Switzer Super Report

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Switching gear

Today's Switzer Super Report has a lot to do with gears. Charlie Aitken believes the stock market is switching gear and he's named a few stocks that he thinks will lead the pack in the recovery.

Meanwhile, I've thrown the focus on super gearing, and had a chat to a top SMSF lawyer to find out what we really can and can't do to a property that has been bought using borrowed SMSF money. We also warn you about the top five mistakes SMSFs make when super gearing, and we take a look at the fundamentals driving the market into the end of the year and what stocks look cheap.

Happy investing!

Sincerely,

Peter Switzer

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Making money out of property in an SMSF

by Peter Switzer

During the week I sorted out my reservations about investing in property inside an SMSF during an interview I had with one of Australia's top SMSF lawyers.

Dan Butler from DBA Lawyers was a guest on my *SWITZER* program on the Sky Business Channel.

This video is on up on our website, and if you are thinking about using your super fund to buy property, I would recommend you look at it closely (click here to watch it on Super TV).

One of the reasons I've been a bit toey about property in super has been the Australian Tax Office's recent draft tax ruling, which has brought conflicting interpretations from super experts.

In a nutshell, the ruling – which lawyers tell me you can't rely on 100% because it's only a draft ruling – has suggested you could change a property you have bought using borrowed money inside your SMSF.

Before the ruling, it was basically impossible to buy a beaten up property using borrowed funds and then renovate or restore the thing. This was crazy because it stopped you from pocketing capital gains and higher rents and also stopped you from maximising the returns in your super fund.

Note: you could always have bought a property using your own existing SMSF money and you could have knocked the thing down and turned it into a block of apartments – the issue is that you couldn't use your SMSF to borrow, or gear (known officially as a limited recourse borrowing arrangement), to buy a property and then also use borrowed funds to renovate it.

Now, after talking to Dan, I believe if you use your SMSF to borrow money to buy the property, you then can use your existing SMSF money to renovate or restore your property. This means you could add rooms and even a pool – but remember, you can't make these changes using borrowed funds.

I believe this is real progress and a fair interpretation by the ATO because it means those who don't just want to be in shares can give themselves exposure to direct property. But more importantly, it helps SMSF trustees to enhance the value of the asset and the potential income flow, which is the trustee's obligation. They are supposed to make investment decisions that help their retirement goals.

One other little observation about property in SMSFs, which some people might not have thought of, is this: you could buy a property, renovate it, rent it out, keep it until you are retired, and then withdraw it as a lump sum and live in it.

There would be stamp duty, of course, but no capital gains tax!

Property inside an SMSF is starting to look better and better. However, until the government legislates the changes, there'll continue to be some debate about what you can and can't do. In the meantime, if you plan to borrow to buy property for your SMSF with the intention of renovating, run you're plans by a lawyer.

The stocks that will lead the recovery

by Charlie Aitken

I drove a couple of laps at Mt Panorama, Bathurst last weekend and this is the view down Conrod Straight. There's nothing like a clear track ahead.

But why on earth am I starting an equity strategy note with this photo? Because, in my view there are times when the market track is clear ahead and it's safe to put the investing foot flat to the floor.

I believe there is a very large gap between what equities are discounting based on economic predictions and what the economic reality will be, particularly in companies that deal with China.

Similarly, in terms of equity liquidity, there is also a very large gap between the prices of stocks short-sellers have been shorting compared with where a long-only fund would value a stock. This was evident this week in all things China related, where the China macro bears simply got destroyed.

Short-selling is when an investor aims to make money on a stock's price decline. This is done by borrowing shares in that company from a third party, selling them, and then after the price falls, buying the shares back at a cheaper price and returning them to the owner – profiting from the decline. Those who are 'long' own the stock.

I believe when short-covering starts in earnest in Australia (that is, when shorters start to buy the shares back to close out their short positions), and it hasn't yet, that price gains in the most shorted stocks will be much larger than anyone currently forecasts. Just look how easily the ASX 200 "melted up" 113 points on Monday on low volumes.

Volumes are low because shorters and sellers are exhausted. Private investors are also very cashed up after selling at the bottom and switching to cash and fixed interest.

