Switzer Super Report

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Baby steps

Europe is making headway with its debt problems - with or without Great Britain - but this is just the start. As 26 European nations move to adopt German-style fiscal discipline, I'm looking at what Europe needs to do next and what's in store for the global economy and the markets.

Also in the Switzer Super Report, stockbrokers are seeing weak prospects for many Australian companies, but amid the gloom there are five companies in the past week they now say to 'buy'. Plus, we road test St.George's Super Fund Home Loan product and tell you how it stacks up, and we explain the special role of market-linked income streams and how they work. Have a great week!

Sincerely,

Peter Switzer

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What Europe needs to do next

by Peter Switzer

Trying to understand what the European Union deal that got the thumbs up from 26 out of the 27 countries — Great Britain being the dissenter — is as challenging as understanding Europeans. Peoples of the New World such as Aussies and Yanks don't always get our European friends because the inputs on the Continent have been very different to ours and so the outputs are a little 'head-scratchingly' hard to comprehend at times!

My best early gauge on the value of the EU agreement was Wall Street and the Dow went up 186 points, so that's a good start. However, this EU agreement to be more fiscally responsible in the future is only another good step in the right direction. There are more to go — be assured of that.

To put this into perspective, when it comes to most matters of substance, the warring tribes of Europe historically have taken diametrically opposed positions and so let's just be grateful for small mercies.

The right direction

The EU has been heading in the right direction over the past month and that's why the Dow Jones index is up 5.24% for the year. That's a long way from the negative 11.4% our local S&P/ASX 200 is down for 2011, though I think we will whittle that gap away over the next few weeks. And I bet we end in positive territory for the financial year, as we have for the past two years — a lot of people forget that fact amidst all of our day-to-day gloom.

For the record, 2009-10 saw the index up 8.7% and that ignores dividends and franking credits. While 2010-11 was up 7.9% in prices alone. That's why I care more about financial year returns rather than calendar year results.

Let's now look at what was achieved at the EU Summit and see if it's going to help our portfolios end up in positive territory for 2011-12.

In a nutshell this is what I see:

- Chancellor Angela Merkel of Germany has imposed German fiscal discipline on the EU and 26 out of 27 countries went along for the ride.
- The UK said no and this has weakened the deal slightly but at least the debt-troubled PIIGS (Portugal, Ireland, Italy, Greece and Spain) have agreed to give up their dodgy debt ways.
- The debt solution for the PIIGS is still not clear but gaining agreement for future fiscal discipline is a start and it could bring forth supportive responses from the International Monetary Fund (IMF) and Group of 20 countries (G20).
- There is a plan to bring forward the European Stability Mechanism that has a 500 billion euro war chest and that adds to the 200 billion euro from the central bank action.

A final point needs to be made: the German win over the EU could mean a longer deeper recession because of the tightening measures; the group's actions are very different to the USA's spend and prosper approach.

Will the European Central Bank intervene?

I'm hoping we see some monetary stimulation to help bring down bond yields in Europe. That will help share prices and prevent a European recession derailing global economic growth.

This is the way *The New York Times* saw the deal over the weekend and it does sound an important word of warning to investors: “Mrs. Merkel’s strategy remains highly risky. A year ago she had miscalculated when she insisted that any bailout had to include the private sector’s chipping in with the public sector, a requirement included in the Greek rescue. The markets punished Italy and Spain for that stance, and it was dropped last week at the Brussels gathering.”

That’s why I hope to see some monetary irresponsibility ASAP as a reward for future EU fiscal discipline.

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Road test: St.George Super Fund Home Loan

by Paul Rickard

The Australian Tax Office's (ATO) draft ruling that allows SMSF trustees to make improvements to a property purchased using borrowed money will drive the rapid development of tailored lending products. In Commonwealth Bank launches Super Gear loan, I reviewed the Commonwealth Bank's super gearing product. Another bank active in this space is St.George, which has a facility called the 'St.George Super Fund Home Loan'.

A quick re-cap on the key rules and risks in borrowing to invest in property. Firstly, your SMSF can't buy a property from yourself or a related party, or rent a property to yourself or a related party. It has to be a legitimate purchase of a property from an unrelated party on commercial terms – everything has to be on an 'arms length' basis. Secondly, you can't use borrowed money to improve the property, however, you can use existing money in your SMSF to fund the improvements.

On the risk side, the biggest risk may be exposure to a single asset. While property might do well, other asset classes might do a lot better. Moreover, if your SMSF needs some money in a hurry to pay a liability or start paying a pension, property is not particularly liquid. You can't sell the 'front bedroom' and keep the rest – so make sure the property is part of the overall asset mix. Like any geared investment, even if it is positively geared, the ultimate return will largely depend on any capital gain from selling the property – so invest carefully.

