Switzer Super Report

Issue 28, 24 October 2011

Super finish

The events of this week are critical in determining where stocks will end up at the end of the year, and so far, so good. Company earnings in the US have gotten off to an encouraging start, and Europe is creeping ever so closer to a solution to its debt problems. Today, I take a look at the question on everyone's lips: can they do it?

Also in today's Switzer Super Report, we give you the latest buy, sell and hold recommendations for companies in the ASX 100. We also explain how you can play the role of a bank by using your SMSF to lend to others, and we examine the unanswered questions from the government's proposed changes to super contribution caps.

I hope you enjoy this week's report. If you have any comments or questions, please contact us at questions@switzer.com.au.

Sincerely,

Peter Switzer

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This week's events are the critical decider

by Peter Switzer

A Yuletide rally could be railroaded if the Europeans are too hard on the banks this week in what will be the crucial test of the European Union's rescue plan.

That said, judging from Wall Street's positive reaction over the weekend to the right noises coming out of Europe ahead of this weekend's EU Summit and the inevitable outlining of the rescue plan on Wednesday, it looks like we're set for a good finish for the stock market in the run-up to Christmas.

I did say 'good' and avoided the word 'great' because the US Congress could hurt optimism with spending cut decisions.

But I'm gambling that they won't behave as badly as they did in August, when the market nosedived on not only the antics of those in Europe, but also on the US credit rating downgrade and the impasse of the debt ceiling extension in the US Congress.

But back to the issues at hand, and the French leader, Nicolas Sarkozy, was very upbeat over the weekend.

"Work is progressing well on the banks, on the fund and the possibilities of using this fund, the hypotheses are narrowing, and a rather broad agreement is in the process of being drawn up," Sarkozy said, as reported by Reuters.

"On the question of Greece, things are progressing. We haven't finished yet. We have until Wednesday."

So Wednesday is the big day where we should get a definitive plan, and it will set the scene for shares for the rest of the year. But there could be one tricky issue — the haircut for the banks.

A part of the deal will have to involve the banks that have lent to Greece and that now have debt in the vicinity of 160% of gross domestic product (GDP) this year. The European leaders need to come up with a level of debt loss for the banks, which is better than the market was expecting, but good enough to ensure that the debt rescue plan works for the PIIGS (Portugal, Ireland, Italy, Greece and Spain).

Reuters says a debt study showed losses for lenders might have to be as high as 50-60% to make Greek debt and others sustainable into the future.

That's a lot higher than the 20% loss the banks were talking about previously, so there's a big debt repair gap that will have to be dealt with by the EU leaders. It's critical that the market thinks the banks are going to be better off, or there will be a sell-off.

Another important test for the plan will be convincing the market there is enough money in the European Financial Stability Facility to stabilise the region. The starting point is €440 billion (A$589 billion), but we need to see a lot more in there to build on the rising investor confidence we have seen in the past few weeks.

On the subject of money, and with many European countries strapped for cash, there are suggestions that China could bankroll some of the rescue in return for treatment as a 'market economy', which would improve the country's access to European markets. But the Europeans are divided on whether to go down that road.

As Aussie investors, this calendar year has been a shocker, but if we can see a new and credible plan emerge out of Europe this week, then shares will rise for a decent finish for the financial year.

By the middle of next year, I can see another market take-off in anticipation that 2013 will be a much better year for the US and global economy. But this all rests on a damn great plan coming out this week.

Let's hope the Europeans can achieve an overdue personal best.

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The broker wrap

by Rudi Filapek-Vandyck

Stockbroker recommendations

ASX code	Company name	Old Rating	New Rating	Broker
Upgrade				
CDD	CARDNO LIMITED	Neutral	Buy	Macquarie
MCR	MINCOR RESOURCES NL	Sell	Neutral	UBS
HGG	HENDERSON GROUP	Sell	Neutral	Macquarie
TOL	TOLL HOLDINGS	Sell	Neutral	Macquarie
AGO	ATLAS IRON	N/A	Buy	UBS
Downgrade				
CRZ	CARSALES.COM	Buy	Neutral	Deutsche Bank
CPU	COMPUTERSHARE LIMITED	Buy	Neutral	RBS Australia
ALL	ARISTOCRAT LEISURE	Neutral	Sell	Credit Suisse
ERA	ENERGY RESOURCES	Buy	Neutral	Deutsche Bank
IRE	IRESS MARKET TECHNOLOGY	Buy	Neutral	Credit Suisse
OZL	OZ MINERALS	Buy	Neutral	Credit Suisse
SUL	SUPER RETAIL GROUP	Buy	Neutral	Citi, Credit Suisse
TEN	TEN NETWORK HOLDINGS	Buy	Neutral	Macquarie
TWE	TREASURY WINE ESTATES	Buy	Neutral	Deutsche Bank

