Switzer Super Report
Advice you can trust

Thursday 5 May 2016

Look at the big picture

It's been a week filled with market ups and downs and budget announcements, so it's time to step back and look at the big picture.

In today's *Switzer Super Report* Charlie Aitken revisits the sell in May theory, while our regular super specialist Tony Negline warns superannuants to be prepared, as he provides a detailed look at the super measures announced in the Budget.

The budget theme continues, with Tony Featherstone uncovering stocks well positioned from the government's infrastructure splurge.

Sincerely,

Peter Switzer

Inside this Issue

Sell in May?
by Charlie Aitken
02

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Sell in May?

by Charlie Aitken

What a stunning few days in the local and global equity markets, with the combination of earnings confirmation and central bank actions driving very high levels of stock specific and index volatility.

Don't get me wrong, stocks like Telstra (TLS), Sydney Airport (SYD), Transurban (TCL), Treasury Wine Estates (TWE) and Baby Bunting (BBN) have done wonderfully for my portfolio, but it's time to consider the overall picture of where markets are.

After a period of pretty subdued volatility, it seems pretty clear to me that the next few months are going to be a bit of a bumpy ride and we need to be very certain of where we are invested.

I have been writing that it's a very important two weeks for Wall St and the Australian Securities Exchange and that has turned out to be accurate.

This all begs the question: is it time to sell in May and go away?

Let's firstly look at the S&P/ASX200 where, after the rate cut on Tuesday, the index hit what would be classified as "valuation resistance" in terms of 12 months forward P/E ratio. The chart below from Morgan Stanley depicts the situation clearly.

This is interesting because, as you can see above, this has historically been the top of the range with an average 27.6% PE de-rating from hitting this level to the next trough based on the four times we have hit this level in the last 16 years.

I would have to agree that on pure forward earnings based P/E ratio valuation, the S&P/ASX200 does appear capped around 5300 at the index level. Unless we see major positive earnings revisions to FY17 numbers, which at this moment in time seems unlikely, I think the S&P/ASX200 as an index will struggle to break through that valuation resistance.

Of course, it's a market of stocks not a stock market, that is why I will remain invested in the growth stocks I like (which you read about in these notes), but take index protection out against my Australian investments. I do think it's time for some index protection against Australian holdings, but that is a tactical position I will take rather than a structural one after the index has bounced almost +10% in quick time.

Earnings and valuation fears

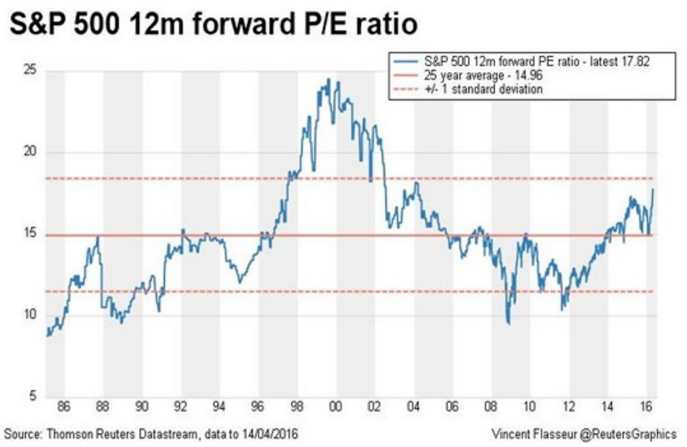
According to Thomson Reuters, at the July 2015 peak last year, the S&P 500 was trading on a 12 month forward PE of 17.12 times. Subsequently, the S&P slumped 12% over earnings and valuation concerns, prompted by a raft of negative issues. However, after a double bottom at 1870, the S&P miraculously recovered to close near the year's high with a strong end-of-year rally.

At the start of 2016, however, valuation fears resurfaced again and the S&P fell a further 12% in a savage Jan/Feb sell off. Once again, valuation fears proved to be the catalyst, with March quarter earnings forecast to fall 8.3%. If realised, this will mark four consecutive quarters of declining earnings. The last time this occurred was in the GFC from June 2008 to March 2009.