How the St.George facility stacks up

On paper, it looks pretty attractive with high lending ratios, competitive interest rates and terms, and a unique offset facility.

Loan sizes start at $100,000, and go up to a maximum of $2 million against residential property.

The loan to value ratio (LVRs), which is the amount of the property's value your fund can borrow, is favourable, and depends on the type of property and SMSF trustee structure as follows:

	Individual Trustee	Corporate Trustee
Residential Property (metro)	72%	80%
Serviced Apartments	63%	70%

Apart from the LVRs, another key issue is the servicing ratio – that is, the income to support the payment of interest on the loan. St.George uses a ratio of 1.1-times for standard property, and a higher 1.25-times for serviced apartments. Commonwealth Bank on the other hand uses a standard 1.25-times.

St.George offers a little more flexibility in what it counts as 'income', and will include the rental income, other investment income in the fund, and concessional contributions (both the compulsory employer 9% and salary sacrifice). These amounts are then discounted by 20% – so the effective servicing ratio is 1.375-times for standard property.

On the interest rate front, St.George charges the same standard variable rate for a Super Loan as it does for a normal investment property loan. The standard variable rate is 7.30% (effective 19 December). Competitive fixed rates for two, three, or five-year terms are also available, as well as interest only rates (for terms up to 15 years).

A unique feature of this loan is the availability of an 'offset facility', which works like a normal online bank account. While it can't be used to re-draw, cash deposited into the offset account will automatically reduce the principal amount that the interest is calculated on. So, it would probably make sense for an

SMSF taking out a loan to move their bank account to St.George.

Another plus for the St.George product is that they are slightly more flexible around the use of personal guarantees. These will be required if you are self-employed, or if you are using income such as salary sacrifice or for that matter, the investment income of the fund to support the servicing test.

And the cost?

St.George charges a fixed establishment fee of $1,500, legal fees of $615, and a loan service fee of $12 per month. A fee of $205 per guarantee is also charged. In the first year, this will be a minimum of $2,259. You will also need to get a certificate from a qualified financial adviser stating that you know what you are doing.

Further, unlike Commonwealth Bank's Super Gear, which packages the 'Limited Recourse Borrowing Arrangement', St.George customers need to find their own 'security custodian' to hold the legal title to the property while the loan is outstanding. St.George has a panel of solicitors that can help with the documentation – or you can talk to your solicitor or administrator. Prices for this service are coming down – if you are paying more than $2,000 for a standard arrangement, you are paying far too much.

Overall, the product stacks up pretty well. Competitive interest rates on residential property, attractive LVRs and the offset facility. It probably has been targeted at (and suits better) newer investors setting up an SMSF, rather than well-established SMSFs with a diversified portfolio of other investments. This market will get more competitive, so it will pay to shop around.

A St.George Lending Manager is the point of contact, or your mortgage broker. Victorian and South Australian funds can contact Bank of Melbourne and Bank SA respectively. And by the way, St.George will also lend against commercial and rural property, however it comes from a different part of the Bank and you will need to talk to a Business Banker!

The broker wrap: 5 buys

by Rudi Filapek-Vandyck

Changes to stockbroker recommendations in the past week

Code	Company	Old Rating	New Rating	Broker
BTU	BATHURST RESOURCES	Neutral	Buy	Credit Suisse
FBU	FLETCHER BUILDING	Neutral	Buy	JP Morgan
ILU	ILUKA RESOURCES	Neutral	Buy	RBS Australia
IOF	INVESTA OFFICE FUND	Neutral	Buy	UBS
PPC	PEET & COMPANY	Buy	Buy	Citi
ABC	ADELAIDE BRIGHTON	Buy	Neutral	JP Morgan
CLO	CLOUGH LIMITED	Buy	Neutral	RBS Australia
GCL	GLOUCESTER COAL LTD	Buy	Neutral	Credit Suisse
HFA	HFA HOLDINGS LIMITED	Buy	Neutral	UBS
HIL	HILLS HOLDINGS LIMITED	Buy	Neutral	Citi
NCM	NEWCREST MINING	Buy	Neutral	Deutsche Bank
OKN	OAKTON LIMITED	Buy	Neutral	Macquarie
PRG	PROGRAMMED MAINTENANCE SERVICES	Buy	Neutral	Citi
TCL	TRANSURBAN GROUP	Buy	Neutral	Citi
UGL	UNITED GROUP LIMITED	Buy	Neutral	RBS Australia

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Citigroup strategists have advised investors across the globe to have a good look at their portfolios and reconsider those companies for which Europe represents a substantial part of sales and profits. In Australia, Citi highlighted three familiar names: **Cochlear** (COH), **Goodman Group** (GMG) and **QBE Insurance** (QBE). The implication here is that forecasts for these companies will increasingly come under pressure next year and this is likely to weight on the share price.

