Switzer Super Report

Issue 26, 17 October 2011

Hot property

Things continue to fall into place for a rally into the end of the year, allowing many of us 'stayers' to breathe easier after the volatile ride. But stocks aren't the only asset type being set for capital gains, with house prices also likely to start nudging higher.

So in today's Switzer Super Report, we take a look at where to buy property for the best capital growth. We also analyse one investment product you should steer clear of, bring you up to speed on the changes in broker buy and sell recommendations over the past week, and explain how you can take an artwork or collectable out of your SMSF to use for yourself.

Have a great week!

Sincerely,

Peter Switzer

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36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

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What to watch in the coming weeks

by Peter Switzer

I was sitting in a café in the Blue Mountains and was spotted by a guy who used to work for St. George Bank a few years back and had now retired. Apart from the usual hello, his first question was – "are you a stayer?"

In fact, it was Caulfield Cup Day, but I suspected he wasn't talking about punting on the four-legged lottery of the sport of kings.

Looking a little puzzled, I inquired: "You do mean the market?" He nodded and I said: "You can bet on it!"

My investment strategy, in case you haven't noticed, is to buy about 20 companies. This helps keep my exposure to any one company to about 5% (although I do sometimes break this rule for companies I like for dividend purposes).

Once I've got my companies, I'm a stayer. Especially in times like these when the term deposit rate is 6% at best, then I think you can hold a parcel of stocks that will return around 5-6% a year in a flat market; add in dividends and franking credits and this return can be closer to 8-9%. And if you invest using your SMSF, then your franking credits could possibly bring you the added bonus of a tax refund (read, insert link).

By the way, if the stock market manages even just a small rise in share prices over the year, then that return would be closer to 10%, which is pretty damn good, especially if the cost of running your SMSF is low — and it should be or I'd stop doing it!

Sure, there will be times when I will reposition my portfolio to ride the capital gain, but that's when I'm prepared to take the risk.

So, can we finish the calendar year positively?

My gut feeling tells me 'yes', but I know my portfolio's value is going to be determined by, as CNBC's Bob Pisani says, "the hands of a bunch of European bureaucrats".

And while these bureaucrats have not been great deliverers, Pisani has pointed out that the CEO of German bank Deutsche Bank, Josef Ackermann, has said he's "confident we are getting closer to a comprehensive package" that should sort out Europe's woes.

The big events to watch will be the EU Summit on 23 October and then the G20 on 2 November. At the moment, we've seen markets turn positive on Euro-talk, but now we have to see some Euro-walk.

Pisani sums the real issues up in a nutshell saying that the New York Stock Exchange's traders want to know what the now approved European Financial Stability Facility will actually be able to do. Then there is the issue of recapitalising the banks and whether these lenders to the PIIGS — Portugal, Italy, Ireland, Greece and Spain — are prepared to cop a bigger haircut than they were earlier in the year.

Finally, traders want to know what the role of the International Monetary Fund will be in smoothing out the rocky road ahead for the PIIGS and ultimately, the exposed banks. Remember, this is the reason our stock market has been rocked – the fear of a credit freeze will always do that. However, the end of fears over a credit crunch can lead to a big bounce back in stocks, just as we saw in early March 2009.

One final point: all of these protests against corporate greed around the world —Rome had a big one over the weekend — will put more pressure on European politicians to get real. Normal people are getting sick of the type of capitalism run by our current crop of politicians, and so some genuine leadership needs to be found.

And while we could do with some of that here, I reckon where they need it most — Europe — has the chance over the next few weeks to either make or break both their own union and our portfolios' values.

In Europe we trust!

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The Broker Wrap

by Rudi Filapek-Vandyck

Changes to broker stock recommendations

Code	Company	Old Rating	New Rating	Broker
Upgrade				
(HGG)	HENDERSON GROUP PLC	Sell	Neutral	Macquarie
(TAH)	TABCORP HOLDINGS LIMITED	Sell	Neutral	Macquarie
(WSA)	WESTERN AREAS NL	Neutral	Buy	Credit Suisse
(CSL)	CSL	Neutral	Buy	Credit Suisse
(CQO)	CHARTER HALL OFFICE	Neutral	Buy	UBS
Downgrade				
(ERA)	ENERGY RESOURCES OF AUSTRALIA	Neutral	Sell	UBS
(FBU)	FLETCHER BUILDING LIMITED	Buy	Neutral	Macquarie
(JHX)	JAMES HARDIE INDUSTRIES N.V.	Neutral	Sell	JP Morgan
(NVT)	NAVITAS LIMITED	Buy	Neutral	Credit Suisse

Source: FNArena

Fund manager **Henderson Group** (HGG) enjoyed an upgrade courtesy of Macquarie, with the broker moving to Neutral from Underperform to reflect improved value following recent share price weakness. This has offset ongoing weakness in fund flows thanks to still tough equity market conditions. Macquarie is also attracted to the yield of 6%.