Lazarus recovery for US equities

Amid a loud chorus of bearish sentiment, the Feb meltdown was viewed by many as the second leg of a new equity bear market. Or so it seemed? In the meantime, another stunning, Lazarus-like recovery has seen the S&P surge nearly 15% from the Feb 10 low to the recent peak of just over 2100.

As the chart below shows, before last week's 1.5% correction, the S&P 12 month forward PE was trading at 17.82 times or 4% higher than the level, which prompted last year's sell off. To be sure, equities are expensive with the forward S&P PE trading at a 19% premium to the 25-year average.



What has changed?

While US earnings continue to deteriorate, some of last year's fears have subsided. The Fed has backtracked from an earlier forecast of four rate rises, to just two for this year. A weaker US dollar has supported a dramatic rebound in the oil price, which has recovered 65% from the Feb low.

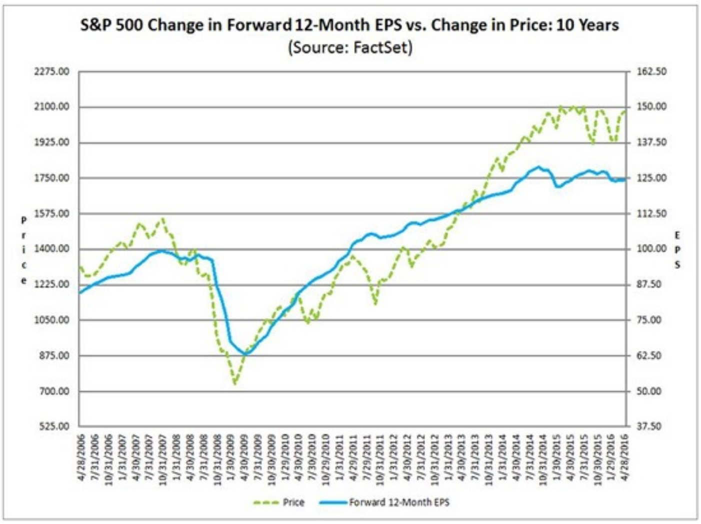
The Chinese government has implemented another large credit-fuelled fixed asset investment program. The stimulus is working, with recent data providing confirmation of an economic recovery, especially for the housing sector. Elsewhere however, US, European Union and Japanese economic data remain mixed.

Is the rally sustainable?

The reporting season has been disappointing, with many industry leaders posting weaker earnings on significantly downgraded forecasts. The prime example has been Apple, which reported earnings of $1.95 versus expectations of $2.00. This compared to $2.31 in the prior corresponding period. In addition, tech heavyweights Alphabet (Google), Microsoft and Intel have all suffered 10-15% falls after weaker than expected results.

The first FactSet chart below shows the widening gap between US earnings and equity prices over the last few years. It's clear that S&P earnings plateaued in 2014 and speculation of an earnings recession appears well justified.

The second chart shows the significant gap between Q2 16 earnings forecasts and equity prices, as analysts further downgrade 2Q 16 estimates. Certainly, it's difficult to expect further price gains driven by PE expansion rather than earnings growth.



Bond yields vs earnings.

Despite an obvious "earnings recession", elevated equity valuations remain supported by multi-decade lows for bond yields. In turn, low bond yields are a product of a benign inflationary outlook and a low growth environment.

Indeed, the latest CPI reading confirmed that inflation remains very low by past standards. In addition, last

Friday's US GDP reading revealed 2Q annualised economic growth at just 0.5%. While 1Q GDP figures are seasonally weak, all the recent data suggests the US economy remains fragile. As such, the Fed failed to provide any guidance on the timing of any rate rises.

The implication is the Fed "put" remains in place for equity investors. Once again bad news is good news. Are investors becoming complacent again? Prior to last week's fall, the VIX had declined to 13.4, near the Aug 2015 low of 12.5. It's worth noting this level preceded the Chinese equity meltdown last year.

Clearly, investor sentiment can change quickly. Recently, I wrote on the positive factors supporting commodities. At the time, negative sentiment was pervasive. Subsequently, the resource sector has staged an impressive rally.

