Switzer Super Report

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The month ahead

Understanding economics and the markets is one thing; understanding politicians is another - especially the ones in Europe! In today's report, I've looked to what we can expect of the markets in the coming month and how politics will play a decisive factor in where stocks end up.

Also in the Switzer Super Report, Charlie Aitken names the stocks that will take advantage of growth sectors. Ron Bewley is back with his portfolio-building series and he'll teach you how to master the art of sector weighting. And we shine the spotlight on the super rules, explaining how segregated assets in your SMSF are taxed, as well as why it's important to understand the difference between 'in-house assets' and 'related party investments.' I hope this helps with your investment decisions.

Sincerely,

Peter Switzer

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T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

My outlook for the market

by Peter Switzer

The predicament we investors find ourselves in is reminiscent of Woody Allen's take on the Cold War where the threat then was a nuclear war. He said: "More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us hope we have the wisdom to choose correctly."

The European Union (EU) is now at a crossroads and the path it chooses could have a massive bearing on what happens to the global economy, financial markets and our wealth-building portfolio of assets.

The last time I reported on the economic and market outlook I was chancing my arm, not on my training as an economist or on my 30 years of economic, financial and business commentary or on my 20-odd years of personal investment advising and education, but on what politicians might decide to do!

I'm not trained for this and deciphering politicians makes investing in stocks like what we see at the track, where our lack of knowledge and the many variables from crooked jockeys to temperamental horses turns it all into a big punt!

The Germans were given a big wake-up call on Wednesday — and it was overdue — when they were forced to pay over 2% for trying to sell their 10-year bonds. This poor bond issue now puts pressure on the longevity of the euro and should force the Germans to accept a Ben Bernanke-style role for the European Central Bank (ECB). This will help reduce interest rates for EU governments and add to money supply. It could also help European stock markets head up because it will shorten the continent's expected recession.

Over the past week, some of the confidence I had in my last economic and market update has weakened with the US economic growth reading for the third quarter coming in at 2% rather than 2.5%. Other economic stats, such as durable goods orders, were softer than expected, but consumer sentiment was higher at about 64 in November when economists expected roughly 60. I think the Yanks are still on the improve and only a serious fallout in Europe could heighten the chances of a recession in the States.

Meanwhile, the failure of the US Congress's super committee to outline new budget cuts is a problem, but I don't think it's a derail factor for the economy and Wall Street.

Over to China and the latest manufacturing numbers tell us that the country's attempt to slow down growth and inflation has worked, but the question is: has it worked too well?

The recession troubles in Europe will hit China because the EU is its biggest customer. This, along with our lower interest rates, explains why the Aussie dollar is now around 97 US cents and is heading lower. Locally, I expect another rate cut in December if this market negativity persists and therefore the chances of a Santa Claus rally for stocks now rests with the EU and particularly the Germans.

This market slide can be arrested if we see the overdue 'shock and awe' from the EU, but if we don't, the number of investors sitting on their hands, safe in cash, will escalate and share prices can only slide.

I would like to confidently predict that European officials will get their act together, but the historian in me, as well as my poor qualification as a punter, means for me that what happens to stocks in the short-term is all guesswork!

In the long-term, history says stocks go up and that's why I will be a buyer of stocks soon, but I play a long game based on buying quality stocks at bargain basement prices, if they are available.

I am hoping that the EU gives the ECB the chance to nuke their problem. It will take guts, but that's what leadership is all about!

'In-house assets' and 'related party' investments

by Andrew Bloore

Several issues need to be considered when devising an SMSF investment strategy, including the superannuation investment rules. One of these issues includes the substantial distinction that can be drawn between an 'in-house asset' and a 'related party investment'.

An **'in-house asset'** is an asset of the fund that is a loan to, an investment in or a lease with a related party of the SMSF.

A **'related party investment'** is also an asset of the fund that is a loan to, an investment in or a lease with a related party of the SMSF that meets one of the exceptions of the 'in-house asset' rules.

They seem similar, but one is in fact a subset of the other and the distinction is relevant because a fund is not permitted to invest more than 5% of its capital in an 'in-house asset', whereas no such cap applies to a 'related party investment'.

So, when is a 'related party investment' not an 'in-house asset'? That is, what are the exceptions to the 'in-house asset' rules?