On the other hand, suggest those same strategists, these stocks are also likely to rally at times of euro-optimism, offering a different perspective for market participants who aim to play short-term price movements.

The past week has seen double the number of downgrades to upgrades by brokers in the FNArena database, with 10 ratings lowered and just five increased. Total Buy recommendations now stand at 57.1%, down from 57.4% last week.

Upgrades

Among the upgrades were **Bathurst Resources** (BTU), where Credit Suisse moved to an Outperform rating from Neutral given a view the smaller cap plays are now the more attractive in the Australian coal sector. Bathurst's overall rating also benefited from Citi initiating coverage with a Buy rating.

A recent profit warning saw the **Fletcher Building** (FBU) share price suffer, but in JP Morgan's view the sell-off was overdone. On valuation grounds, the broker upgraded it to an Overweight from Neutral despite a cut in its price target.

Iluka (ILU) has announced better-than-expected titanium oxide price increases, which has forced brokers across the market to lift earnings estimates and price targets. The changes suggest some upside remains for the stock, enough for RBS Australia to upgrade to a Buy rating from Hold.

A US asset sale by **Investa Office** (IOF) was well received by the market given a price in excess of book value. The sale saw it upgraded to a Buy given the potential valuation upside from further asset sales.

Management at **Peet** (PPC) offered cautious commentary at the group's AGM this week and the market reacted by pushing down the stock. The falls have been overdone according to Citi, which has upgraded it to a Buy.

Downgrades

Among the downgrades was **Adelaide Brighton** (ABC), with JP Morgan cutting its rating to Neutral from Overweight following relative outperformance. This is a valuation call as the stock is now trading close to the broker's price target.

Clough (CLO) has reported some cost overruns and margin pressure on two contracts, enough for RBS

Australia to downgrade it to a Hold, again a valuation call on the part of the broker.

Valuation is also behind Credit Suisse's downgrade of **Gloucester Coal** (GCL) to Neutral following recent share price outperformance.

With earnings to be impacted by some one-offs, UBS has cut forecasts for **HFA Holdings** (HFA). A lack of positive momentum has caused the broker downgrade it to Neutral.

A lack of positive catalysts is also behind Citi's downgrade of **Hills Industries** (HIL), as earnings are still being impacted by the strong Australian dollar and ongoing challenges in the building industry.

Deutsche Bank has lowered forecasts for **Newcrest** (NCM) given changes to production expectations, with these changes seeing a reduction in price target. On valuation grounds, the broker has moved to a Hold from Buy, the only non-Buy recommendation on Newcrest in the FNArena database.

Demand for IT services is expected to remain subdued given weak domestic economic growth and to reflect this Macquarie sees scope for some contract cancellations. This is likely to impact on earnings for **Oakton** (OKN), so the broker has downgraded it to Neutral.

A solid run in **Programmed Maintenance** (PRG) shares has seen Citi downgrade it to Neutral on valuation grounds. The downgrade comes despite a modest increase in price target. Citi has also downgraded **Transurban** (TCL) to Neutral on the same basis.

United Group (UGL) has acquired the DTZ trading assets and this offers the company a European property footprint. Despite this, RBS Australia sees a slower rate of margin improvement going forward, enough to downgrade it to Hold. Targets for the stock have risen overall to reflect the impact of the acquisition.

Changes to earnings forecasts (EF)

Code	Company	Old EF	New EF	Change	No. of brokers
AWE	AWE Ltd	6.871	7.086	3.13%	7
CPU	Computershare	51.447	52.513	2.07%	7
SWM	Seven West Media	41.313	42.075	1.84%	8
SUN	Suncorp	78.325	79.400	1.37%	8
IMD	Imdex	22.040	22.207	0.76%	3
CPB	Campbell Brothers	305.329	307.043	0.56%	7
NHC	New Hope Coal	29.775	29.900	0.42%	3
MGX	Mount Gibson	38.088	38.163	0.20%	8
ABC	Adelaide Brighton	23.550	23.575	0.11%	8
BTU	Bathurst Resources	- 0.600	- 0.667	11.17%	3
AZT	Aston Resources	17.980	- 3.600	- 120.02%	5
GBG	Gindalbie	0.671	0.243	- 63.79%	6
IGO	Independence Group	12.820	7.560	- 41.03%	5
TCL	Transurban	12.314	8.929	- 27.49%	7
PPC	Peet	7.108	5.792	- 18.51%	6
PAN	Panoramic	11.475	10.175	- 11.33%	4
AWC	Alumina Ltd	5.893	5.387	- 8.59%	8
APN	APN News & Media	13.438	12.350	- 8.10%	8
CLO	Clough	7.433	6.833	- 8.07%	3
TNE	Technology One	7.767	7.200	- 7.30%	3

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

How market-linked income streams work

by Tony Negline

Market-linked income streams (MLIS) first appeared in the early part of this century and have never been particularly popular because they were designed to solve a very limited range of problems. Some people tried to rename them Term Allocated Pensions or TAPs, but it's unusual to see these names used now.

