Switzer Super Report

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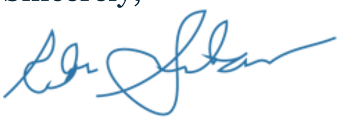
A job well done

Everyone's attention will be focused on the EU summit on Friday night and fingers crossed Europe's politicians can finally agree to solve their debt problems. But if there's a silver lining, it's that SMSFs have been handling the recent volatility pretty well, as I talk about today.

Also in the Switzer Super Report, Charlie Aitken alerts you to the 15 top stocks to lead the rally as well as his picks for sustainable yields. Ron Bewley continues his popular portfolio-building series and focuses on using risk and return. We also bring you up to speed on allocated pensions as well as two tax benefits of SMSFs compared with large funds. Let's hope I have some positive news to tell you about Europe on Monday!

Sincerely,



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

SMSFs are doing "pretty well"

by Peter Switzer

At a time when both industry and retail super funds are losing some of their best customers to self-managed super funds (SMSFs), it was interesting to hear what the Australian Taxation Office (ATO) thinks of us as a group of investors.

"They've done pretty well as a group," said Stuart Forsyth, the Assistant Commissioner of Taxation for SMSFs. (He said it! You can watch the video evidence on Super TV.)

I found that an intriguing observation because the ATO has the data to make such an opinion because it's the chief supervisor of SMSFs.

Now, prior to the GFC, there was always a bit of an industry expert concern that too many SMSF trustees were too heavily exposed to cash. A variety of arguments were advanced such as, "they were talked into an SMSF by their accountant but don't know how to invest like a fund manager and so they just leave their money in term deposits".

And while there was some accuracy in these disparaging observations for some busy types, I suspect that the importance of the job for the chief investment officer — that is, the trustee that actually owned the money — meant that they didn't want to leave themselves too exposed to the stock market.

This proved to be a very sensible view to have in 2007, especially after five straight years of double-digit gains of which four of them exceeded 20%!

But that's the past. What should the sensible investor do right now?

The gambler punts that Europe gets it right this week at the European Union (EU) Summit in Brussels on Friday night (AEST) while the safe player waits. The cautious investor will miss the market bounce if a consensus in the eurozone happens faster than history suggests it possibly could.

That said, putting your money on the Europeans has been a failed strategy for two years and while I think over the next few months, we will see the groundwork laid to build a bull market – it won't happen overnight.

Geoff Wilson of Wilson Asset Management thinks that 2013 will bring the take-off for the stock market but that doesn't mean some really positive moves can't happen before that time.

History says the stock market does well in the last two years before a US presidential election, though the third year of the four-year cycle is better than the fourth.

Also, when 10-year bond yields are less than average dividend yields, as they are in the US now, history points to a 20%-plus uptick in stocks in the ensuing year.

The New York Times in analysing Germany's Chancellor Angela Merkel noted she's seemingly ignoring financial market pressure to act quickly, while others in the EU look like nincompoops.

The NYT even had a more compassionate take on her colleagues: "But as European leaders prepare for crucial meetings this week in Brussels, what may have seemed like timid or even bumbling leadership is looking more like a consistent strategy of brinkmanship aimed at remaking the eurozone in Germany's likeness."

Merkel is seen as a new age 'iron maiden' — a Mrs Bismarck, if you like — who has been whipping her

PIIGS (Portugal, Ireland, Italy, Greece and Spain) into shape. But this is a double-edged sword as both success and failure for the EU will be hers to savour or regret.

Apparently she is in daily contact with the Obama administration, but it will be her European co-members she really has to keep onside and committed to her German-style economic repair plan for the EU.

This is an important week for Europeans and the world's investors as not only will the Brussels summit have a big bearing on the longevity of the eurozone, but the European Central Bank (ECB) should also cut interest rates at their meeting on tonight (AEST).

Markets are tentatively optimistic about this week and if they are right, it puts me closer to the time when I will tell anyone who is prepared to listen that the worst is behind us. That's when the bull market stampede will begin, the bears will go into hibernation and SMSF trustees will see much better returns. But I guess — given what the ATO says about you — many of you already know much of this!