Some of the most common exceptions to the 'in-house asset' rules include:

- a life policy issued by a life insurance company, but not a life policy acquired from a member of the SMSF or a relative of a member;
- an investment in a pooled superannuation trust made on an 'arm's length' basis;
- real property subject to a lease, or to a lease arrangement enforceable by legal proceedings, between the trustee of the fund and a related party of the fund, if the property is business real property of the fund throughout the term of the lease or lease arrangement;
- an investment in a widely held unit trust;
- a unit trust in which the unitholders have fixed entitlements to all of the income and capital of the trust and fewer than 20 entities between them do not have fixed entitlements to 75% or more of the income or capital of the trust;
- property owned by the fund and a related party as tenants in common, other than property subject to a lease or lease arrangement between the trustee of the fund and a related party.

In addition, an SMSF is able to invest in a unit trust or a company without that investment being considered an in-house asset if certain conditions are met. The main conditions include, but are not limited to, the unit trust or company not acquiring an asset from a related party of the fund other than business real property, do not directly or indirectly lease assets to related parties other than business real property and do not conduct a business.

For example

Mr and Mrs Brown have set up an SMSF in which they are the members and trustees. The Fund has $70,000 in cash and, as Trustees, they would like to use that to buy a one-third interest in a residential property in Byron Bay used for holiday letting.

As individuals, Mr and Mrs Brown will own the remaining two-thirds of the property and they plan to borrow money to fund this purchase using their private residence as security.

Mr and Mrs Brown want to use the holiday property when it's not being rented. However, it will be available to rent for the whole year.

What areas of concern would you have to consider for the purposes of this example in relation to the 'in-house asset' restrictions?

The SMSF and Mr and Mrs Brown can invest as tenants in common in a residential property because it falls within one of the exceptions of an 'in-house asset'. The property would need to be bought from an unrelated party.

However, they or any related party would not be permitted to rent or reside in the property otherwise it would constitute an in-house asset. The in-house asset rule is a day-by-day test and any stay by Mr and Mrs Brown or a related party would require the Trustees to include the full market value of the property as an in-house asset of the Fund. If the market value exceeds the 5% rule, then the Trustees are in breach of the in-house asset rules.

Andrew Bloore is the chief executive officer of SuperIQ.

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Stocks to buy in a sinking market

by Charlie Aitken

Last Friday night I experienced the West Australian skills shortage first hand when trying to get a taxi from the packed Burswood Entertainment Complex to Cottesloe Beach. Now, don't get me wrong – Perth has always been a taxi nightmare, but the problem gets even worse in a mining boom because the skilled taxi drivers move to the Pilbara to drive 200 tonne iron ore trucks for $200,000 a year.

The most interesting aspect of my conversations while in Perth is that large scale, long duration projects are moving into the spend stage and that is starting to have a multiplier effect on the WA service economy. We have all known that about $120 billion-plus of new resource projects have been announced in WA, yet there is always a 12 to 18 month lag between major project announcements, approvals, contract awards, and then finally capital expenditure (capex) starting. What's interesting for us now is that capex intentions are becoming capex spend.

The point is that **BHP Billiton, Rio Tinto, Fortescue, Hancock, Chevron, Shell, Apache**, and **Woodside** have started physically deploying large chunks of capex, which is finding its way into the WA engineering, contracting and mining service sectors, and then down into the transport, fabrication, heavy equipment, labour hire, accommodation, and logistics sub-contractors. The capex starting gun has been fired and the WA economy can look forward to at least three more years of unprecedented resources sector capex spend.

This was confirmed at a stock specific level this week, where engineering leader **Monadelphous** (MND) gave a very upbeat earnings guidance. Monadelphous expects revenue growth of "at least 15%" in the first half of fiscal 2012, which is very bullish considering the company is conservative. The fact Monadelphous has such forward transparency in their business is a clear confirmation that the capex gun has been fired in WA. We forecast Monadelphous to grow its earnings per share (EPS) by a cumulative 50% over the next three years.

Similarly, down the market cap chain a little, the capex spend theme was confirmed by contractor **NRW Holdings** (NWH) Wednesday, who forecast a 100% increase in net profit after tax in the first half of 2011/12. The market was 'surprised' by this yesterday, sending NHW's shares up 13%.