I'm not sure whether investors will continue to look past deteriorating earnings growth, and equity markets will remain supported by the Fed and low bond yields to subsequently make new highs. But I am certain of one thing. The outlook for US economic and earnings growth is uncertain. The strong equity market rebound and the VIX confirm that investors have become complacent to risk once again. That means volatility is set to return. In fact, volatility has proved to be the only constant since the end of the Fed's QE policy. It's time to be tactically cautious and I have taken out index protection against my US stock investments.

Broadly, it does appear things are lining up for sell in May to be prudent. More accurately, take some profits in May after a mighty bounce.

Infrastructure winners from the budget splash

by Tony Featherstone

Investors have good reason to be cynical about government infrastructure projects. There's been more talk than action this decade, despite Australia's largest cities becoming increasingly congested and badly needing infrastructure upgrades as their populations swell.

But some good signs this year suggest investors should pay greater attention to infrastructure-related companies. Those that build the roads, dig the tunnels, lay new rail track and repair existing lines, could have stronger earnings tailwinds in the next five years.

The market is aware of the potential. CIMIC Group (CIM) – formerly Leighton Holdings – UGL (UGL) and several other infrastructure-related stocks have rallied over 12 months, amid rising expectations of greater demand for their products and services and improving sentiment in the resources sector.

Even so, they look better value than infrastructure owners. As an aside, I have been bullish on infrastructure owners for several years, partly because a lack of new projects and urban densification playing into the hands of monopoly asset owners.

However, two of my long-time favourites, Sydney Airport (SYD) and Transurban (TCL), look fully valued.

I understand fund managers voicing concern about Sydney Airport and Transurban's valuations, higher debt levels, and that they are benefiting from a low interest-rate environment. These are valid points but some fund managers have issued the same warnings for several years and missed out on two of the market's best stocks.

It's all a matter of timing and investment horizon. Investors should take profits on Sydney Airport and Transurban, and other interest-rate-sensitive stocks for that matter, as expectations for rate rises build. That seems some way off, with the Reserve Bank cutting the official cash rate again this week and the odds for another rate cut in 2016 shortening.

Nevertheless, I would not buy either stock at current prices. Existing investors have reason to maintain their holdings and prospective investors might wait for better value to emerge in the next market sell off or correction, or consider infrastructure-service providers.

This 2016 Federal Budget includes more than $33 billion for infrastructure projects over the forward estimates – if you can believe them. It is adding another $50 million a year to the Roads to Recovery Programme from 2019-20, and providing another $594 million in additional equity funding for the Brisbane-Melbourne inland rail project to acquire land and continue pre-construction and due-diligence activities. Another $115 million has been committed to fund preparation work on the Western Sydney Airport project – a sweetener to win votes there.

The Federal Government's $1.5 billion Victorian infrastructure package, conditional on the state government matching it, will upgrade the Monash Freeway and other key transport infrastructure in Melbourne. The investment is long overdue in Australia's fastest-growing city.

Some state governments, too, are getting their act together on infrastructure. The latest Victorian budget shows the state is in a strong fiscal position, not afraid to take on debt when interest rates are low, and finally cranking up some big transport projects.

The Victorian government's decision to fully fund the giant Melbourne Metro rail project builds on its $1.46 billion investment to construct the Western Distributor and the controversial $1.6 billion Sky Train that rids Melbourne of nine of its worst road and rail intersections. However, perspective is needed. It will take years for some projects to kick in and a significant amount of federal government funding starts from 2019-20. Nevertheless, there finally seems to be more action and funding for real infrastructure projects.

That's good news for engineering and construction companies. The trick is finding those with higher exposure to infrastructure projects in New South Wales and Victoria. Both states have stronger economies, faster population growth, and greater need for infrastructure. Asset-recycling strategies are starting to work and have potential to fund more new infrastructure.

NSW alone is expected to account for 40% of infrastructure construction between 2015 and 2020, according to Infrastructure Partnerships Australia. The mining states of Queensland and Western Australia are expected to lag on new infrastructure projects.