FNArena, Switzer Super Report

For the second week in a row, downgrades from the eight brokers in the FNArena database have outnumbered upgrades, with total Buy recommendations slipping to 58.7% from last week's 59.3%.

Among the few receiving an upgrade this week were **Cardno** (CDD), Macquarie lifting its rating to Outperform from Neutral on the back of the company announcing the acquisition of TEC in the US. The new assets are seen as a good fit with existing operations and should boost earnings.

Macquarie also upgraded fund manager **Henderson Group** (HGG) to Neutral from Underperform on valuation grounds. Looking through short-term market headwinds suggest the stock is attractive even post some cuts to earnings estimates, while a 6% dividend yield is also viewed positively by the broker.

Toll Holdings (TOL) was also upgraded by Macquarie to Neutral from Underperform, this change also reflecting an improved valuation for the stock at current levels. A review of its model saw Macquarie make minor changes to earnings forecasts and its price target.

On the resources side, an initiation of coverage by UBS with a buy rating on **Atlas Iron** (AGO) has lifted overall ratings for the stock.

Among the companies downgraded was **Super Retail Group** (SUL), with Citi, BA Merrill Lynch and Credit Suisse all downgrading it to Neutral from Buy previously on the back of the purchase of the Rebel Sport assets.

The general view is that the assets being acquired are not top quality and a full price is being paid, while the magnitude of the deal also changes Super Retail's risk profile going forward. Price targets have thus been reduced on the back of the acquisition, while earnings estimates have been adjusted lower to reflect earnings dilution from a share issue to pay for part of the purchase.

A soft retail environment won't help Super Cheap succeed with the Rebel Sport purchase, and it has also seen Deutsche Bank downgrade **Carsales.com** (CRZ) to a Hold rating, the broker also lowering earnings estimates as well as its price target.

It is a similar story for the likes of **Computershare** (CPU), which was downgraded by RBS to a Hold rating on valuation grounds given tough operating conditions, and **Aristocrat Leisure** (ALL), which was downgraded to Underperform; Macquarie downgraded **Ten Network** (TEN) to Neutral on the same basis.

Oz Minerals (OZL) also copped a downgrade to a Neutral rating from Credit Suisse after a quarterly production report that disappointed on the gold side, while Deutsche Bank downgraded **Energy Resources of Australia** (ERA) to Hold on the back of an unexpected rights issue. **Rio Tinto** (RIO) is underwriting the capital raising and is likely to boost its equity ownership past 80% as a result.

Changes to earnings forecasts (EF)

Company	Code	Previous EF	New EF	Change	Brokers
Upgrade					
Paladin Energy	PDN	1.753	2.076	18.43%	7
Map Group	MAP	6.187	7.259	17.33%	6
Gindalbie Metals	GBG	1.014	1.157	14.10%	6
Fortescue Metals	FMG	66.755	70.329	5.35%	8
Gujarat NRE	GNM	6.600	6.933	5.05%	3
Gloucester Coal	GCL	47.800	50.200	5.02%	5
Caltex	CTX	113.550	117.483	3.46%	6
Iluka Resources	ILU	117.863	121.313	2.93%	8
Graincorp	GNC	77.518	79.377	2.40%	6
Mount Gibson Iron	MGX	42.425	43.200	1.83%	8
Downgrade					
Oz Minerals	OZL	113.513	95.200	- 16.13%	8
Panaust	PNA	29.408	25.058	- 14.79%	8
Cochlear	COH	255.638	220.275	- 13.83%	8
Fletcher Building	FBU	49.237	43.661	- 11.32%	8
Beach Energy	BPT	4.780	4.240	- 11.30%	5
Alumina	AWC	6.479	5.899	- 8.95%	8
Perseus Mining	PRU	25.433	23.600	- 7.21%	6
Bank of Queensland	BOQ	105.725	100.813	- 4.65%	8
BHP Billiton	BHP	447.124	426.898	- 4.52%	8
Customers	CUS	12.740	12.200	- 4.24%	5

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

For more information, visit FNArena.com.

