Switzer Super Report

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It's huge!

It finally appears that Europe is starting to come to the table. And as its bank recapitalisation plan begins to unfold, we can expect to see a lot more smiles on investors' faces. But, as I write about today, we're not over the line just yet.

Also in today's Switzer Super Report, FNArena's Rudi Filapek-Vandyck kicks off our new weekly broker wrap to keep you up-to-date with the latest buy, sell and hold recommendations, Tony Negline has done the math on whether it's better to put money into your super or your mortgage, and Paul Rickard road tests the Commonwealth Bank's new product designed to help SMSFs invest in property.

All the best for the week!

Sincerely,

Peter Switzer

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It's going to be a huge one

by Peter Switzer

This week for investors and wealth-builders, as the old Channel Nine footy commentator Darrell Eastlake would have said, will be "HUGE!" And that's despite the fact that there isn't any real big market-moving data out in the United States.

In the States, the markets will be looking at earnings from the likes of Alcoa, JPMorgan and Google, while on the economic front there will be retail sales and consumer sentiment on Friday.

At home, there is a collection of data that will impact on the interest rate outlook and therefore the Aussie dollar. Remember, if some late mail comes in on Melbourne Cup Day that suggests we're going to get an interest rate cut, then the dollar should give up some ground.

This week we have the NAB business survey tomorrow, housing finance and consumer confidence on Wednesday, and unemployment figures on Thursday.

Personally, I'm hoping for a rate cut to help the housing sector and all of the industries suffering the consequences of the patchwork economy.

A lower dollar would also help a lot of stocks, such as David Jones and other consumer discretionary businesses. But that said, our dollar could be pushed higher by the HUGE issues of the week.

Those issues pertain to Europe and the negotiations over Greece and its fellow PIIGS (Portugal, Ireland, Italy, Greece and Spain) whose debts are putting an enormous question mark over the European and world banking systems.

Meanwhile, the tiny European Union member Slovakia has yet to decide whether it will support its fellow members to bail out Greece. The Slovaks have an average income of $1,000 a year and aren't keen to dedicate billions of euros to bail out the laidback Greeks.

The New York Times looked at the Slovakian reaction from the point of view of the younger generation.

Sebastian Petic, an 18-year-old law student in Trnava, repeated a popular Slovakian joke to the reporter: "For 500 euro, you can adopt a Greek. He will sleep late, drink coffee, have lunch and take a siesta, so that you can work."

Fortunately, older Slovakians remember how times were under the thumb of Communism and see the EU as a generally positive experience.

The world economy, the global financial system and our shares rest on the votes of both Slovakian and Finnish politicians, but I suspect there is a lot of big EU country pressure to get these votes across the line.

All of this is important ahead of the EU Summit Meeting October 13-14 and it comes as both the German and French leaderships are backing recapitalisation of the banking system, though they don't totally agree on how they will do it.

Also, the big banks such as ING are putting pressure on their European leaders to act, releasing a report called 'Time for a European TARP/SCAP', which argued that, "the market is requiring a more co-ordinated and accelerated re-capitalisation of the European banking system".

Wisdom is starting to prevail in Europe and that will underpin a market rally, but recent history has taught us not to overrate the capacity of Europeans to solve their very European problems.

Over the next few weeks I expect huge and huger weeks to unfold, which will either create a HUGE rally or another big slide.

The broker wrap

by Rudi Filapek-Vandyck

Broker Recommendations

Order	Company	Old Rating	New Rating	Broker
Upgrade				
1	ALUMINA LIMITED	Sell	Neutral	Citi
2	BATHURST RESOURCES LIMITED	Neutral	Buy	UBS
3	BHP BILLITON LIMITED	Neutral	Buy	Credit Suisse
4	BILLABONG INTERNATIONAL LIMITED	Neutral	Buy	Citi
5	CHARTER HALL OFFICE REIT	Neutral	Buy	UBS
6	COFFEY INTERNATIONAL LIMITED	Neutral	Buy	UBS
7	CSL LIMITED	Neutral	Buy	Credit Suisse
8	TABCORP HOLDINGS LIMITED	Sell	Neutral	Macquarie
Downgrade				
9	CALTEX AUSTRALIA LIMITED	Neutral	Sell	Credit Suisse
10	NATIONAL AUSTRALIA BANK LIMITED	Buy	Neutral	Citi
11	QBE INSURANCE GROUP LIMITED	Buy	Neutral	UBS

Source: FNArena

The first week of October has again brought more ratings upgrades than downgrades by the eight brokers in the FNArena database. The six upgrades double the number of downgrades in the period and total Buy ratings now stand at 59.5%, up from 59% previously.