Stocks leveraged to infrastructure construction theme

A dozen or so larger stocks provide exposure to this theme. They include Adelaide Brighton (ABC), Boral (BLD), CSR (CSR), James Hardie Industries (JXD), Fletcher Building (FBU) and Brickworks (BKW) in building materials; UGL, Downer EDI (DOW) and CIMIC in the contractors; and Lend Lease (LLC) in construction.

Monadelphous Group (MND) and WorleyParsons (WOR) also provide infrastructure exposure, but it is a smaller percentage of revenue compared with specialist players in this area. DuluxGroup (DLX) is another with leverage to infrastructure activity.

Adelaide Brighton (ABC) and Boral (BLD) provide some of the strongest exposure to infrastructure activity and the latter is especially well positioned in the outperforming NSW economy. Both companies look fully valued after solid share-price gains over three years.

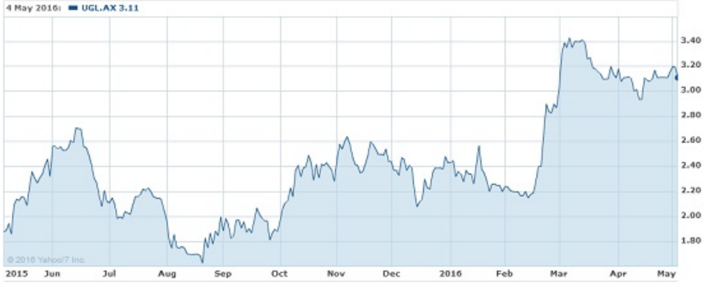
CIMIC has around 40% of its revenue exposure to transport infrastructure projects, on Macquarie Securities' numbers. Although it has good medium-term prospects, CIMIC looks a touch overvalued after soaring this year on better-than-expected earnings growth and strong earnings guidance.

UGL and Downer EDI offer better relative value, although neither is cheap. UGL provides outsourced engineering, asset management and maintenance in transport and utilities infrastructure. About 40% of its revenue is in rail and defence projects – an interesting position as the federal and state governments show renewed interest in big-ticket rail projects.

UGL has plenty of exposure to rail tunneling and passenger rail operations, and should benefit from a ramp-up in oil and gas maintenance contracts. UGL has a history of volatility, but its new management appears to be building a more sustainable business that can capitalise on coming growth in infrastructure projects.

The market has a negative view on UGL. Two of nine broker firms that cover it have a buy recommendation, three have a hold, and four have a sell. A median share-price target of $2.79, based on consensus analyst estimates, suggests it is overvalued at the current $3.19. UGL is due for a share-price pullback and consolidation after racing from $2.20 to $3.20 in a matter of months, as the resource sector bounced. But its recovery has a long way to run and it deserves a spot on watch lists, with a view to buying below $2.80.

Chart 1: UGL



***Source**: Yahoo!7 Finance*

Downer EDI is another contractor that has had mixed fortunes over the years. Unlike most other infrastructure-related stocks, it has delivered a negative total return over 12 months (minus 22%). Its five-year average annualised total return (including dividends) is 3%.

Downer has good exposure to new projects through its infrastructure and rail divisions. The transport sector contributes about 22% of its revenue, as does the mining sector. About 10% of its revenue comes from the utilities sector, and its engineering, construction and maintenance divisions provide most of the rest.

Downer's loss of Fortescue Metal Group's (FMG) Christmas Creek mining-services contract, although not unexpected, was disappointing, given it was a sizeable deal. But Downer is in the running for some key rail projects that will be decided this year and, if successful, would boost its rail division and medium-term earnings visibility.

Three of 10 brokers have a buy recommendation on Downer, six have a hold and one has a sell. A median share-price target of $3.50, using consensus estimates, implies it is fully valued.

Like UGL, Downer is due for a share-price consolidation after rallying from $2.95 to $3.50 this calendar year. Also like UGL, it has a lot of lost ground to make up and has the right management in place to capitalise on stronger infrastructure demand in coming years.

Chart 2: Downer EDI

Source: *Yahoo!7 Finance*

Neither stock is for the faint-hearted or deserves to be chased higher at current prices. Their exposure to resource projects adds a layer of risk.