The ASX 200 is now up 23% off its recent lows in US dollar terms, which means huge losses for those who have shorted both Australian equities and the Australian dollar on the view that China's economy was headed for a 'hard landing'.

It's also worth noting the most shorted stocks led the rally, which will be exactly how this unfolds into year-end.

I believe total short positions in Australian equities are grossly underestimated.

The ASX 200 has reached a very critical technical level. The downtrend from the April highs of 4,255, and once we break through, stocks will head up to the next technical level of 4,477, where we will reassess our risk on our trading strategy.

I've argued that predatory shorters had been targeting any company with a pending debt roll on the view that corporate debt markets were closed. Yet in the last week we have seen Seven West Media (SWM), Primary Healthcare (PRY) and Asciano (AIO) all refinance substantial debt facilities at lower rates. Debt markets are well and truly open with last week seeing $3.2 billion of weekly inflows to high yield funds – the largest inflows since 2003 as a percentage of assets under management.

These US corporate debt markets are well and truly open, which makes predatory shorting of Fortescue (FMG) on debt issuance concerns look ridiculous. I remain of the view that Fortescue will launch a debt issue after 'Euromess' comes to an end, and once that's confirmed, you will see a massive 'short-cover the fact' rally in Fortescue, just as you have in Seven West Media and Primary Healthcare. Fortescue will get a debt issue away right as the spot iron ore price bottoms, which will lead to an explosive short-covering rally.

The other sector where short positions remain enormous, yet fundamental, and technical momentum is improving is discretionary retailers. The two major shorts – Myer and JB Hi-Fi – continue to rally and there simply isn't any real stock supply around.

Inflation is in the Reserve Bank of Australia's target range, giving the big green light to rate cuts. And there is no industrial cyclical sector with greater leverage to rate cuts than discretionary retail, yet it's the industrial sector with the biggest short positions. Again, that is an explosive upside combination and we maintain a very bullish stance on Australian discretionary retail stocks.

Forge Group (ASX:FGE) – Buy

We've reinstated our buy rating for Forge. Revenue coverage in fiscal 2012 has improved significantly (+90%) since June and with the scope for further improvements. We see the downside risk abating. Forge generates an exceptional return on equity (ROE), sits in a net cash position with very high operating cash conversion. Average contract sizes continue to grow and there is a developing thematic in West African investment that the stock is leveraged to. Trading at 5.1 times fiscal 2012 EBITDA (earnings before interest, tax, depreciation and amortisation) valuation is relatively undemanding and we retain our Buy rating and target price of $6.50 per share.

Webjet (ASX:WEB) – Buy

We think it is rare for a mature company to have an organic opportunity as good as this: Webjet is about to embark on a major initiative targeting the online accommodation segment. The scale of the opportunity is amplified by the fact that if successful, it is likely to deliver margin improvement given hotels and accommodation margins are almost twice as high as flights. Our underlying thesis is that Webjet appears well positioned to gradually increase its share of the domestic online accommodation market from 0.65% in fiscal 2012 to 9.5% in fiscal 2023. Our target price is $4.92.

Woodside Petroleum (ASX:WPL) – Buy

Woodside remains attractive buying in our view. It is the only major LNG producer in Australia for the next three years, with a near-term step change through the Pluto Foundation Project due to start in less than six months. The market is not factoring in any Pluto expansion or the upside potential at the Browse LNG or Sunrise LNG projects, despite progress at all three. The likely sell-down of Shell's remaining 24% stake in Woodside is acting as an overhang, but if this is removed the stock will re-rate, particularly if another LNG project is announced. Our share price target is $40.

Why I haven't sold Cochlear

by Ron Bewley

As I wrote two weeks ago, I bought Rio Tinto (RIO), BHP Billiton (BHP) and Boart Longyear (BLY) at what I thought – and still think – were attractive prices. That BHP and Rio are even cheaper today to me makes them even more attractive. Boart Longyear is already starting to run away.