Macquarie also upgraded **Tabcorp** (TAH) to Neutral from Underperform following a trading update that supports the view the stock offers value around current levels. A move to a more positive rating is not justified in the broker's view given overhanging uncertainty of compensation relating to claims in the Victorian market. Earnings estimates have been trimmed as part of the review.

Among resource stocks, Credit Suisse has upgraded **Western Areas** (WSA) to an Outperform rating from Neutral, due to revisions to earnings and price target on the back of changes to nickel price expectations.

Credit Suisse has also upgraded **CSL** to Outperform from Neutral following changes to foreign exchange assumptions. Again, there have been related changes to earnings forecasts and price target. **Charter Hall Office** (CQO) has been upgraded by UBS to Buy from Neutral because while a consortium bidding for the stock has lifted its offer, there remains scope for a revised offer.

On the downgrade side, Credit Suisse has lowered its rating on Navitas (NVT) to Neutral from Outperform to reflect a full valuation. While the Knight Review offered some positives, the broker notes earnings are unlikely to be impacted prior to FY13. This suggests a full short-term valuation.

A rights issue announced by **Energy Resources of Australia** (ERA) has prompted Deutsche Bank to downgrade the stock to Hold from Buy. Not only was the issue a surprise but Deutsche notes even if the key Ranger 3 Deeps project goes ahead, it will be one of the world's most expensive uranium mines.

Deutsche has sliced its price target as well on the news, while other brokers in the market similarly lowered both targets and earnings forecasts to reflect the dilution to earnings per share from the capital raising.

A downgrade to earnings guidance by **Fletcher Building** (FBU) given ongoing difficult operating conditions has seen brokers lower earnings forecasts and price targets. Macquarie has gone a step further, downgrading to Neutral from Outperform on valuation grounds, as any recovery in earnings appears set to take some time.

James Hardie (JHX) is another building materials group to suffer a downgrade, JP Morgan moving to an Underweight rating from Neutral on the back of lower earnings forecasts. Price target also comes down as the broker sees little chance of strong performance relative to the sector in the current market.

Brokers ceasing coverage have also been a feature this week, with both Macquarie and JP Morgan stopping coverage on **ConnectEast** (CEU) given shareholder approval of a takeover offer. Macquarie has also dropped coverage on **Minara** (MRE).

Change in company earnings forecasts

Symbol	Company	Old earnings forecast	New earnings forecast	Change	No. Surveyed
Upgrade					
GBG	Gindalbie Metals	0.614	1.014	65.15%	6
OGC	Oceanagold	15.388	18.697	21.50%	3
PDN	Paladin	1.672	1.753	4.84%	7
NCM	Newcrest Mining	208.971	217.229	3.95%	8
PRU	Perseus Mining	24.600	25.433	3.39%	6
CTX	Caltex Australia	110.900	113.550	2.39%	6
WHC	Whitehaven Coal	37.950	38.750	2.11%	5
TCL	Transurban Group	12.157	12.400	2.00%	7
AIZ	Air New Zealand	10.326	10.524	1.92%	4
VBA	Virgin Blue	2.571	2.614	1.67%	7
Downgrade					
ROC	ROC Oil	0.259	- 0.169	- 165.25%	4
MRE	Minara Resources	5.400	3.500	- 35.19%	3
CER	Centro Retail	4.250	3.633	- 14.52%	3
AWC	Alumina	6.832	6.009	- 12.05%	8
BPT	Beach energy	5.280	4.780	- 9.47%	5
FBU	Fletcher Building	49.214	46.293	- 5.94%	8
PPT	Perpetual	169.614	160.486	- 5.38%	7
PAN	Panoramic Resources	17.325	16.450	- 5.05%	4
OKN	Oakton	20.300	19.420	- 4.33%	5
IGO	Independence Group	25.294	24.334	- 3.80%	5

Source: FNArena

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

For more information, visit FNArena.com.

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A high-yielding investment to avoid

by Paul Rickard

With the recent fall in term deposit rates, trustees may be tempted to look around for some 'alternative' higher yield income investments. One that caught my eye last week was an advertisement in the *Australian Financial Review* from a company called Australian Public Trustees Limited. The ad promoted an eye-catching rate of up to 8.75% on a five-year term investment in their income fund, so I decided to dig a little deeper.