Despite their lack of popularity, MLISs plays an important role in the pension system.

The role of MLISs in the pension system

If your SMSF pays a lifetime pension that has gone pear-shaped financially and an actuary can't certify that the pension's likely future health is robust, then you have to convert your lifetime pension to an MLIS. If you don't do this then Centrelink will impose various penalties. If you convert the lifetime pension to an MLIS, then Centrelink will allow you to retain these concessions.

If you're in this circumstance I strongly recommend you seek expert advice because the process of converting a lifetime pension to an MLIS can be quite tricky.

An MLIS is a type of account-based pension and therefore has typical features of this product genre. That is, the account balance will increase with capital gains and income earnings and decrease because of income payments and expenses. They suffer from the perennial problem for all these pension types; namely, you have to think very carefully about how income is generated in them.

This type of income stream was specifically designed to offer the Reasonable Benefit Limit and Centrelink concessions that had only been given to guaranteed lifetime pensions and annuities with specific design features. The Government wanted to give these to a wider product range.

The RBL and Centrelink concessions were removed in July 2007 and at the same time it was made impossible to commence a new MLIS, except in very limited circumstances.

There are four major features to an MLIS:

1. The pension is non-commutable;
2. The term of the pension remaining at any point in time;
3. The income that must be paid during a financial year; and
4. The investments used by super fund trustees to provide the required income.

Non-commutable

As noted, the product is non-commutable, which means once it has started it can't be stopped except to transfer the current account balance to another MLIS, non-commutable lifetime pension or annuity. More importantly, you can't take a small lump sum out of the product.

Term

The term of the pension has to be determined before the product commenced. Under the initial design of the product a complex system was put in place to determine what terms were allowed. The allowable terms took into account a pensioner's life expectancy at commencement or the life expectancy of any nominated reversionary and their life expectancies if they were both up to five years younger. It was an unnecessarily complex system designed to provide flexibility and help people, but confusion was all it achieved.

Fortunately, in time this system was dropped for something a little bit easier to understand. Now, the term of an MLIS can be anywhere between the life expectancy of the pensioner and the period of years to their one-hundredth birthday. If there is a nominated reversionary, then the term of the pension can be anywhere in a similar time spectrum.

For example, a 65-year-old male currently has a life expectancy of 18.54 years, with 35 years until he turns 100 years of age. This means the terms allowed for an MLIS are between 19 and 35 years.

Once the term has been selected, the level of income that has to be paid can be determined by reference to the remaining years in the products life. For example, let's look at a 65-year-old male who commences an MLIS with a 30-year term.

This will mean that in the first year his income must be between 4.9% and 6.0% of the MLIS's initial account balance where the assets are valued at net market value.

These minimum and maximum income levels are reset each 1 July based on the pension's remaining years. As the remaining term gets smaller, the level of income that must be paid gets larger. For example, with 20 years to run, the minimum pension must be 6.3% and 7.7% of the pension's account balance at this point in time.

The purpose of the increasing income is to ensure that at the end of the product's term all the remaining account balance will be paid out as income.

Did you know?

The popularity of annuities has boomed since the onset of the global financial crisis and its lingering stock market volatility. You can find out more about this type of income stream on our website under All about annuities.

The week ahead

Australia
Monday 12 December: Housing finance (October)
Monday 12 December: Trade (October)
Tuesday 13 December: NAB business survey (November)
Tuesday 13 December: Lending finance (October)
Wednesday 14 December: Consumer sentiment (December)
Wednesday 14 December: Speech by RBA Deputy Governor to the Australasian Finance & Banking Conference
Thursday 15 December: New car sales (November)

Overseas
Tuesday 13 December: US Retail sales (October)
Tuesday 13 December: US Federal Reserve meeting
Thursday 15 December: US Producer prices (November)
Thursday 15 December: US Industrial production (November)
Friday 16 December: US Consumer prices (November)

Annual general meetings
Wednesday 14 December: Westpac Banking Corporation (WBC)
Thursday 15 December: Orica Limited (ORI)
Thursday 15 December: National Australia Bank (NAB)

Upcoming ex-dividend
(Dividends not yet available)
Thursday 22 December: APA Group (APA)
Thursday 22 December: Commonwealth Property Office Fund (CPA)
Thursday 22 December: CFS Retail Property Trust (CFX)
Thursday 22 December: Australand Property Group (ALZ)
Thursday 22 December: MAP (MAP)