Switzer Super Report

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Europe matters

Just when we thought Europe has its act together, the Greek tragedy re-emerges. But will interest rate cuts here at home be enough to buoy our market and protect it from global panic?

"Markets can stay irrational for longer than an investor may stay solvent," JP Goldman highlights today, citing the famous quote attributed to John Maynard Keynes. And it's therefore critical that your SMSF portfolio is designed to take the hit. But a great sell-off also open up great opportunities, and with Australian banks announcing their final dividends, Charlie Aitken has some buy recommendations that will take advantage of the current investment climate.

Also in today's Switzer Super Report, we take a look at the legal consequences of borrowing money from your SMSF, as well as how to go about bringing overseas retirement savings home to Australia without overpaying tax. I trust this information will be useful to you.

Sincerely,

Peter Switzer

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Bank stocks, rate cuts and a Greek tragedy

by Charlie Aitken

I suspect the Prime Minister of Greece got some interesting phone calls from world leaders this week as he single-handedly caused global markets to tumble. There's absolutely no way Greece will be a having a referendum on the 50% debt haircut, and if they did, chances are nobody would turn out to vote!

The problem is the markets are very twitchy after having just rallied between 15% and 30% and any sign of delay in the European rescue package has short-term ramifications – most of which have played out this week.

The Greeks need to remember that they lied their way into the EU, cheated with the help of Goldman to stay in the EU, and now the world is helping them stay in the EU.

I strongly suspect the rest of the world won't put up with any more rubbish from them and hopefully in six months time we won't have a peripheral fishing hamlet running daily global financial market sentiment.

But in amongst all this negativity was some genuinely positive Australian news from the Reserve Bank of Australia (RBA) on Tuesday. I was at a restaurant in Sydney's Eastern Suburbs when the rate cut to 4.5% was confirmed and everyone cheered. The funny thing is, I suspect the vast bulk of people in the restaurant didn't even have a mortgage!

While I see most commentators describe the RBA's 25 basis point rate cut as a one-off, we think that is completely wrong. We believe the 'neutral setting' described by the RBA is between four and 4.25%, meaning you will get another 25 basis point rate cut in December and potentially another one after that in February. The RBA never has, and never will, move in 25 basis point brackets only.

The good news is it appears that carry traders in the Australian Dollar were surprised by the rate cut, with the Aussie down to US1.034¢. While we all like the high Aussie for overseas travel, the fact of the matter is it has clearly damaged Australia's international competitiveness in a wide variety of sectors, but particularly in inbound tourism, education, agriculture and manufacturing.

Personally, I think the best thing that could happen to the beleaguered East Coast economy is a series of rate cuts and a falling Aussie dollar.

As interest rates fall in Australia, you will see marginal global money leave our fixed interest markets. Carry traders have been investing in some of the highest interest rates in the world and an appreciating currency. In fact, the Aussie dollar's gain has made them way more than the underlying interest rate. As the currency changes directions with interest rates, you will see money leave our fixed interest markets and I believe through time that will drive the Aussie dollar down to the US95¢-100¢ range. This would be good for Australian equities, but particularly for foreign earners.

Our strategy remains to switch from the fixed interest yield 'bubble' to fully franked equity yield, particularly as the Big Four banks go cum their final dividends (the period when an investor can buy a stock in time to receive its dividend).

We also remain positive on Australian discretionary retailers because we feel two rate cuts before Christmas and a falling Aussie dollar (that is, less competition from offshore websites) will make Christmas sales better than expected.

Today is just another day we will use global macro weakness to look for bottom up stock specific value.