Yes, we can all fret about Italian or Spanish bond yields, but we are all missing a huge structural growth story right under our noses. I couldn't be more bullish on Western Australia, but this is not just about owning mining companies, it's about owning every derivative of the mining investment cycle and every direct and indirect play on WA economic outperformance as the money really starts flowing inside the state.

Perth Airport traffic is up 7% from a year ago, every hotel is full, the casino is full, every decent restaurant is now full, property prices are bottoming and office rents are rising.

Our number one recommendation remains to come out of the euromess with a heavily east-facing portfolio of structural growth stocks, that is, companies set to benefit from Asian demand. In Australia that means mining and mining service stocks, but I would also extend that strategy to companies that benefit from broader WA economic growth, consumer confidence, and broader discretionary spending.

In my view there is a total disconnect between what the equity market is discounting and what is actually happening in WA; that won't last, stocks exposed to this growth will soon attract a premium. That is why at a strategy level I am banging the table on this theme.

Here are some other stock recommendations:

Iluka Resources Ltd (ILU) – Buy

We continue to rate Iluka as a 'buy'. We expect continued tightness in the zircon and the titanium dioxide pigment (TiO2) feedstock markets driven by strong demand from China, India, Middle East, Asia and South America. We expect Iluka's share price to continue its upward trend as attention is focused on the short- to medium-term earnings, TiO2 pricing announcements (due early Dec/Jan), and its strong balance sheet.

Target Price: $20.05

Wednesday's closing price: $14.50

The Reject Shop (TRS) – Buy

We remain attracted to The Reject Shop based on a strong store rollout profile and margin upside from positive operating leverage. This supports our 20% EPS compound annual growth rate for 2012 to 2015. The Reject Shop is well positioned to recover from the setbacks in fiscal 2011 and subsequently re-rated by the market, with fiscal 2013 shaping up to be a more normalised year for the business. With the business trading on price to earnings ratio of 8.9 times for fiscal 2013 and an enterprise value/EBITDA of 4.9 times, we maintain a 'buy' recommendation.

Target Price: $12.26

Wednesday's closing price: $9.92

IOOF Holdings (IFL) – Buy

We've downgraded our fiscal 2012 earnings for IOOF by 7.5%. Where previously we estimated 3% growth for the year, our revised forecast is for negative 5% underlying cash EPS growth. Despite the negative adjustment, our investment view remains positive as we believe IOOF is in a unique position as the only middle-sized, fully-integrated wealth manager, providing differentiation from the major banks and AMP. IOOF remains attractive for any would-be acquirer, while on the other hand, has balance sheet strength to embark on accretive acquisitions itself. The company has steady recurring earnings, a diversified model with 8% fully-franked yield to support the share price. We retain our 'buy' rating with a lower price target of $7 based on earnings revisions, down from $7.30 previously.

Target Price: $7

Wednesday's closing price: $5.37

Charlie Aitken is the managing director of [Bell Potter Securities].

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Will one member's gains offset another's losses?

by Tony Negline

A Switzer Super Report reader recently asked me a good question about whether his capital losses would be offset against his wife's capital gains in their DIY super fund, or if individual gains and losses only applied when completing the annual return.

At face value, fund tax issues – including capital gains tax (CGT) – are all performed at the fund level not the member account level. This means that capital gains can be offset by losses regardless of who earns them.

However, the tax system is never this straightforward and there are exceptions to this rule, especially when paying pensions because the way the fund's pension and non-pension assets are segregated can impact the amount of tax payable.

Tax and segregation

Before we can discuss CGT in greater detail, I need to explain some structural issues impacting all super funds.

If your super fund is paying a pension and if your trust deed permits, you can elect to segregate pension assets – that is, specific assets are tagged for the purpose of paying pensions. This means all earnings (typically income and capital gains) on these pension paying assets need to be allocated correctly in the fund's financial accounts.

The Australian Tax Office (ATO) says super funds using the **segregated approach** should have a separate bank account specifically for pension assets, but some people in the super industry don't agree and the law is open to multiple interpretations.

Data from the ATO suggests most SMSFs paying pensions don't bother segregating their pension assets and instead use another method of preparing their fund accounts – the **unsegregated approach**.

