royal assent until the second half of last year. The Tax Office has now announced that in early February, it will begin issuing assessments for the Higher Income Earners Super Tax for the 2012/13 financial year.

In very simple terms, if you have income of more than $300,000 in 2012/13 then you will pay 30% tax on super contributions made by your employer or any contributions you claim as a tax deduction. (You can get more details on how this new tax works in an article I wrote in May last year here.)

When you get one of these notices, you'll have a short period of time to work out what you want to do.

You can pay the tax out of non-super fund money. If you select this option, you will have 21 days from the date of the tax notice to pay the tax.

Alternatively, you can ask your super fund to pay the tax for you. For this option, you will need to send to your super fund a formal ATO "release authority".

The ATO can't issue these notices until you submit your personal tax return and your super fund has sent contribution information to the ATO. This means that if you haven't put in your tax return, it might be a while before you see this new ATO document with its demand that you pay a tax liability.

As many of you would be aware, ATO documents can sometimes be a bit difficult to understand. If you disagree with the information on the notice, especially the amount of tax owing, then make sure you follow the detailed information about objecting to the Tax Office's assessment. Please seek advice if you're unsure.

Tax deductibility of expenses

Also recently a draft tax ruling on the tax deductibility of expenses paid by your super fund was released. In particular, it deals with how much of an expense can be claimed as a tax deduction, where some of the cost relates to your super pension assets, and the rest of the expense relates to your non-retirement money.

At the moment the ATO expects this ruling to apply from 1 July 2014 and will replace some of the information contained in TR93/17 which we have previously reviewed here.

At this stage I don't think this ruling will have a huge impact on most SMSFs (some large super funds might face some difficulties). At the moment there's nothing that needs be done about this draft ruling until it is finalised. I'll provide full details about these rulings, once they've been made official.

Incidentally the ATO says that it intends to release at some stage during 2014, another Tax Ruling on the overriding tax deductibility of super fund expenses. I believe this ruling will have more significance to SMSFs and I will provide more details when it's published.

Asset segregation

Our final issue involves a draft Tax Determination released in June 2013 about how assets can be segregated between your non-pension and pension parts of your super fund.

Pension assets are segregated if they're specifically identifiable within your super fund's financial accounts and records as pension assets. In effect, it means specific assets have been set aside for the purpose of paying pensions.

Most SMSFs use the unsegregated assets approach and don't need to worry about this draft determination. Funds using the unsegregated assets method need to obtain an actuarial certificate each year to get an exemption from income tax.

Some of the information contained in this determination was reasonably controversial and some quite complex problems were raised with the ATO about its views.

As a result of this feedback the ATO has elected to withdraw the draft document. It has said it will release a revised document about asset segregation and bank accounts.

The bottom-line – funds with segregated accounts can use their current approaches and don't need to worry about the ATO draft determination that has been rescinded.

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Are insurance companies worth holding on to – or buying?

by Questions of the Week

Question 1: *I have the opportunity to purchase additional shares in IAG through its share purchase plan – should I take up the offer? Is it good for the shareholder or only for the share-offerer?*

Answer (By Paul Rickard): I don't like insurance as an industry and am pretty ambivalent about both IAG and their acquisition of the Wesfarmer's insurance business. My guess is that they have paid too much and like most acquisitions, it will turn out in the long run to be shareholder decretive rather than shareholder accretive.

That said, given the price for the new shares is no higher than $5.47 and the current market price is around $5.80 – you would (on paper) be mad not to take them up. The 6.0% gain should more than cover transaction costs if you decide not to keep the shares and sell them back on market. The offer doesn't close till Friday 24 January – so if you are paying by BPay, you don't need to make a call till around Wednesday 22 January (check with your bank).

Question 2*:* *I purchased 1400 QBE shares at $14.80. Should I keep them?*

Answer 2 (By Paul Rickard): I think that if you can wear the pain, I would hang on to them.

I am in a similar situation – and feel that the QBE business is fundamentally sound and that they will benefit from both a falling Australian dollar and higher US interest rates.

That said, I don't expect any material recovery in the share price in the short to medium term. The QBE board and senior management has lost all credibility with the market – the last announcement was just such a surprise and their third strike – so it will now take the scoring of a number of home runs by QBE before credibility is regained. I think it will be at least 12 to 18 months before you start to see analysts putting a 'buy' recommendation out on QBE.

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