How you can be the bank

by Tony Negline

It's fairly tempting to want to play the role of a bank when you've got a large sum of money sitting in your SMSF and someone wants to borrow it. And with interest charges, loaning money can be a nice little money earner for your fund, and one that helps diversify your investments.

Of course, the risks involved in becoming a lender can vary dramatically and strict due diligence is warranted. On top of that, there's a number of strict super laws to abide by.

So what can and can't be done?

The first point to note is that all loans must be conducted at arm's length. That means your SMSF can't loan money to you or to your relatives.

Additionally, your super fund can't loan money to you or your relatives through another entity. For example, your super fund can't loan money to me so that I, in turn, loan it to you. The Australian Tax Office (ATO) takes the view that this rule applies to money loaned to trusts or companies, which then provide credit to you or your relatives.

However, your fund can still lend to trusts or companies controlled by you or your relatives as long as the money stays at arm's length. And in such cases, there is a strict limitation on how much can be leant – typically, no more than 5% of the market value of the fund's assets.

Before your SMSF makes a loan, you must make sure the trust deed permits lending. You also need to make sure your SMSF's investment strategy permits lending. If not, you and any other trustees, will need to rewrite the documents.

The investment strategy should consider the type of return you expect after all costs and taxes, as well as the net interest rate you want to charge on the potential loan. If the loan won't generate the required return, then it may not be an appropriate investment.

The next issue to consider is the loan itself. You need to approach this issue in much the same way a bank would – determining risk is crucial.

You should ask the borrower and their related parties for copies of their credit files. This will tell you if they have defaulted on loan repayments or have unpaid bills. It's not definitive information, but it's better than nothing. Borrowers can obtain a copy of their credit file from mycreditfile.com.au.

You also need to take into account what the borrower intends to use the loan for and what the loan will be secured against. It's highly unusual for a bank not to look for security on their loans, so your SMSF must have the same attitude.

Once you're happy with these steps, make sure to execute a proper loan agreement that has been correctly completed. This agreement must detail all repayment terms including the loan period, frequency of repayments and how the amount of interest outstanding is determined. Penalties for default must also be mentioned. You need to make sure you've clearly determined your rights in the event of a default.

You also need to make sure the borrower doesn't get loan terms from your super fund that are more favourable than what is available in the marketplace. For example, you can't lend money at a 0% interest rate. This is dictated by the arm's length rule, which is in place to make sure that such transactions happen at market rates.

You super fund's trustees should take it upon themselves to have this agreement drafted by an appropriately qualified and experienced solicitor. Like all such agreements, the cost of this should be the paid by the borrower.

Once the loan is in place, you, in your role as a trustee, must make sure the loan agreement is followed – especially, the minimum repayment requirements. If there's a breach, you must be prepared to act like a bank. That is, you must be prepared to seize assets to make good any potential loss.

One final word of warning – be very careful about loaning money to overseas parties. There is an increasing number of overseas-based sharks preying on unsuspecting SMSF investors, and there is little chance you'll ever get your money back if such a loan defaults.

Points to remember:

- **Your SMSF can't make a loan to you or your relatives.**
- **Limits apply if your SMSF makes a loan to a trust or company owned by you or your relatives.**
- **All loans must be made at market rates.**
- **Check the borrower's credit record before making a loan.**
- **Make sure to establish what the loan will be secured against.**
- **The loan terms need to be clearly set out in a legal document.**
- **A qualified solicitor should write the loan agreement.**
- **You must be prepared to seize assets in the event of a default.**

It may be your last chance to boost contributions

by Paul Rickard

In February, the Government announced a major change to contribution caps. However, eight months later we're still waiting to find out exactly how the new rules will be applied.

