Switzer Super Report

Issue 43, 15 December 2011

Stuck in the mud

It's hard to listen to what's going on in Europe and not feel down in the dumps, but as DIY super fund investors, we've got time to ride out this storm. The market is overly focused on the short term, but as I talk about today, we shouldn't be.

My view is shared by Charlie Aitken, who in today's Switzer Super Report points to a basket of 19 small-cap stocks that have been battered by the uncertainty but stand to lead the market higher as confidence returns. Plus, we highlight the commodity ETFs available in Australia, run over when an SMSF trustee can and can't be paid for services, and give you tips on buying property in a beleaguered market like the US. It's an interesting mix of advice and I hope you enjoy it!

Sincerely,

Peter Switzer

Inside this Issue

Growth is on the horizon
by Peter Switzer
02

switzersuperreport.com.au

Switzer Super Report is published by Switzer Financial Group Pty Ltd AFSL No. 286 531
36-40 Queen Street, Woollahra, 2025
T: 1300 SWITZER (1300 794 8937) F: (02) 9327 4366

Growth is on the horizon

by Peter Switzer

This week I want to share with you the observations of my favourite US analyst — Abby Joseph Cohen — who is the senior investment analyst at the legendary money making operation called Goldman Sachs.

Cohen is an ex-Federal Reserve economist and joined Goldman in 1990 and has not only been responsible for some big calls, but is regarded as a legend on Wall Street.

Talking on CNBC she said the Brussels summit was one small step along the way to putting Europe on an even keel and while she pointed to the likelihood Europe is already in recession and volatility hurting investor confidence now, she saw opportunities.

Meanwhile, US economic activity is performing better than expected in some key areas, but investors still have a risk aversion attitude that will hold back stock prices. Part of the current selling is fund managers taking profits as they square up their books for end-of-year reporting, but Cohen insists there is great value in stocks.

"By almost any metric there is very good value in the US equity market," she said. "On a P/E (price to earnings) ratio basis, we are at 12-times earnings when we would normally be at 16 to 18-times with this sort of low inflation."

On the dividend/discount model, she says the S&P 500 index is 35-40% underpriced! The S&P index is also very cheap on a book-to-value basis.

Given that, note carefully what Cohen says: "Investors right now are taking a very short-term view and don't want to think about the valuation and how that valuation may get unlocked in 2012." Investors have no tolerance for company performance or economic data disappointment and run to cash.

Cohen says Thanksgiving usually brings more optimism about the future, but Europe's woes have been such a challenge because the unknown factor is bigger than what most investors are used to. Like the rest of us, she wants to see some policy advancement in both Europe and the US, but says Goldman's investment strategy team is still focusing on good growth companies, which are currently great value.

She thinks US financials are a classic case of undervalued companies with growth potential, but she wasn't arguing all companies were great buys.

This year my advice to investors has been to buy on the dips and concentrate on great dividend paying companies. This meant that companies such as Telstra and the Commonwealth Bank have been great buys this year, but of course there were many others.

I think this strategy still works because when Europe eventually comes up with something that is more credible and possibly involves some additional liquidity, the stock market will take off and all boats will go up on a rising tide.

That said, in this newsletter and on my Sky Business TV program next year, I will be searching for the potential high-growth companies that are badly undervalued in this negative, highly volatile investing environment. Watch this space!

An unbelievable basket of small cap stocks

by Charlie Aitken

I thought I'd be as contrarian as possible today and write about the investment case for small-cap Australian industrials on a day where bipolar equity indices are again besotted with Europe.

While hedge funds are clearly only playing equity index futures, leveraged sector exchange-traded funds (ETFs), physical commodities and currencies on a daily basis, long-only funds have been mostly focused on mega cap stocks due to liquidity. This means just about nobody professional has been touching smaller capitalisation stocks, which suggests the greatest upside leverage to a recovery in sentiment lies in the right smaller cap stocks.

In the US, small-cap stocks have started leading Wall Street and that trend seems to be coming to Australia. There were some very solid upside moves right across the Australian small and mid-cap universe on Monday, with percentage gains large because we are coming off such low share price bases. Highly shorted stocks such as Melbourne IT (MSB) led the gains.

Growing interest and demand for small-cap stocks are key barometers of improving risk tolerance. It's worth noting the one-year chart of the ASX Small Ordinaries (XAO) is testing both the downtrend from April and near-term trading range resistance around 2,400.

The spot price of gold, which I feel is the benchmark of true global fear, has been correcting and this is a medium-term positive for risk equities.

The point is if small caps start leading the market then just about **NOBODY** is positioned for it. This could easily be a repeat of what happened after GFC 1 as forced small-cap sellers were exhausted. This is strongly worth monitoring.