And with the bank reporting season under way, let's end with our latest recommendations for bank stocks:

Company	Code	Recommendation	Target Price	Closing price 2 Nov.
Suncorp Group	SUN	Buy	$9.70	$8.43
National Australia Bank	NAB	Buy	$28.00	$24.91
Commonwealth Bank	CBA	Accumulate	$50.80	$48.22
ANZ Banking Group	ANZ	Accumulate	$22.60	$20.90
Westpac Banking Corp	WBC	Hold	$21.70	$21.52
Macquarie Group	MQG	Hold	$26.60	$23.62
Bank of Queensland	BOQ	Hold	$8.50	$8.30
Bendigo and Adelaide Bank	BEN	Hold	$9.15	$9.40

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JP Goldman

How Europe will affect us

by JP Goldman

It now seems increasingly likely that Europe will remain a dead weight dragging on the global economy over the next year or so. Indeed, just when we thought Europe may be getting its act in order, Greek Prime Minister George Papandreou has thrown a spanner in the works by suggesting his country should hold a referendum on its bailout package.

Should European troubles continue, the question remains whether the Australian economy will be materially affected – and whether Europe will also drag down our stock market.

In theory, Europe shouldn't matter much. But alas, such is the integrated nature of financial markets these days – and the tendency of investor fear to overrule reason in the short-run – that the risk remains that our market will be under pressure for as long as Europe dithers, even if our economy improves.

As Keynes once said, markets can stay irrational for longer than an investor may stay solvent. That may create short-term pain, but it could throw up bargains for patient long-term investors.

In terms of economic size, the eurozone is a major economic bloc (it's made up of countries that use the euro, therefore excluding European Union (EU) members like Britain). According to International Monetary Fund estimates, it accounts for around 15% of global output – similar to that of China and just less than the United States' 20% share.

But as with the United States, the eurozone's contribution to global growth in recent years has not been great. The region grew by 1.8% in 2010, and the IMF forecasts even slower growth of 1.6% this year, and 1.1% in 2012.

The broader EU accounted for just 8% of Australian exports last year, with around half going to the UK. China, by contrast, took one quarter of Australian exports, and Japan another one fifth. Korea alone accounted for 9% of exports – or slightly more than for the whole EU.

That said, should Europe go into recession, it will have knock-on effects for Australia given the region provides a lot of business to our Asian neighbours. For example, the EU accounted for about one fifth of China's exports last year – a slightly greater share than that exported by China to the United States.

Indeed, in its statement announcing the cut in official interest rates this week, the Reserve Bank of Australia noted that Asian trade performance was "starting to see some effects of a significant slowing in economic activity in Europe, where the prospects are for economic weakness to continue."

In terms of financial exposure, Australian banks should be relatively immune from any write-down in European debts. Analysis by the RBA reveals that Australian banks hold virtually no sovereign debt from troubled countries such as Portugal, Italy, Ireland, Greece and Spain (PIIGS). And exposure to the debt of European banks as a whole amounts to $56 billion – which may seem large, but is only 1.9% of total assets. Exposure to the PIIGS's banking sector is only $7.8 billion, or 0.3% of total bank assets.

But Europe's anaemic banks could have other consequences for Australia in that solvency concerns could lead to an escalation in interest rates in the wholesale funding markets, as evident in 2007 and 2008.

It's important to note, however, that Australian banks have reduced their reliance on often volatile short-term wholesale funding in recent years and increased their reliance on long-term funding and local deposits. Indeed, local deposits now account for around one half of bank funding needs, up from 40% in 2008. And fortunately, the debt exposures now in question are relatively more transparent then during the subprime crisis.

At the end of the day, moreover, to the extent that local banks face some wholesale funding costs pressures from abroad, the RBA should be able to largely offset this impact if need be through lowering the official cash rate further, which would reduce local deposit and short-term wholesale funding costs.

What the RBA can't control is animal spirits, or the risk that further financial market volatility undermines local business and consumer confidence. All it can do is what it did two years ago, and slash interest rates aggressively if need be. Even at 4.5%, the official cash rate could fall a lot further if required, which is luxury not shared by Europe or the United States. With relatively low public debt, Australia also faces much less aggressive fiscal tightening than other countries in the next year or so.