Not everything has been rosy in my portfolio. In the last couple of months I took a big hit on the chin when Cochlear (COH) had a recall. As regular readers of my column would know, I had a big holding in Cochlear (for me) that I had bought over a number of years at an average price of $61.78. It was $72.18 at the close on 9 September before the market was informed of the recall. The stock immediately plunged to $57.50.

I could have sold out with no big loss when dividends are taken into account – but I didn't. To me Cochlear has a great story and the pre-emptive nature of the recall could well stand it in good stead in the future. It got as low as $45.77 on the market bottom on 4 October. Already, it is above $60 again. To me, news of this nature causes panic selling. It may not get back above $80 again anytime soon. I just didn't want to get lost in the panic.

Current broker forecasts have a median target price of $57 and a range of $43.75-$80 for Cochlear. That is, the brokers on average expect its stock price to fall from here and their recommendation of a '3.3' supports that.

Previously, I have written that I wouldn't buy a stock with a poor broker recommendation (read, What not to buy: Part 4 – what the brokers say), but I also wrote that I wouldn't necessarily sell. Had the downgrade been due to general factors, I might have sold by now, but it wasn't.

Because I have followed this stock closely each day from my first buy in June 2007 to the present, I feel I can make an informed view on the impact of a recall. Had I held 50 or more stocks, I probably wouldn't have been as confident. Had I not had an SMSF, a fund manager may have sold me out at the wrong time. To me, it is now at least a hold – that is, until I learn more.

In the meantime, I think things are going to get better for stocks.

After two brutal months in the market, the rally that took us back over 4,200 on the ASX 200 could have the legs to take us through to Christmas. I don't believe in Christmas rallies and such stuff, it is just that the stars are aligning.

Let's look at the positives:

1. Obama came up with the Jobs Bill. It's getting nowhere in Congress, but it was the thought that counted. The market rallied.

2. Double dip fears of recession for the US have gone for all but the committed. Recent economic data kept surprising on the upside. Companies like Caterpillar in the US not only reported strong earnings and revenue, they are very optimistic about their future – and Caterpillar's future is based on growth in infrastructure and agriculture around the world.

3. As the US elections get closer, there is now talk of a third quantitative easing package (QE3). Remember, it was QE2 that fuelled the last big rally from September 2009 and the recent correction back down was without any QE.

4. Fears of China's hard landing melted away as its data – including inflation – improved.

5. India overtook Japan to become the third largest

country in the world (by GDP) behind the United States and China. Our region continues to gain in strength.

6. The EU missed getting its act together by last Sunday (23 October) as promised, and won't have it all together by today, but it seems they will have at last got the ball rolling. Markets rallied very strongly last Friday and Monday on the strength of these rumours.

7. There is now hope – and certainly reason – for the Reserve Bank of Australia to cut interest rates soon, if not on Melbourne Cup Day. I spoke about why I believe we should get a cut on SWITZER last week, and you can watch a replay on Super TV.

8. The G20 (Group of 20 Nations) is expected to present a global approach to solving the European debt crisis when it meets on 3 & 4 November. Even China is expected to throw its hat in the ring.

Of course, those on the sidelines have missed the first 10% of the rally, but such is life. Although I have remained reasonably confident throughout the last two months – and only sold to reduce risk in my margin loan – no one (including me) was certain that we would be at this stage by now.

It is so important to ignore lost opportunities and focus on the future.

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Top 5 super gearing traps

by Tony Negline

You don't have to be a self-managed super fund expert to know that super gearing is becoming a very popular strategy. And as more people jump in and gear their super, it's only natural that more people are running into problems.

Super gearing – formally called limited recourse borrowing – is when your SMSF borrows money to invest. It's become particularly popular lately because of the potential to borrow to invest in property. You can find out more about super gearing on our website.

Like any super strategy, there are some risks. In my view, I'm not convinced that many people adequately consider these risks, so I've pulled together my top five risks in this area for you to take into account before you take out an SMSF loan.

One: It's 'borrowing', stupid (apologies to Bill Clinton)

Super gearing involves not only taking on debt, but also heightened risk. Gearing magnifies gains and multiplies losses (for example, if you borrow to invest in a stock, and that stock falls, you not only have lost money on the falling stock, but you need to find additional capital to pay back the loan). One major risk with all borrowing is the possibility that you can't make the necessary loan and interest payments. To help prevent this, you need to do some careful cash flow analysis to ensure that you can afford the repayments if you were to suffer an unexpected income drop or expenses increase.