So, who is Australian Public Trustees, and what is their income fund? Well, let's start with who they're not. Australian Public Trustees is NOT, in their own words, a "Statutory or Licensed Trustee Company, or the Public Trustee of the Commonwealth or any State or Territory, or related to a Government Authority of any kind".

Australian Public Trustees is part of Stanfield Funds Management Ltd, an ASX-listed company with a market capitalisation of about $4 million (ASX:SFN). Australian Public Trustees is the fund administrator of the Australian Public Trustees Income Fund, an open-ended unit trust.

The Fund invests in mortgages secured against public and social infrastructure, government-leased properties, and commercial and residential property. It has an interesting structure with two classes of units: Term Investment Units and Ordinary Units. Stanfield Funds Management holds all the Ordinary Units, with the public being invited to invest in the Term Investment Units, which rank ahead of the ordinary units in any winding up of the Fund.

An investment in Term Investment Units offers the investor the potential of a high-income return, paid monthly to your nominated bank account. The rates being offered are in Table 1:

Table 1: Australian Public Trustees rates

Term	Rate (pa)
3 months	6.00%
6 months	6.50%
1 year	7.75%
3 years	8.25%
5 years	8.75%

Source: Australian Public Trustees

So, why have I said this is an investment to avoid?

Simply, it's not a high enough return to justify the risk. If you want to take some risk, you can do better elsewhere.

What is the risk?

Well, firstly it's a tiny fund. According to an ASX announcement from Stanfield, it is a little more than $3 million. While the small size of the fund doesn't in itself necessarily mean higher risk, the nature of the mortgage investments the fund invests in means that it is currently exposed to a handful of individual assets.

More importantly, the major risk is around liquidity. While the fund has stated that it will hold a targeted minimum of 10% of its asset portfolio in cash for liquidity purposes, the assets it is currently investing in are relatively illiquid. There is a market for mortgage investments, however, it's not anywhere as liquid as the stock market or bond market. If several term investment units mature around the same time and investors want their money back, the 10% in the liquidity buffer may not be enough to go around.

Finally, the supplementary product disclosure statement dated 19 September 2011 has this interesting statement: "The Directors have elected not to publish the Audited Financial Statements (of the Responsible Entity and the Fund) on the website of Australian Public Trustees at this time". Say no more.

So what are some alternatives for the yield-hungry SMSF? Two fixed income investments that can be bought or sold on the ASX are Heritage Notes and Healthscope Notes. While at different parts of the risk curve, they do highlight the potential returns available.

Heritage Notes (ASX:HBSHA) are subordinated, unsecured debt securities of Heritage Building Society, one of the larger building societies in Australia. Initially rated BBB- from Standard & Poor's, details of these notes are:

Issuer	Heritage Building Society
Issue Size	$30,000,000
Coupon/Interest Rate	10.0% pa
Maturity Date	27/10/14*
Interest Paid	Quarterly – 27/4, 27/7, 27/10, 27/1
Gross Price	$106.50
Accrued Interest	-$0.19
Capital Price	$106.69
Yield to Maturity	**7.50%**

Source: Heritage Building Society

The Heritage Notes don't mature until 25 October 2019. However, a penal rate of interest applies if the notes are not redeemed in October 2014 and are hence priced on that basis.

Healthscope Notes Limited (ASX:HLNG) were issued in November 2010. The Company is part of the Healthscope Group, a leading Australian private healthcare services provider (hospitals and pathology services).

The notes are subordinated to the senior debt of the Group. As the prospectus prominently said, "The Healthscope Group has a substantial amount of debt" – more than $1.5 billion as at 30/6/11 – so these notes are close to the 'junk' category and hence the high yield. The company is in compliance with all its banking covenants. Details are:

Issuer	Healthscope Notes Limited
Issue Size	$200,000,000
Coupon/Interest Rate	11.25% pa
Maturity Date	17/6/2016
Interest Paid	Quarterly – 25/3, 25/6, 25/9, 25/12
Gross Price	$95.50
Accrued Interest	$0.77
Capital Price	$94.73
Yield to Maturity	**12.75%**

Source: Healthscope

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Hot property: where to buy for strong capital growth

by Alia McMullen

Australian property prices are about to enter a new cycle of growth as investors take advantage of low interest rates and a market that has experienced sluggish price growth over the past four years, says a leading property expert.