Both stocks suit experienced investors with a 3-5 year horizon and who can tolerate volatility before a stronger period of infrastructure-related earnings growth kicks in. And most of all, watch and wait for better value in two unfolding turnarounds in the contractor space.

– Tony Featherstone is a former managing editor of BRW and Shares magazines. The column provides general information rather than specific advice or recommendations and takes no account of an investor's individual needs. Readers should do further research of their own or talk to their adviser before acting on themes in this article. All prices and analysis at 4 May 2016.

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Super changes: Don't panic

by Tony Negline

This week, the government handed down a wide range of changes for the super system.

Many of the changes impact higher income earners or those with significant money in super.

All but one of the changes begins on 1 July 2017. This gives you plenty of time to think about how you might adjust your plans based on the new regime.

Before doing anything with your money – inside or outside super – you should wait until a change has been formalised. I have been working with superannuation budget announcements for more than 25 years and have often seen adjustments to policies between their release and the legislation or regulation being made.

Remember an election is around the corner

Don't be afraid to tell the candidates in your House of Representatives electorate or your State/Territory Senate candidates that you're unhappy about some particular change that has been proposed. At this time of the electoral cycle year, they are very happy to hear your views.

Get ready to adjust your plans

I would be surprised if most people didn't need to make some changes to their retirement plans because of these Federal Budget changes.

The super changes in detail

1. Non-Concessional Contributions (NCCs)

The NCC cap has been changed to a lifetime limit. This is a good idea. There are two problems with the announcement – its size ($500,000 – indexed to average wages in $50,000 increments) and the fact that it applies from 3 May 2017 and to all NCCs made since 1 July 2007.

The $500,000 NCC cap is too small, especially given some of the other changes proposed as part of the government's package.

If you have made more than $500,000 in NCCs before 3 May, then you won't be allowed to contribute anymore, without facing tax penalties. You will not be required to withdraw these from the super system.

As all NCCs since 1 July 2007 will count towards this new cap, there will be a range of people caught out, especially those who had made, say, $540,000 in NCCs contributions and were planning to make additional amounts in a few years' time.

2. Maximum pension account balance of $1.6 million

Broadly, there are four categories of people impacted by this change:

a. Those who have pensions with account balances of more than $1.6 million on 1 July 2017. If this is your situation, then you will have four options:

i. keep the excess in your pension and pay penalty tax, including tax on the earnings of those super assets.
ii. return the excess money to the accumulation phase and pay 15% tax on earnings and capital gains.
iii. withdraw the excess from the super system and invest privately or;
iv. withdraw the excess from the super system and, if possible or relevant, contribute some or all of the

money in your spouse's name.

b. Those who have pensions with account balances under $1.6 million on 1 July 2017.

If this is your situation then you won't have to change anything, however, you will not be allowed to commence pensions with total account balances above $1.6 million from that date onwards. If you go above the cap with any new pensions after June 2017, then you will have the four options mentioned in point a. above.

c. Those yet to commence pensions, who will have more than $1.6 million in your account balance – you will have similar options to point a. above

d. Those who won't have started a pension before 1 July 2017 and will almost certainly fall under the $1.6 million cap – you will not need to do anything.

The $1.6 million cap will be indexed by average wage increases in $100,000 amounts. However, once you have used your cap, then there is no further scope to access any increases in the cap that occur over time.

After June 2017, if your pension account balance dips below $1.6 million, then you won't be permitted to add to your pension money.

Similarly, if your account balance goes above $1.6 million, then you won't need to take money out of your pension.

This is a complex proposal and will be tricky for some people to work through. For example, we don't know how the government will choose to deal with people who have private and public sector pensions.

I have long advocated splitting super benefits with spouses. This change justifies my views, as a couple will be allowed a total of $3.2 million in super pensions.

3. Concessional contribution cap reduction

This will be reduced to $25,000 for all taxpayers. This is a very negative move, especially as most people make larger super contributions in the final working years before retirement (after children have been raised and educated and the family mortgage has been paid off).

The government has completely ignored the normal lifecycle that most families follow.

As this change doesn't apply until 1 July 2017, anyone impacted will need to consider making higher contributions for the 2016 and 2017 financial years.