With this approach, all super assets are placed in one big pot and net earnings are allocated to each member accordingly. To get an exemption from tax for your pension income each year with this unsegregated approach you need to get an actuarial certificate. (In some cases you may also need this certificate if you use the segregated asset approach.)

Using the segregated approach costs more because it typically requires more fund administration and accounting work. It would seem that most super fund trustees have decided that the extra admin expense isn't justifiable.

When running your fund, it's possible, subject to your fund's trust deed, to actually go one level below segregation between pension and non-pension assets and allocate specific assets to specific members.

Importantly, the segregated (at fund and member level) and unsegregated approaches create different CGT outcomes.

If your SMSF uses asset segregation for its pension assets then you should ignore any gains or losses from the disposal of these assets. A capital loss from a segregated pension asset can't be used to offset any other capital gain earned by your SMSF.

If your SMSF has unsegregated pension assets, you need to factor in capital gains and capital losses. Capital losses from unsegregated pension assets aren't included as deductions when you calculate your fund's income subject to tax.

If your unsegregated pension asset SMSF has a net capital loss, it can be carried forward each year until it can be offset against an assessable capital gain. Your fund's net capital gain (gains less losses) is added to the SMSF's assessable income before working out the amount of tax-exempt income, as per the actuarial certificate.

For our reader, the key issue will be how their fund prepares their financial accounts as to how CGT is treated.

Finally, trustees of super funds need to uphold the obligation to act equally between all members. This means that our reader needs to consider if it would be reasonable that one member benefits from a tax outcome generated by activities which clearly involved another member. It’s true that here we’re talking about husband and wife and it’s likely that ‘what’s mine is yours’ applies. However, such a concept doesn’t apply in all trusts, including super funds.

If you’re in doubt, I think you should consider getting good advice regarding your personal circumstances.

Building your portfolio: sectors & index-hugging

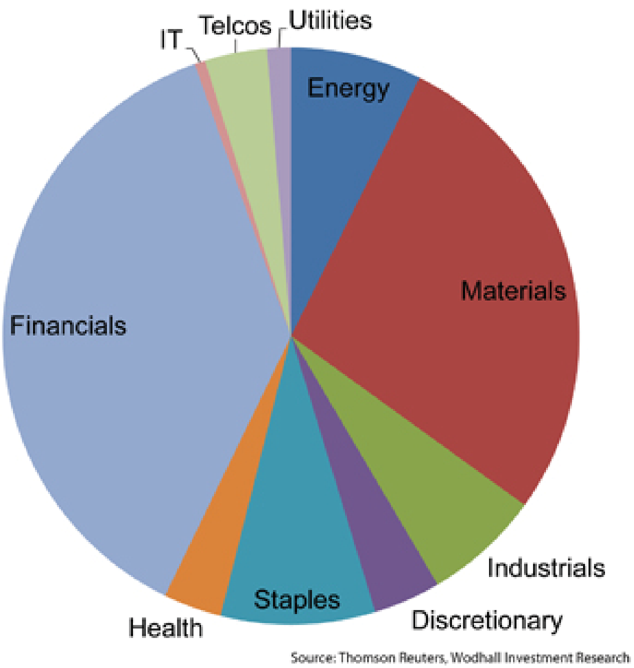
by Ron Bewley

A critical part of managing your own SMSF portfolio is understanding how to manage risk by investing in different sectors of the market.

Most Australian equities fund managers use the ASX 200, or sometimes the ASX 300, as a reference point or benchmark to compare one fund manager's performance to that of another.

Fund managers also calculate tracking error, which is a measure of how closely they follow the performance of their benchmark. Typically, this statistic reflects the standard deviation between the monthly returns of the fund and the benchmark over a period, such as three years.

Chart 1: Sector weights of the ASX 200, 30 June 2011



Source: Thomson Reuters, Wodhall Investment Research

Funds often have limits put on them about how big a 'bet' or position the manager can take on a given sector, and these are benchmarked against the sector's weighting. The composition of the ASX 200 is shown in Chart 1. Materials, including mining and building stocks, had a weight of 27.6% at the end of FY2011. A fund might have been restricted to invest 27.6% of its allocation in that sector plus or minus say 4%, in other words, 23.6% to 31.6%. But more on this in my next column.

The tighter the constraints and the smaller the tracking error, the closer the performance of the fund likely is to the index.

So why pay for such active management?