Two: Forgetting to plan for the unexpected

Most super gearing cases to date have involved real estate. Problems typically arise in real estate investment transactions if your income has fallen or other sources of funds have dried up. For example, your tenant leaves and you can't find another one. It might also come about because of a sharp increase in interest rates. Alternatively, you might need to fund some urgent repairs to the property.

Three: Your super gearing documents stink!

Super gearing is a complex transaction that involves state and territory law, such as property and duty provisions. It also involves Federal laws, such as the super and income tax laws. And if the lender is a bank, then it will involve their lawyers and risk management people. Combining all of these threads into a property transaction can be extremely confusing and challenging, especially as the banks' lending people are just starting to learn about super (which happens to be the case!).

There have been many cases when a lender's lawyers have asked for provisions that are simply not required or might even be in breach of various laws.

In most states and territories, the super gearing documentation needs to be signed in a certain order. If you get this order wrong, then you may be up for ad valorem stamp duty more than once.

When the loan is repaid, you need to successfully navigate the title transfer back into the super fund's name without incurring stamp duty on the property transfer again, so appropriate action needs to be taken to prevent this when you're setting up your super gearing arrangement.

Fortunately, most people who have been involved in super gearing transactions – super fund trustees, accountants and financial planners – have all needed significant assistance from people who understand how the different strands of the transaction fit together.

There is a strong case not to purchase pro-forma documents available from some websites because there are simply too many mistakes that can be made by the unwary in this area.

Four: You want to renovate or improve the property

Technically, an asset can't be replaced or altered under the super gearing laws. There are some exceptions to this rule for company shares or trust investments. But what about 'improvements' to property? In many cases, improvements are considered to be significantly altering the asset held in a super gearing transaction. However, there is some debate about this point in super circles because of a draft ruling issued by the Australian Tax Office that states that you may soon be able to borrow money to make improvements that don't significantly alter a property asset. Read Peter's story [Making money out of property in an SMSF](). So if you want to make any structural changes to an asset in a super gearing arrangement, I suggest you get some solid advice on the specific change you would like to make before commencing.

Five: Gearing may not be the best option

Sometimes it may be easier to hold an asset outside of your SMSF. Some people get particularly attracted to the tax concessions attached to super and rush towards them, sometimes at great cost to themselves because super doesn't provide the flexibility they need. A good example of this is people who want to use super gearing to buy an apartment that their young adult children will rent, only to find out later that relatives can't be involved in such a transaction.

Check list:

- **All gearing involves risk.**
- **Don't assume unexpected events won't happen and make sure you have a plan that covers them.**
- **Make sure you use quality super gearing documents.**
- **Be very careful about renovating or improving your super gearing property.**
- **Is super the best structure to hold the asset you want to buy?**

Important information: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. For this reason, any individual should, before acting, consider the appropriateness of the information, having regard to the individual's objectives, financial situation and needs and, if necessary, seek appropriate professional advice.*

Did you know?

You can use exchange traded funds (ETFs) to reduce risk and diversify your investment portfolio. To find out more about ETFs, read What is an ETF? and Which Aussie index ETF is best?

Don't Miss this!

Woolworths has increased the size of its subordinated notes issue to $700 million and set the margin at 3.25% (read Paul Rickard's article, Do Woolworths' hybrid notes offer good returns?). Woolies says up to $25 million will be allocated to eligible shareholders, and that due to strong demand, it has cancelled the general public offer.

This means that if you don't already own Woolworths' shares, you'll need to apply using a broker or wait to purchase the notes once they're trading on the ASX. If you already own Woolworths' shares, you can apply via www.woolworthsnotesiioffer.com.au.

If you hope to snare some of these notes, you better act fast because the offer is likely to close oversubscribed. Unless you are getting a firm offer from a broker, you should also avoid making overly large applications because Woolies is only likely to accept part of your offer.