The 15 stocks that will lead the rally

by Charlie Aitken

As you know, I've been maximum bullish/fully risk on/'recklessly positive' from early October when the ASX 200 was at 3,850. In that time it has risen by more than 10%. Since then, the RBA has cut domestic cash rates by 50 basis points from 4.75% to 4.25% – a drop of more than 10%. I don't think it's a coincidence that the ASX 200 has rallied almost exactly in line with cash rates in percentage terms.

I also believe December will not end in a market whimper. I believe the ASX 200 will take out the widely reported technical resistance level of 4,350 and head to our long held technical target of 4,477. That would represent the top end of the recent, well defined, lower, bear market trading range. When the market approaches 4,477, we at Bell Potter will reassess our short-term trading strategy.

My strategy

The way to play the next leg of this rally, in my view, is to buy the most shorted stocks and sectors. The next leg of this won't be a 'risk on' rally as such; it will be a 'short-covering' rally of grand scale as macro shorters realise the top-down short-trade in high beta stocks (materials, discretionary retailers, financials and biotechs) is over. Remember, in reality, shorting is just 'deferred buying'. (Short sellers aim to profit from a stock's decline by selling shares they don't technically own. Short covering is when short sellers buy the shorted stocks to close out their positions.)

While Australia's 'Big Four' banks have already seen some short-covering and will not lead the next leg of this short-covering rally, they will still trade higher, led by National Australia Bank (NAB).

I believe the next leg of the rally will be led by highly-shorted stocks such as:

1. JB Hi-Fi (JBH)
2. Harvey Norman (HVN)
3. Myer (MYR)
4. Billabong (BBG)
5. Seven West Media (SWM)
6. Mesoblast (MSB)
7. Bluescope (BSL)
8. Macquarie Bank (MBL)
9. Fortescue (FMG)
10. Atlas Iron (AGO)
11. Western Areas (WSA)
12. Paladin (PDN)
13. Woodside Petroleum (WPL)
14. Rio Tinto (RIO)
15. BHP Billiton (BHP)

In the heavyweight index sectors, resources will slightly outpace banks from here on short-covering. It is worth finishing today's note with a fundamental and technical view on BHP Billiton, the largest ASX 200 index weight stock, accounting for 11.65% of the index.

BHP Billiton (BHP) – Buy

One of the highlights of my year was being criticised in the Melbourne tabloid press for recommending BHP shares. I mean seriously, I will happily accept any justified criticism of our views, but to be criticised for recommending buying BHP after they have corrected by falling 28% and they are trading on the lowest EV/EBITDA ratio in 30 years still amazes me. But that aside, we have clearly reached the point where the fundamentals and technicals are converging on BHP Billiton. While the stock price has fallen 28% since April, our earnings estimates are all but unchanged for fiscal 2012. The price to earnings ratio is just 8.9-times, EV/EBITDA 6.2-times, return on equity (ROE) is 33% and sustainable yield (progressive dividend policy) is 3%.

On the technical side, the downtrend from the April high is being tested, while $34 has proved a 'triple bottom'. At Wednesday morning's ADR conversion price of $37.33, BHP is bang on the downtrend line from the April high. Our view is that downtrend will break and the next shorter-term technical target is around $41.50. If you are looking for the single best risk adjusted, mega cap, east-facing (Asia), highly liquid way of playing a less risk averse world, BHP is it. Our medium-term price target remains $54.87.

- *Price target: $54.87*
- *Wednesday's close: $37.02*

Kingsrose Mining (KRM) – Buy

We have remodelled Kingrose and reduced our exploration value to take account of the maiden resource at Talang Santo. We have increased our modelled mine life to 10 years. This is over and above the life of mine afforded by the current resource (six years); a result of confidence that Kingrose will prove up and discover more high-grade systems. Kingrose is undertaking aggressive exploration with 12 drill rigs and a $14 million exploration budget over the next 12 months.