Citi upgraded **Mirvac** (MGR) to a Buy to reflect the view that management's moves to reposition the portfolio imply negative risks for the property developer are reducing. This is especially the case given a high level of earnings through the 2014 financial year have already been secured, adds the stockbroker.

Charter Hall Office (CQO) is another property play to score an upgrade. UBS lifted its recommendation to Buy given the view that an offer for the company at closer to net tangible asset backing could still emerge.

For **CSL** (CSL), changes to foreign exchange assumptions by Credit Suisse have been enough to justify an upgrade to an Outperform rating. This reflects increased upside potential relative to a price target that has also been revised higher.

Both **Tabcorp** (TAH) and **Alumina** (AWC) have enjoyed upgrades on valuation grounds, the former from Macquarie and the latter from Citi. **Tatts** (TTS) has also been upgraded to Hold by Citi, due to higher earnings estimates and an increased price target thanks to higher ticket sales from the introduction of Saturday Lotto Six.

BHP Billiton (BHP) has similarly been upgraded to Outperform by Credit Suisse as recent share price weakness is pricing in overly pessimistic commodity price reductions in the broker's view. An initiation of coverage for **Campbell Brothers** (CPB) with a Buy rating by Merrill Lynch has lifted overall ratings for that company. BA-ML's initiation includes earnings estimates 8-16% above consensus through fiscal 2014.

On the downgrade side, Credit Suisse has cut its rating on **Caltex** (CTX) to Underperform from Neutral on the back of revised oil price and Australian dollar forecasts. This has the effect of impacting on expected refining margins.

For Citi, a further deterioration in the global economic backdrop has driven changes to earnings estimates and price target for **National Australia Bank** (NAB). These changes are enough to see it downgraded to a Hold rating from a Buy previously. Forecasts and price target have also been reduced.

It is a similar story for **QBE Insurance** (QBE), as UBS has downgraded it to a Neutral rating given the view the market is unlikely to recognise what appears to be good long-term value thanks to poor operating conditions and current margin volatility. The downgrade by UBS was accompanied by cuts to earnings estimates and price target.

Solid recent share price performance and tougher conditions in the US have been enough for UBS to downgrade **Sonic Health** (SHL) to Sell from Neutral, the broker arguing current earnings risks are not being fully priced in by the market. Earnings estimates and price target have also been trimmed.

Earnings forecasts

Change in broker earnings forecasts (EF)

Company	Symbol	Previous earnings forecast	New EF	Change	No. of brokers
Positives					
Gindalbie Metals	GBG	0.614	1.029	67.59%	6
Technology One	TNE	6.767	7.933	17.23%	3
Orica	ORI	170.975	196.425	14.89%	8
National Australia Bank	NAB	249.088	266.025	6.80%	8
Dulux Group	DLX	21.486	22.500	4.72%	7
ANZ	ANZ	214.500	224.575	4.70%	8
Newcrest Mining	NCM	208.971	217.229	3.95%	8
Perseus Mining	PRU	24.600	25.433	3.39%	6
Caltex Australia	CTX	110.567	113.550	2.70%	6
Whitehaven Coal	WHC	37.820	38.750	2.46%	5
Negatives					
Murchison Metals	MMX	1.033	- 0.733	- 170.96%	3
Minara Resources	MRE	5.400	3.500	- 35.19%	3
Alumina	AWC	7.160	6.443	- 10.01%	8
Paladin Energy	PDN	1.867	1.753	- 6.11%	7
Perpetual	PPT	170.657	160.486	- 5.96%	7
Graincorp	GNC	81.130	77.518	- 4.45%	6
Oakton	OKN	20.300	19.420	- 4.33%	5
Insurance Australia Group	IAG	29.425	28.213	- 4.12%	8
Thorn Group	TGA	20.227	19.467	- 3.76%	3
Sims Metal Management	SGM	133.500	128.500	- 3.75%	7

Source: FNArena

The increase in offer for Charter Hall Office has caused brokers to adjust price targets higher in accordance with the change in offer, while some increases to estimates for **Caltex** by Citi have seen both overall earnings estimates and price target for the stock move higher.