John McGrath, chief executive of east coast-based McGrath Estate Agents, says rising investor finance and a stabilisation in auction clearance rates are starting to signal that cashed-up investors are ready to spend again after years of GFC-inspired stock market volatility and mixed house price growth.

The opportunity to snap up property at the start of a new price-growth cycle is an attractive one for many self-managed super fund trustees, particularly those with a high net worth who can purchase property while still maintaining a diversified investment portfolio.

Switzer generally advises that property investments should not exceed 30% of your SMSF – and that's on the high side. However, trustees who have exceptional knowledge of the property market may choose to have a higher exposure to this asset class.

Based on data from mortgage broker Australian Financial Group, which has a 10% market share, investors accounted for 37.7% of new mortgage finance approvals in September, up from 34.5% in September last year.

"If you select the right locations and types of property, you can actually do extremely well over the next three to five years in most parts of Australia," McGrath says.

"Historically, property has doubled every seven to eight years in most of the major cities. We haven't seen that in the last seven or eight years because of the economic cycle, but I think there will be a catch-up to some degree once we get beyond the current major economic issues."

But what and where should you buy for the best returns?

Firstly, McGrath says stick with residential property with a five- to 10-year investment timeframe.

"Residential is better because it's very hard to get it wrong. You can get commercial, industrial and retail property wrong quite easily – I would leave that to the expert investors and the trust funds," he says.

Secondly, the most stable residential property investments are found within capital cities.

"Within those areas, the hot spots, particularly in Sydney, Melbourne and Brisbane, seem to be the inner-city ring, which is seven to eight kilometres from the middle of the CBDs," he says, adding that the closer the property is to water – such as the Brisbane River, Port Melbourne, Sydney beaches and Sydney Harbour – the better.

Thirdly, aim to make your money through capital growth – not high rental yields – by identifying suburbs with strong price growth potential. McGrath says high rental yields can be misleading because they are often higher in areas that don't experience robust capital gains.

"The big money that I've seen made and experienced myself in property is strong capital gains," he says.

To identify these growth opportunities, McGrath says look at the in-demand neighbourhoods and investigate nearby suburbs that have not yet experienced the same strong price gains, but will benefit from a flow-on effect.

"I'm very strong on the inner-west corridor between Glebe and Haberfield," he says, referring to the Sydney market. "Haberfield to me is a very strong suburb: strong investment prospects, close to the city, good capital growth prospects, and that fits that inner-city ring."

John McGrath's Top Sydney Metro Suburb Picks

Houses	Apartments
Abbotsford	Bronte
Breakfast Point	Cremorne Point
Frenchs Forest	Dawes Point
Freshwater	Earlwood
Haberfield	Kensington
Northbridge	Newtown
Palm Beach	North Parramatta
Queenscliff	Pyrmont
Seaforth	Sans Souci
Sylvania Waters	Wollstonecraft

Source: McGrath Estate Agents

He says Sydney beachside suburbs such as Bronte, which took a hit during the GFC, are also likely to bounce back as the economy improves.

Fourthly, McGrath says houses have historically generated higher capital gains compared with apartments. However, the gap has been narrowing as apartments become increasingly popular with young professionals and baby boomers.

And last of all, if you want to invest in more affordable areas outside inner-city rings, aim to keep your investment within a 90-minute drive of a major city.

Top regional picks for NSW, ACT, southern QLD	
Balgownie, NSW	Hamilton, NSW
Broadbeach Waters, QLD	Katoomba, NSW
Burleigh Waters, QLD	Kingston, ACT
Caves Beach, NSW	Lennox Head, NSW
Ettalong, NSW	Town Beach, NSW

Source: John McGrath Estate Agents

"The structure of regional cities can change quite dramatically," he says, noting how the closure of a large company in a regional town can have an adverse effect on its economy by reducing employment and consequently demand for housing.

He says property in regional areas, like Wollongong, that have quick commutes to a major capital have good capital growth prospects.

Once you have identified your property, don't skip over the due diligence. Make sure the building is structurally sound, check for nearby development proposals, and if applicable, get a strata report, to make sure your investment won't become a money pit.

"Whether you're investing in shares or property, if you're investing in good quality assets at what today, I think, will look like very good value ¬in hindsight – in either market, property or equities, it's a good time to actually accumulate some good quality assets."

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How to take an artwork out of your SMSF

by Tony Negline

Investing in art is one way to diversify your SMSF portfolio – especially because the asset class is generally less volatile than stocks. And if you catch a rising artist on the way up (like the example of Del Kathryn Barton in Alistair Bailey's column last week), you can also realise some extraordinary capital gains.