- *Price target: $2.00*
- *Wednesday's close: $1.58*

Sustainable yield stocks

Banks are the best pound-for-pound option.

Our sustainable yield screen analysis looks to rank a mix of size, risk, growth, yield and value factors to pick the sectors and stocks that are most likely to maintain yield on a cross sectional basis. The Top 5 (ex Property Trust and Utilities) in the sector screen are Consumer Durables & Apparel, Retailing, Banks, Diversified Financials and Materials. The sector to move up the most since last month is Consumer Durables & Apparel. Banks remain the best large cap, lower risk-yield option with the Big Four banks in the top ten large cap ideas.

The best stock ideas with a market cap above $350 million, after removing property, utilities and infrastructure stocks are listed below.

The large cap stocks in the sustainable top 150 screen with greater than 6% yield expectations are:

WBC, CBA, NAB, ANZ, MQG, IAG, TLS, ASX, SUN, QBE and AMP.

Best large cap stock ideas:

ILU, BHP, WBC, CBA, NAB, ANZ, MQG, LEI, IAG, RIO

Best mid cap stock ideas:

OST, MND, FXJ, DOW, BOQ, GFF, DJS, MYR, CGF, SGM

Best small cap stock ideas:

MGX, KCN, PBG, WTF, APN, TRY, PTM, CRZ, IRE, FLT

Portfolio building: sectoral allocation risk-return

by Ron Bewley

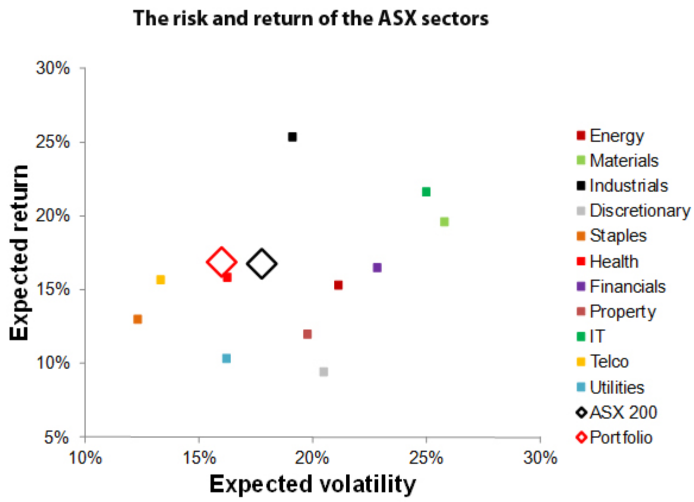
Like many analysts, I determine my portfolio weightings by my forecast of the risk-return trade-off – among other things!

I gave you a rundown of my sector weightings in Part 1 of my sectoral allocations series, when I focused on why an investor might not want to simply follow an index, like the ASX 200. Today, I'll explain how I determine risk and return.

The essence of the argument is that an investor needs to be compensated for taking on extra risk by expecting an extra return. Forecasts of risk and return change over time, and sometimes sharply. Therefore, an investor needs to 'rebalance' a portfolio from time to time, which is something I'll write more about in the New Year.

The mean-variance approach to risk-return – for which Harry Markowitz was awarded the Nobel Prize in Economic Science in 1990 – balances the expected return against expected volatility for each asset (in my case, my assets are the sectors of the ASX 200). One thing to note straight away is there is more to risk than volatility, but often volatility is about the only thing we have got to work with.

I show my forecasts in the chart below – more details can be found on my website, particularly in my Woodhall Quant Quarterly publication. Obviously, if these forecasts are of poor quality, any analysis based on them will be of little use. However, if the relative returns forecasts turn out to be wrong by about the same amount, that type of error is likely to be less serious than if the relativities of the sectoral forecasts are very wrong. The same goes for expected volatilities.



Source: Thomson Reuters, Woodhall Investment Research

In the chart, the Industrials sector has the highest expected return and a middling volatility forecast – only a little more than the index itself. Industrials dominate all of those sectors that have higher forecast volatility (to the right of the black square) and lower forecast returns (below the black square). However, (Consumer) Staples, say, has a lower return but a much lower volatility. Therefore, Staples might be preferred to Industrials by more conservative investors and vice versa. Of course, it might be better to hold some of several sectors, if not some of each of all 11 sectors.