The upgrade in rating for **CSL** has been accompanied by an increase in price target and earnings estimates, while on the other side of the ledger changes to commodity price and foreign exchange assumptions have brought about cuts to price targets for **BHP** . JP Morgan has similarly lowered its target and forecasts for **Alumina**, while BA-ML's initiation on **Campbell Brothers** has brought down the average price target for the stock.

Factoring in full year earnings has sparked some changes to earnings estimates for **Gindalbie** (GBG) and **Perseus** (PRU), while on the back of recent commodity price movements earnings and price target for **Newcrest** (NCM) have also been adjusted. Earnings estimates for **Whitehaven** (WHC) have also risen to account for additional volume assumptions.

Forecasts for **Murchison Metals** (MMX) have been lowered to reflect increased uncertainty with respect to the Jack Hills mine and associated port and rail infrastructure projects. Changes to commodity forecasts see cuts to earnings estimates for **Alumina** and **Paladin** (PDN), while Paladin's earnings have also been adjusted for the recent capital raising.

Outlook commentary at **Oakton's** (OKN) annual general meeting indicated a still soft operating environment and this sees cuts to estimates across the market, which has also impacted on price targets.

Thorn Group (TGA) has missed out on a contract re-tender and this has brought about some reductions to earnings estimates and price target, while a weaker macro environment has generated cuts to earnings forecasts for **Sims Metal** (SGM). Price targets for the shares have also come down as a result.

Note: FNArena monitors eight leading stockbrokers, which are: BA-Merrill Lynch, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie, RBS and UBS.

Commonwealth Bank launches Super Gear loan

by Paul Rickard

Borrowing to buy property has become the hot topic for SMSFs since the Australian Tax Office released a draft ruling that clarifies some of the key concepts related to gearing within your super to buy or renovate property. And given the enquiries we've had from Switzer Super Report readers, we've found out what 'pre-packaged' solutions are offered by the major banks and given them a quick road test for you.

If you haven't already, you can bring yourself up to speed with the ATO's draft rules in Tony Negline's column [New opportunities open for SMSFs investing in property].

The good news for SMSFs is that the Commonwealth Bank has a product called Super Gear. The bad news is that some of the other banks are still working out what to do. Our guess is that within six months, most of the banks will have a packaged solution that allows SMSFs to gear to buy property because in a quiet lending market, this is one of the fastest growing parts.

So what do I mean by a 'pre-packaged' solution? Simply, a compliant structure that passes the test for gearing – formally known as a Limited Recourse Borrowing Arrangement. You don't have to prepare separate documentation and set up a bare trust to hold the asset – the financial institution has done the hard work for you.

Like any pre-packaged solution, Super Gear comes with a number of rules, and not unexpectedly, some fees and charges.

Let's start with the rules. On paper, you can borrow within your SMSF to invest in residential property, commercial property or rural property. That's fairly straightforward.

It becomes more complicated when determining how much you can borrow because this depends on your SMSF's trust structure (is it a corporate or individual trustee?) and whether the members are willing to provide 'individual indemnities' (that is, personal guarantees).

Following recent changes to the Consumer Credit Legislation, the Commonwealth Bank will only lend against residential property if the SMSF has a corporate trustee. The following table sets out the maximum loan-to-valuation ratio (LVR, which is the amount the bank will lend you expressed as a percentage of the property's value) offered by Super Gear:

Super Gear maximum LVR

Property Type	Individual Trustee		Corporate Trustee	
	No Indemnity	Indemnity	No Indemnity	Indemnity
Residential Property	n/a	n/a	50%	**80%**
Commercial Property	40%	40%	40%	**65%**
Rural Property	40%	40%	40%	**65%**

Source: CBA, Switzer Super Report

Another rule worth noting is that the loan has to be positively geared and the investment income within the SMSF (including any rental income on the property) has to be more than 125% of the estimated interest expense on the loan.

Also, before the bank will lend to your SMSF, you are required to obtain a sign-off from a qualified financial planner – no exceptions. While this may seem prudent given the potential overexposure to a single asset, I can't really see what the difference is between this product and an SMSF investing in the share market through installment warrants; it seems to be an overly cautious approach by the bank.

So, what does it cost?

Well, it turns out there are quite a few fees. Your SMSF will pay an establishment fee of 0.8%, a product maintenance fee of \$45 per month, and a loan-servicing fee of $8 per month (for residential property) or $32 per month for commercial property. So, for a loan of $300,000, your SMSF will pay an establishment fee of $2,400 plus a fee to your financial adviser, and then annual bank fees ranging from $636 to $924.