4. Carry forward of concessional contribution cap

A rolling catch up provision for concessional contributions will be permitted over five year periods. Amounts not used over each five-year period will be lost. However, you will only be permitted to access this rule if you have less than $500,000 in super assets.

We don't know how, when or who will determine if you fall below, at, or above this threshold. We also don't know when the rolling 5-year periods will begin. I see this as a potentially very complex provision and I can see many investors inadvertently breaching these provisions and facing penalties.

5. Transition to Retirement Pensions (TTR)

Earnings taxable – the earnings and realised capital gains of these pensions, will now be taxed at 15%. This will apply to all TTR pensions even if they commenced sometime ago. In addition, all pension income paid from these pensions will be taxed as pensions and not as lump sums.

6. 30% contribution tax for those earning more than $250,000

Currently, this higher tax applies for those earning more than $300,000. Income for this measure is taxable income, reportable fringe benefits, concessional contributions under your cap and net investment losses.

7. Contribution flexibility for those aged 65 to under 75

The ridiculous work test that currently applies to this age bracket is being removed and contributions will be allowed, regardless of work status. This applies to concessional and non-concessional contributions. This is very good reform and long overdue.

8. Working individuals can claim their personal super contributions as a tax deduction

Currently, only a small band of employees can claim their personal contributions as a tax deduction. This silly rule is, at long last, being removed. Effectively, employees will be able to choose to contribute via salary sacrifice or in their own name and receive the same tax treatment.

9. Spouse tax offset

The income threshold for this small tax offset will be increased to $37,000. Currently, it is $10,800. The tax offset, available when you make contributions for your spouse who earns less than the income threshold, will remain as a maximum of 18% on up to $3,000 of contributions, or $540. No offset will be permitted when spousal income exceeds $40,000.

10. Low income super tax offset

This is currently payable if you have income of $37,000 or less.

The maximum offset that can be paid is $500. This effectively returns the super contribution tax paid for those on modest incomes. This replaces the Low Income Super Contribution that was due to expire on 30 June 2017. Effectively, there is no change, except the name of the benefit will change from "contribution" to "tax offset".

11. Pension changes

The government will allow deferred annuities and other similar products, however, these will not be permitted in SMSFs. After taking advice from the Australian Government Actuary, the government elected not to make any changes to the minimum drawdown percentages for account-based pensions.

Many people will need to revisit their retirement income plans.

However we have an election, possibly a new responsible minister, a lobbying process and legislative process to travel through before any of these changes are legislated. So I would encourage you not to act with undue haste.

One final note: the above points do not discuss important changes made to defined benefit schemes, including public sector unfunded schemes. There have been some important changes made for these types of super funds and these points are not discussed in this article.

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Buy, Sell, Hold – what the brokers say

by Staff Reporter

In the good books

CVN Carnarvon Petroleum (CVN) Upgrade to Outperform from Neutral by Macquarie B/H/S 1/0/0

Macquarie upgrades its recommendation to Outperform from Neutral, retaining a 12c target. This is to reflect the recent under-performance and the near-term drilling of Roc-2.

Megaport (MP1) Upgrade to Add from Hold by Morgans B/H/S 1/0/0

Morgans expects the cash burn in the June quarter will be lower, as the software services company was running hard in the March quarter to establish itself in North America. The share price has fallen significantly in recent months and the broker believes the stock now represents good value on a risk/reward basis. Hence, the rating is upgraded.

In the not-so-good books

Alumina (AWC) Downgrade to Underperform from Neutral B/H/S 4/1/2

Credit Suisse analysts believe the tide has unexpectedly turned in favour of more upside surprises from the global steel cycle. This reversal has pretty much lifted all boats inside the commodities sector. However, the analysts are not in the bull's camp when it comes to metals. They warn share prices might have run up too hard for multiple representatives for non-steel specific exposure.

Amcor Limited (AMC) Downgrade to Neutral from Buy by Citi B/H/S 3/4/1

The analysts consider Amcor well positioned to participate in what they regard as the inevitable consolidation of the US flexible packaging sector. The analysts note Amcor is the leader in the medical sector in the US but it has very limited presence in food.