But let's face it, owning an artwork in an SMSF is not much fun. Back in July, I explained that when your SMSF invests in an artwork or collectable, you can't personally 'enjoy' that asset. Rather, you must store it away from your home, or rent it to a museum or corporation of some sort (read, Don't get stung by new SMSF artworks and collectables rules).

But, once you reach retirement age, theoretically, you can withdraw that artwork or collectable, which means it's then yours to enjoy.

As with many things within super, such a transaction is tricky. So how do you carry it out without getting into trouble?

First of all, you must establish why you're withdrawing the asset:

- Maybe it's because you can't satisfy the new super rules about artwork and collectibles, which set valuation and storage requirements. If that's the case, you have until June 2016 to remove the assets from your fund. Perhaps you can't get appropriate insurance. Under these circumstances, it may be best to remove the asset from your SMSF.
- Maybe you want to make a benefit payment to yourself. If you want to keep the artwork, you'll have to pay yourself a lump sum because pension income payments can only be made with cash or cash equivalent (such as an electronic funds transfer). Remember that you can only pay yourself a lump sum benefit from your super fund if you satisfy a Condition of Release. [insert link to resources centre) Appropriate amounts of benefits tax – and other taxes such as Capital Gains Tax, which I'll discuss below – have to be considered at this point.
- Maybe you want to gift the asset prior to your death. It's often advantageous to deal with your super assets prior to death because after the age of 60 you can take benefits out of your super fund tax-free, whereas after death your non-dependants will likely have to pay tax on the Taxable Component portion of the benefit.

Whatever your reason for taking the artwork or collectible out of your fund, you now need to make sure you follow certain steps in order to comply with the super laws.

The new super rules about these types of assets demand that when artwork or collectables are paid in specie or sold to a related party of your fund (which includes fund members, their relatives and other entities), then you must have an independent valuer assess the asset.

The valuer must provide a market value for the nominated asset, which is then used by the super fund in determining adjustments to account balances and any tax issues.

It would make sense that this valuation is provided before the ownership of the asset is transferred, however there is nothing in the super laws that specifically makes this demand. In order to ensure you don't run into problems, make sure the valuer is an independent, acknowledged expert in the particular asset class.

The Australian Tax Office is expected to release a ruling on these points regarding SMSFs at some stage, and we'll bring you up-to-date with any changes or clarifications they announce.

Once the ownership of the asset is changed into your own name, then the trustees will have to consider the capital gains tax implications on the SMSF as a result of the sale or benefit payment of the artwork or collectable. (The asset will not incur any tax liability for the fund if it is being wholly used to pay a pension.)

The next step is for the trustees to amend the fund's asset register to reflect that the asset is no longer owned by the fund.

In some cases you may need to review your fund's investment strategy and how it has been implemented. If, after the asset is removed from the fund, the fund no longer owns any artwork or collectables, but the investment strategy says that these asset classes will be held, then clearly this will need to be addressed.

Finally, if a benefit is being paid out in specie then you'll need to make sure all trustees complete the relevant documentation, such as a Payment Summary. They will also need to make sure that member account balances are appropriately adjusted.

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The week ahead

Australia
Monday – 17 October: Lending finance (August)
Monday – 17 October: New car sales (September)
Tuesday – 18 October: Reserve Bank Board minutes
Wednesday – 19 October: Speech by RBA Assistant Governor

Overseas
Monday – 17 October: US Industrial production (September)
Tuesday – 18 October: US Producer prices (September)
Wednesday – 19 October: US Consumer prices (September)
Wednesday – 19 October: US Housing starts (September)
Wednesday – 19 October: US Beige Book
Thursday – 20 October: US Existing home sales (September)
Thursday – 20 October: US Leading index (September)

Upcoming company full-year results
Friday – 21 October: Ten Network Holdings
Thursday – 27 October: Australian Pharmaceutical Industries
Thursday – 27 October: National Australia Bank

Ex dividend
Monday – 17 October: Countplus Limited (CUP) (3¢)
Friday – 28 October: Ten Network Holdings (TEN) (11¢)

Did you know?

If you invest in property and you plan to renovate or build, there's a big difference between what you can do using existing funds within your SMSF and what you can do using a loan. For example, your SMSF can borrow money to buy property, but not to fundamentally change that property – that is, you can't extend the house – whereas, you can use existing funds within your SMSF to make extensions to a building. To find out more, read:
How to use super gearing to buy property
New opportunities open for investing in property
Commonwealth Bank launches Super Gear loan
How to develop vacant land using your SMSF