There's better news on the interest rate front. For a variable rate loan secured by residential property, you can expect an interest rate that is close to the Commonwealth Bank's standard variable rate, which is currently 7.81%. For loans secured by commercial or rural property, this will be quite a bit higher.

Overall, the Commonwealth Bank deserves credit for being one of the first banks to develop a specific product for the SMSF market. The fees are on the high side and it is very "Commonwealth Bankish" with an overly restrictive set of rules, however the interest rates are competitive. As some of the other banks realise the potential of this market, competitive pressure will lead to lower fees and more accommodating product structures.

One final point – the product is only available through the Commonwealth Bank's Business Bank, so if you go to a branch, don't be surprised if you get a blank stare. Ask specifically for a business banker, or telephone their business line on 13 19 98.

Should I invest in super or pay off my mortgage?

by Tony Negline

I'm sure many of you have tussled with the question of whether it's better to put excess savings into your super or toward your mortgage.

It's a question I was asked recently by a listener of Peter Switzer's *The Super Show* on 2GB.

For the sake of anonymity, let's call our caller Jim. He's in his early 50s and he'll be receiving an inheritance of $200,000 fairly soon.

Jim earns $70,000 a year and says he will work for another 15 years. He has a $200,000 mortgage that he expects to have it paid off in 10 years.

He also has $500,000 in super and his employer contributes 9% of his salary – equal to $6,300 a year – into his fund. His employer also allows salary sacrifices, which he currently doesn't use.

The first point is that if Jim can work for as long as possible, then he'll have more time to save for his retirement. Of course being able to work as long as possible depends upon his health, the health of any family members he may need to care for, and his ability – and desire – to keep working.

Assuming he doesn't claim any tax deductions on his salary and has little other income subject to tax, then he'll pay about $14,500 in tax or an average of just under 21% tax for each dollar he earns. Effectively, his mortgage costs him $25,300 in pre-tax income a year.

So what should Jim do with his inheritance?

Pay off the mortgage

If he uses it to pay off his house he will save himself having to pay $200,000 in after-tax mortgage repayments over ten years.

With the $25,300 in pre-tax income no longer needed to make mortgage repayments, Jim could consider making salary sacrifice contributions of $18,700 a year. This will bring his total super contributions up to the concessional contributions cap of $25,000 while at the same time reducing his taxable income.

(If Jim had less than $500,000 in super, then from 1 July 2012 he might have a concessional contribution cap of $50,000. This would mean his salary sacrifice contributions could be higher. However, this policy is still to be legislated.)

So, after allowing for contributions tax, Jim would have added $238,425 to his super over 15 years.

He still has $6,600 in pre-tax salary leftover ($25,300–$18,700 = $6,600), which is roughly $5,200 after tax, and this could also be put into his super as a non-concessional contribution. This would add up to $78,210 over 15 years.

All together, his total additional net of tax super contribution is $316,635 over the 15-year investment period thanks to paying down the $200,000 mortgage early. However, this figure doesn't account for capital gains on his super contributions, so the real figure would be somewhat higher depending on the market returns over that period.

Put it in super

But what would happen if Jim put his $200,000 inheritance straight into his super rather than on the mortgage?

Jim could contribute his inheritance straight into his super as a non-concessional contribution. Let's assume for the sake of this example that Jim's money grows by a net 7% per annum after allowing for all fees and taxes inside super over 15 years. That is, it has grown to $551,800. Of course, we need to factor in that he still needs to pay off his $200,000 mortgage.

As you can see the choice is not an easy one, with the two approaches in this example have very similar results. In reality, the same strategy will never win out every time because the results can vary considerably depending on investment growth, the term of the mortgage, and the amount of interest paid on the mortgage.

You might find some differences between super and mortgage repayments helpful in your decision making:

- Super is locked away and often can't be touched until you retire whereas when you put money toward your home loan, you can often access the capital via a line of credit facility on your mortgage.
- If you accidentally breach one of the super contributions caps, then you face severe tax penalties. Putting money into your mortgage generally doesn't suffer the same problem, unless your lender penalises you for making additional repayments.
- The super system is quite complex and most people find property purchases easier to navigate.

One final point, which is fairly obvious: be careful about putting too much money into any one investment.