In my column on What not to buy: Part 2 – sectors, my reasoning was not about an expected volatility-returns trade-off; in that column I was taking into account the risks I perceived that weren't covered by volatility forecasts alone – such as my opinion of the possible break in the way retail (consumer discretionary) will do business in the future with the adoption of internet practices.

The ASX 200 index, represented by the large black diamond in the chart, has close to an average expected volatility and return. The large red diamond to its left represents one possible portfolio from all of the sectors but in different proportions to those in the index. These differences in index weights are the so-called tilts.

This 'optimised' portfolio (using fairly complicated maths) has much the same expected return as the index but the expected volatility is lower. Of course other portfolios could have been constructed that have much higher expected returns by including more and more Industrials – but with more associated expected volatility. Discretionary, being of low expected return and moderately high-expected volatility, has no place in my own portfolio even without the internet.

So if we return to my own portfolio (which is not the red diamond), I hold no Discretionary, Staples, Property, IT nor Telcos. Clearly, I'm not a conservative investor. I am prepared to take the volatility swings and hold on for the long term, even through the GFC and the current sovereign debt crisis.

But this chart perhaps shows why I'm so overweight in Health. It has about the same expected return as the index but with a lot less expected volatility. Health and Utilities are my 'counterweights' to the riskier resource sectors, including mining services within Industrials. I very much use this type of analysis for my own super fund, but because I think I have the insights, I tweak the theory a bit along the way. To me, science is an excellent starting point and a great source of signalling new trends, but I never follow any method blindly.

Will your allocated pension last the distance?

by Tony Negline

Allocated pensions were a major feature of the Australian super industry for about 15 years – from the early 90s until mid-2007 – and as they were the first market-linked pension in Australia, they caused quite a stir.

In an attempt to simplify the super system, the Government stopped allocated pensions (APs) for all super funds on 1 July 2007, making [lifetime pensions] (for large funds) and [account-based pensions] (for SMSFs) the only options. However, if you commenced an AP before July 2007, as many of you reading this may have, you can continue running that pension until it's either commuted or runs out of money.

In practice, APs operate just like account-based pensions. The account balance is increased by investment earnings, including capital gains, and is reduced by expenses and income payments. Just like ABPs, the minimum and maximum income amounts have to be determined each 1 July using the net market value of the pension's assets.

Will you outlive your pension?

A specific design feature of APs was that they were designed to last for an investor's average life expectancy. For example, in 1994 a 65-year-old male was expected to live less than 15 years. In other words with fluctuations in investment earnings, and even allowing for the minimum income payment, the product on average would run out on about your 80th birthday.

I strongly suspect that not many investors who used these products actually understood this feature. With decent returns and taking modest income drawdowns most, people have managed to make these products last longer than expected.

Why they were attractive

Many retirees were attracted to APs because of their ability to provide pension income using a wider range of assets that specifically allowed them to mark their assets to the prevailing market. They also allowed pensioners to leave the assets to their deceased estate; prior to 1992 such a concept was thought impossible in super funds.

Having said that, AP weren't considered revolutionary when they were released because they worked in a way that was very similar to a life insurance product called a variable annuity, although the Australian Tax Office bludgeoned these to death in October 1988 not long after they first appeared.

So those in the super industry were amazed that the Government officially sanctioned APs just a few years after that ruling was given.

Some life companies started offering allocated annuities (AAs) in 1993. From an investor's perspective, these were essentially the same product as APs except they were provided by a life company and not a super fund. These AAs had one major advantage over APs – at the time AAs had Centrelink income and asset test concessions not available to APs. It didn't take long for the Government to close this loophole.

In many ways it took a good five to ten years before APs became a product with significant market penetration. The take-up of APs was really quite slow and it wasn't until the early part of this century that many SMSFs began offering these products.