The consequence of borrowing from your SMSF

by Alia McMullen

It's tempting to want to dip into your SMSF honey pot if you, your business, or someone you know is struggling for cash. But there's a very fine line between what you can and can't do when lending with your retirement savings, and with the Australian Tax Office currently targeting those that break the lending rules, it's crucial you make sure your transactions are done properly.

First things first, SMSFs can lend money (read, How you can be the bank). Whether or not you're breaking the law largely comes down to whom you lend the money to.

One of the country's leading SMSF legal experts, Dan Butler from DBA Lawyers, says many trustees fall prey to a false sense of security when lending money from their SMSF because if they break the law, they are often not caught out until their next financial audit.

Lending to a friend

To lend from your SMSF, you must make sure that the person or business receiving the money is not a 'related party'. That means you, your spouse, defacto partner, your children, business partners, and in some cases, even a friend.

"If the loan's to a friend, as long as there's no relationship – business relationship, personal relationship, love relationship – it should be OK – as long as it's done at 'arm's length'," Butler says. "To do it at arm's length means they should get it documented, they should have 'arm's length' terms, and they should benchmark it to what the bank's charging."

But, even though you can lend to a friend, the situation is tricky because the reason behind the loan may be taken into account. Butler points to a recent case where a trustee wanted to lend to a friend whose loan requests had been rejected by the banks.

"Now why is the super fund standing in? Is it because it's the best investment in town? Or is because they're wanting to help a friend? If they're doing it because they want to help a friend, they're in breach of the law. If they're doing it because it's the best deal in town, and they're willing to take a punt, then that's OK."

Lending to a related party

Your SMSF can lend to a related party, as long as the loan is limited to 5% of the value of the SMSF's assets (be careful here, because, as you know, the value of assets fluctuates and this could push you over the 5% limit). If you breach the 5% cap, you will have broken the 'in-house asset test'.

Lending to a third party

Butler says the majority of lending is to third parties, and there is quite an active secondary market where sophisticated investors (generally, high net-worth individuals with years of experience in business) network to lend.

Some trustees who have wanted to borrow from their fund have tried to side-step the 5% rule by lending money to a third party, then borrowing that same money from the third party. Butler says this is illegal and the ATO won't go lightly on you if you're found out.

Lending to a private business

SMSFs can lend to private businesses, but once again, the loans must be made at arm's length.Butler says legal and accounting advice is very important before investing in a private business.

In some cases, SMSFs can lend to the business of a related party, but this immediately throws out warning bells because the transaction may be viewed as an in-house asset.

"If there's any relationship there between the business and the self-managed super fund members, we've got to be very, very careful that everything the super fund does stacks up at arm's length," he says.

If you own the company outright, you can't lend it more than 5% of your SMSF's value. The SMSF could potentially lend more if your interest in the company is less than 50%, but you should seek legal advice to determine how much 'significant influence' you have in the company. Tread carefully if your SMSF lends to a company that you partly own with someone that you have other investments with. This is considered to be a tax-law partnership and your shares in the company will likely be counted as one.

The consequences

Butler says contraventions of the law can add up quickly, and in one recent case where two trustees were lending their SMSF's money to four of their struggling businesses, the trustees were found to have broken the law 60 times.

"Merely not having a loan documented is one contravention. Merely failing to collect interest on a loan is another contravention," he says.

The ATO had previously issued a warning to the trustees, but they failed to listen.

"In this case, the fund was rendered non-complying, the trustees were disqualified from ever becoming trustees of a self-managed super fund, therefore they can't be members of a self-managed fund ever again. They're members assessments were hit at $150,000, they got a $50,000 penalty split $35,000 to dad, $15,000 to mum, and they had to pick up the ATO's costs as well as their own costs," says Butler.

How to bring foreign retirement savings home

by Tony Negline

So you've lived or worked overseas and have money sitting in a non-Australian based retirement or pension fund and now you want to bring it home. But moving your retirement savings from one country to another can have some significant tax consequences, particularly if you move too much at once.

This is quite a common problem faced by wanderlust Aussies, with the United Kingdom topping the list of overseas pension fund transfers. Hong Kong, Singapore, New Zealand and the United States are also popular source countries.