One might as well buy the exchange-traded fund (ETF) that replicates the index at a much lower cost if a manager practices so-called index-hugging. Once an investor becomes more prepared to deviate from the index, or, indeed, become 'benchmark unaware', the question of how much risk to take on becomes paramount.

In my previous column on What not to buy, I wrote about even ignoring an allocation to some sectors altogether to reduce risk.

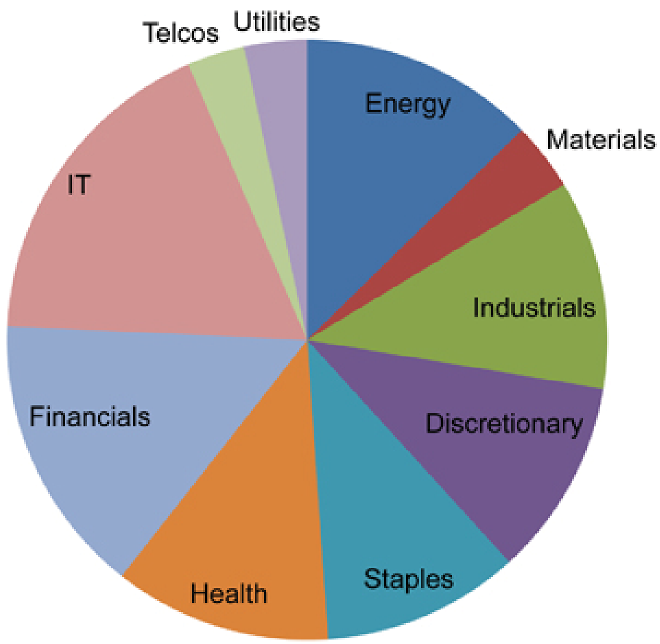
A brief look at the sector weights for the US index, S&P 500, in Chart 2, makes it clear that the compositions of the Australian and US indexes have little in common. Indeed, information technology is the smallest sector on the ASX 200 and the biggest on the S&P 500. Given that the volatilities of returns in each sector can be quite different, taking sizable 'bets' – or positions – can make the returns on the fund and the benchmark quite different.

It doesn't really matter to me how the ASX 200 is composed. It is very different from that of the US and the rest of the world. Indeed, that is one reason why many investors go global – to get more exposure to IT and global pharmaceutical companies.

But returning to risk. My own views on this topic are strong: risk comes first, returns second.

When I started investing in the stock market I kept quite close to sector weights until I started to build up an overall gain against the benchmark in my fund – which I did in case I started losing! The bigger my lead over the index, the bigger the positions I'm prepared to take. And, of course, if that lead gets eroded, I will return to a more conservative allocation.

Chart 2: Sector weights of the S&P 500, 30 June 2011



Source: Thomson Reuters, Woodhall Investment Research

At present, 37% of my fund is made up of materials stocks – all mining stocks and no building materials stocks, etc. – compared with the 27% materials account for in the ASX 200. This is a big 'overweight' position but, in my mind, I have partitioned out my most successful stock, Lynas. I have already sold 40% of my position in Lynas at prices that more than cover all of my buys. In other words, I could say that I'm playing with the casino's money in that stock.

If I didn't do that I would have had to have sold too much Lynas at too cheap a price, in my opinion. After removing Lynas from my sectoral allocation, that leaves me a little underweight at 24% in materials. I manage my Lynas stocks separately so I can better control risk – and I will do so with any other highly successful choices.

I am now (in round terms) 25% financials, 21% industrials (all mining services), 18% health, 11% energy and 1% utilities. Zero in the rest. I won't hug my index or anybody else's.

Ron Bewley is the founder of Woodhall Investment Research.

Have you missed a part of Ron's portfolio building series? Click here to find past articles.

Did you know?

You can get a lot of great stock market tips on Super TV. This week, watch Peter Switzer as he puts competing stocks head to head and asks George Boubouras from UBS and Simon Bond from RBS Morgans "Which one would you buy?".

Don't miss this!

Tomorrow - a Friday lunch in Sydney you will never forget! Former Prime Minister John Howard, rugby great Ewen McKenzie and media man Harold Mitchell take the stage in an exclusive National Leadership Series hosted by Peter Switzer. This is a must-see for anyone in business. Click here for more information.