OceanaGold (OGC) Downgrade to Sell from Hold by Deutsche Bank B/H/S 1/1/3

Deutsche Bank observes a solid March quarter with gold output 10% above forecasts and Didipio and Waihi the main contributors. The broker believes the company's operations are performing strongly and Haile is a quality asset, which will drive the company to a situation where it is the world's lowest cost gold producer. That said, the share price has outperformed and the broker has trouble with the valuation. Deutsche Bank downgrades to Sell from Hold.

Perseus Mining (PRU) Downgrade to Neutral from Buy by UBS B/H/S 2/3/0

March quarter production was well below UBS forecasts. Management cited poor grades and recent blending issues. June half production guidance has been reduced by 21%. Despite a reiteration of the life-of-mine plan, recent downgrades to guidance have reduced the broker's confidence for now.

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Professional's Pick – BWX Limited

by Julian Beaumont

How long have you held the stock?

We initially bought into BWX Limited, which makes the Sukin range of natural skin care products, in June last year. It was actually before its initial public offering in November.

We topped up our holding in the IPO. We have a 13% stake in the business, making us the largest shareholder.

What do you like about it?

It owns a strong brand in Sukin, its industry is growing fast and it is growing even faster.

It is only at the beginning of its push into large offshore markets such as China.

Where do you see the value?

The value is in its continued growth in Australia, including through product extensions such as the new Charcoal range, but larger yet, in the opportunity to push offshore.

The Chinese in particular have shown they love the brand, and needless to say, it's a big market that BWX is only moving into now.

How is it better than its competitors?

It has a very popular brand in Sukin, which is a range of natural skincare creams that sell in the affordable price range. In Australia at least, it leads the industry, and out-sells global brands like L'Oreal and Nivea.

What do you like about its management?

The company has a fantastic CEO in John Humble, who is appropriately named given what he has achieved with the business so far.

He is the company's founder, a substantial shareholder, and he has worked on the Sukin brand for almost a decade now. He is intelligent, practical and measured.

What is your target price on the business?

How long is a piece of string?

At what point would you sell it?

Once it has conquered the world. Offshore sales represent just 15% of the total, and we think that there is potentially a very long runway of growth ahead as it pushes into offshore markets, starting with China this year.

We are likely to hold on for so long as the global opportunity remains and it keeps growing strongly. We expect that to be a long time yet.

How much has it added (subtracted) to your overall portfolio over the last 12 months?

It's been a good contributor given our large shareholding and its strong performance. We initially bought in at $1.10 pre-IPO and topped up in the IPO at $1.50 per share. It now trades around $4.50.

BWX

Source: Yahoo!7 Finance, 5 May 2016

Julian Beaumont is an investment director with Bennelong Australian Equity Partners.

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Murray Goulburn and term deposits

by Questions of the Week

Question: I would like your opinion on the dairy co-operative Murray Goulburn (MGC). It has been sold off recently. I know the fundamentals are not really good because of the latest announcement (downgrading its fiscal 2016 guidance). Is it time to buy, hold or sell?

Answer (Paul Rickard): It's not a stock that I follow closely.

History tells me to be very wary of a stock that is way so far short of its prospectus forecast that it needed to fire the CEO, and has been thrashed in the market.

It may bounce in the very short term, but the likelihood is that there is more downside ahead over the coming months.

Question: With your term deposit page **that shows the latest interest rates, do you take into account the different rates that a personal investor gets compared to businesses?**

I have spent a large amount of time chasing this, with the major banks and the answer is always the same, super funds are considered to be companies, and thus the rates offered will be less.

Answer (Paul Rickard): I am surprised that the major banks won't honour their advertised personal term deposit rates for super accounts. I have never had that experience (and I also run an SMSF with a corporate trustee), and would be really interested to know which bank is in this category.

Certainly, the minor banks (such as Rabobank or ING) offer the same term deposit rates for personal customers as "business customers".

I think you should shop around. With the $250,000 Government Guarantee on a "per name, per institution basis", I really don't understand why you would confine your search to the major banks.

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