The proposed change, which is meant to take effect from 1 July next year, is that the higher concessional contribution cap of $50,000 for members aged 50 or over will only be available to those with superannuation balances under $500,000. Those with balances in excess of $500,000, and all superannuants under the age of 50, will only be able to access a concessional contribution cap of $25,000.

Given that this could possibly be the last year of the higher limit of $50,000 for many members, early consideration of salary sacrifice or other employer arrangements that allow the maximum contribution should be undertaken. As contributions in excess of the cap are taxed at an additional 31.5%, the effective tax rate on any excess is 46.5% – so be very careful that you don't go over the cap.

To be fair to Minister Bill Shorten and his advisers in the Treasury, there are some tricky issues to consider. These were outlined in a consultation paper to which 119 submission were made prior to the closing date of 25 March.

The key issues are:

- Are members who have commenced drawing down their superannuation (for example, through a transition to retirement pension) eligible for the higher cap and, if so, are withdrawals from super included in the account balance?
- When is the account balance measured; on 30 June immediately prior to the start of the year, or on 30 June two financial years earlier? (So for the 2012/13 contribution year, the balance as at 30/6/11.)
- Who assesses eligibility – a full self-assessment model, or the ATO?

If withdrawals already made from super are included in the account balance, fewer members than anticipated will be able to access the higher cap. Some members who have recently commenced a transition to retirement pension may be impacted. On the other hand, if withdrawals are excluded and a member's balance will marginally exceed $500,000 on 30/6/12, it may pay (assuming he or she is over 55) to commence a transition to retirement pension this year.

According to the Minister's office, no timeframe has yet been set for the announcement – this is one of a number of issues being considered in relation to superannuation policy. At the Switzer Super Report, we think that most of this Government's reforms in superannuation have been in the right direction. However, on the cap issue, we believe this policy is absolutely inconsistent with the aim of encouraging self-sufficiency in retirement. Given the community's increasing life expectancy, a $500,000 superannuation balance is not excessive – for many, it is going to be wholly insufficient.

That said, it seems there is little chance of the Government changing their minds on this issue. Further, the Government has also announced that the $500,000 threshold will not be indexed – so there is clearly a disconnect between the Government and the community's expectations in terms of a comfortable retirement.

Although the implementation issues remain unresolved, members should nevertheless be planning to maximise their use of the concessional caps this financial year.

Here's a quick re-cap on the rules for 2011/12:

Concessional super contribution caps for 2011/12

Age of Member	Concessional Contribution Cap
Under 50 during 2011/12	$25,000
Aged over 50 during 2011/12	$50,000
Aged from 65 to 75 during 2011/12	$50,000 on passing the work test

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Concessional contributions include:

- Employer contributions (for example, the 9% SGC); and
- Salary sacrifice contributions.

Contributions by self-employed members where a tax deduction is claimed are also counted as concessional contributions. Self-employed members who engage in a part-time job as an employee need to be cognisant of the '10% rule', which says that the deductibility of the super contribution for tax purposes can only be claimed if "employment related activities" are less than 10% of the individuals' total assessable income.

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The week ahead

Australia
Monday 24 October: Producer price index (September quarter)
Tuesday 25 October: Speech by RBA Deputy Governor Ric Battellino to investment conference
Wednesday 26 October: Consumer Price Index (Sept quarter)
Friday 28 October: Annual National Accounts (2010/11)

Overseas
Tuesday 25 October: US Case-Shiller home prices (August)
Tuesday 25 October: US Consumer confidence (October)
Wednesday 26 October: US Durable goods orders (September)
Wednesday 26 October: US New home sales (September)
Thursday 27 October: US GDP (September quarter advance
Friday 28 October: US Personal income (September)

Company results
Thursday 27 October: Australian Pharmaceutical Industries (full-year)
Thursday 27 October: National Australia Bank (full-year)
Friday 28 October: Macquarie Group (interim results)
Monday 31 October: BT Investment Management (full-year)

Ex dividend
Friday 28 October: Ten Network Holdings

Did you know?

When the stock market rallies, it's often the small cap stocks that outperform. Peter Switzer asks Simon Bond from RBS Morgans to name some small cap stocks that also have a good history of paying dividends. Watch it now on Super TV.