From the time they were first offered until July 2007, APs had to pay an income between a statutory minimum and maximum. A revised set of minimum and maximum factors designed to take into account longer life expectancies were introduced in 2004.

Under the 2007 Better Super changes, the maximum income concept was dropped (except for Transition to Retirement pensions). If permitted by their trust deed, super fund trustees were allowed to adopt this new flexibility, and some SMSF trustees even converted to these new rules without worrying about what their trust deed had to say. If you were one of those, you should get your trust deed updated.

Two tax benefits of SMSFs

by Andrew Bloore

One of the great benefits of SMSFs is the considerable flexibility they offer to investors, particularly when it comes to taxation issues. Outlined below are two of the ways in which that flexibility can be used by individuals to achieve various goals which may not necessarily have been able to have been achieved using a public offer fund.

1. Tax write-back upon commencement of a pension

Say a member has contributed $100k to super during their working life and, upon retirement, the value of those contributions has increased to $250,000 due to a $150,000 unrealised gain that has accrued.

In both an SMSF and public offer fund, the member's statement would not actually show a balance of $250,000. This is because in the event of a request for the payment or rollover of their entire benefit, the underlying investments would have to be sold and the gain crystallised, resulting in a tax liability of $15,000 (that is, $150k less 1/3 discount @ 15% = $15,000). This amount has to be deducted from the member's balance under what accountants refer to as 'tax effect accounting' principles, so the $15,000 goes into an account called a 'Provision for Deferred Tax Liability'. Therefore, the member's statement would indicate a member's balance of only $235,000, not $250,000.

While the recent market performance has been disappointing, this doesn't necessarily mean there wouldn't be a deferred tax provision. The deferred tax liability that would commonly be set aside by most public offer funds would be in the order of 5% of the fund's assets.

For a member of an SMSF commencing a pension in these circumstances, upon conversion to the exempt environment, the accountant or administrator would write back the $15,000 provision subsequent to the commencement, which means the member would be immediately better off by an equivalent amount.

For the member of a public offer fund though, it's a different story. For ease of administration, most public offer funds don't have funds where members can simply convert from accumulation phase to pension phase. Public offer funds ordinarily require members to redeem their investment in the accumulation fund and acquire new units in a separate pension fund.

The effect of this is that members of public offer funds, in effect, pay tax on any unrealised gains that existed at the time they convert into pension phase. In the example above, the member would be adversely affected by $15,000.

2. Pro-active management of taxation affairs

Unlike public offer funds, SMSF trustees only have a couple of members to cater for and can attend to tax-planning opportunities in the following circumstances:

Year-end tax planning:

Funds which have made capital gains during the year and have a tax liability could consider crystallising losses on non-performing shares prior to year-end. Even if a trustee intended to retain shares that had unrealised losses, they could sell them prior to year-end to realise the loss and then re-acquire the shares soon after.

Upon commencement of a pension:

When a fund member is about to commence a pension, an investment schedule can be prepared which shows the unrealised tax position of each of the investments held by the fund. Investments that have unrealised losses can be disposed while still in accumulation phase (that is, tax losses are able to be utilised by members still in the accumulation phase) and defer realising gains until they have entered the exempt environment.

In some circumstances, trustees should consider segregating assets so as to ensure that this works out correctly.

Don't miss this!

Don't miss this Friday's crucial European Union debt crisis summit in Brussels, as France and Germany attempt to lead the 27-nation bloc into a more stable financial future complete with a common tax regime for the 17-members of the eurozone currecny area. But with the United Kingdom throwing a spanner in the works and promising not to support any financial regime that doesn't call London home, will the markets get the results they're looking for? Peter Switzer will have his take on the situation for you in Monday's Switzer Super Report.

Did you know?

Housing supply in Australia's capital cities has been increasing, partly from a drop in demand resulting from lower immigration and foreign student numbers. The improved supply situation takes some pressure off prices. At the same time, interest rates have been falling and many predict an uptick in the property market. To find out what this means for property investors, Peter Switzer spoke to John Edwards, the CEO of Residex and asked: Is now a good time to invest in real estate?