There are many factors that come into play when transferring overseas superannuation money.

Here I'm going to talk about the tax situation in Australia only. Next week, I'll look at transfers from two popular destinations, the UK and New Zealand.

The two key issues that determine the tax treatment of an overseas super benefit when it's transferred into the Australian super system are the investor's residency status and the normal contribution caps (click here to see which cap applies to you).

Residency

'Residency' refers to Australian income tax laws. It doesn't necessarily have anything to do with residency under immigration law. You can be a resident for tax purposes, but not a permanent resident of Australia for immigration purposes.

You'll probably be a resident for Australian tax purposes if you live in Australia or if you've been in Australia for more than 183 days in an income year, unless you can prove to the Australian Tax Office that your permanent or usual home is outside Australia and you don't intend to live in Australia permanently.

The next issue is how the contribution caps come into play.

Contribution caps

The bottom line is that the Australian super system may restrict the amount of money coming into Australia from overseas super schemes. All such transfers are deemed to be contributions under the super and tax laws and therefore must remain within the cap or suffer a tax penalty.

A lot of people get confused on this point because some parts of the tax laws call these 'transfers', which are often taxed differently to contributions.

As overseas super benefits are classed as contributions, anyone aged at least 75 can't move foreign super fund money into the Australian super system. Those aged at least 65, but under 75, must satisfy a minimum work test (at least 40 hours in up to 30 consecutive days).

And before a super fund can accept any overseas super benefit, they'll need your Tax File Number.

When an overseas super benefit is deposited into an Australian super fund, a trustee will need to work out the Applicable Fund Earnings (AFE). The AFEs is basically the amount your overseas retirement savings have earned – through interest or other investments – since you became an Australian income tax resident.

If you have an overseas super benefit contributed into an Australian super fund less than six months after your foreign employment terminated, then your AFE will be zero. The AFE will also generally be zero if you've been an Australian income tax resident for less than six months at the time the money is paid into the Australian super system.

For all other cases, the AFE is subject to tax. You can elect to pay anywhere between zero and 100% of this tax yourself at your marginal tax rate.

If you haven't remained a beneficiary of your overseas super or pension fund, then whatever tax you haven't personally paid will be paid by your super fund. It will pay tax on this amount at 15%.

The ATO has created a special form for this election.

Non-concessional contributions

The portion of an overseas super benefit that represents contributions and earnings to be paid to you if you leave your foreign retirement scheme is reported to the ATO as a non-concessional contribution (officially these payments are called a 'non-assessable foreign fund amount'). Your AFEs are included here, unless you've elected to have the super fund pay the tax on this amount.

As this portion of an overseas benefit is deemed to be a non-concessional contribution, it will count towards your non-concessional contribution limit. In some cases, a super fund will have to return the portion of an overseas super benefit if it causes you to exceed this limit.

Any amount from an overseas super fund that exceeds what legally has to be paid and is not a non-concessional contribution will be deemed to be a concessional contribution and is taxed accordingly. Officially, these amounts are called "assessable foreign fund amounts".

Points to remember:

- Overseas super fund transfers can be tricky.
- Consider the expenses including tax in Australia and overseas before transferring money here.
- The amount of tax you pay will depend on how long you've been an Australian resident for income tax purposes.
- Some of your overseas benefits will count towards your contribution caps.

Don't miss this!

Economists will have eagle eyes on the Reserve Bank of Australia's Monetary Policy Statement tomorrow, as they look for clues to whether another interest rate cut is on its way. Check the Switzer Super Report website for the breaking news.

Did you know?

The Government has introduced the Superannuation Guarantee Amendment Bill to parliament, which, if passed, will raise the rate of compulsory employer-paid super to 12% from 9%.

The Government has also scrapped the age limit on receiving Super Guarantee contributions, which means that as of mid-next year, those over the age of 75 and working will be able to receive employer contributions. For more, read Government scraps the age limit on Super Guarantee.