One of the reasons professional investors have been shying away from small caps is because there has been a feeling that capital markets are closed to them. That has been true, but it's absolutely clear they are reopening in terms of equity capital.

It's also worth remembering that the greatest leverage to domestic interest rate cuts and a peaking Australian Dollar (100.69 US cents) lie in small-cap industrials.

The strategy

I always think the right approach to small-cap portfolio construction is a 'basket approach'. This takes out a little of the stock-specific risk, but doesn't really reduce the upside potential.

On that basis, I asked our quant department to run some screens over the small and mid-cap industrial universe. As we are entering a lower interest rate/slower global growth period, I asked them to screen for what we forecast to be structural growth industrials with high sustainable yield support.

Note the number of discretionary speciality retailers in this list at the bottom of the discretionary spending cycle (JBH, SUL, KMD, TRS). Mining services, engineering, and contracting are also well represented (LCM, EHL, BKN, PRG, AAX, SKE, ASL, WDS, MIN) on that WA structural capex-spend growth we keep banging on about. IT and telecommunications also make a contribution (MLB, TPM and IIN).

Small and medium cap stock recommendations

Code	Company Name	Rating	Target Price	Size	EPS Growth (%)
MLB	MELBOURNE IT LTD	Buy	2.08	Micro	16.28
LCM	LOGICAMMS LTD	Buy	1.70	Micro	39.61
BOQ	BANK OF QUEENSLAND	Hold	8.50	Mid	39.52
TFC	TFS CORP LTD	Buy	1.35	Micro	14.45
EHL	EMECO HOLDINGS	Buy	1.39	Small	18.94
BKN	BRADKEN LTD	Buy	11.29	Small	21.91
PRG	PROGRAMMED MAINTENANCE SERVICES	Buy	2.64	Small	64.30
JBH	JB HI-FI LTD	Buy	16.88	Mid	10.66
AAX	AUSENCO LTD	Buy	3.62	Small	51.70
SUL	SUPER CHEAP AUTO	Accumulate	6.40	Small	14.42
SKE	SKILLED GROUP LTD	Buy	2.54	Small	56.70
KMD	KATHMANDU HOLDINGS	Accumulate	2.03	Small	19.12
TPM	TPG TELECOM LTD	Hold	1.58	Small	33.65
ASL	AUSDRILL LTD	Buy	3.97	Small	13.58
IIN	IINET LTD	Buy	3.25	Small	15.35
WDS	WDS LTD	Buy	0.86	Micro	91.18
CGF	CHALLENGER LTD	Buy	6.30	Mid	19.42
MIN	MINERAL RESOURCES	Buy	16.01	Small	36.71
TRS	THE REJECT SHOP LTD	Buy	12.16	Small	35.83

Bell Potter Wholesale

This list is basically an Australian small-cap industrial growth plus yield ETF and I think it's time to effectively buy that "ETF" and hold it for the next two years.

You have to be absolutely contrarian in small-cap investing, buying in times of macro, sentiment and liquidity gloom. We now have interest rates and the currency helping small-cap Australian industrials and I think it's time to selectively lift small-cap industrial weightings. The list above on a down index day like today is a good place to start.

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.*

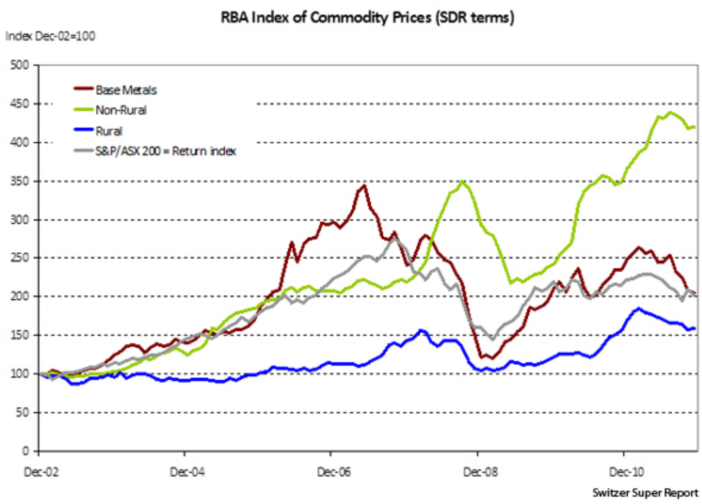
Three commodities ETFs with no currency risk

by JP Goldman

Together with international equity markets, currencies and soon to be launched fixed-income products, Australia's rapidly expanding exchange-traded fund (ETF) market is now also host to a range of commodity plays.

Want exposure to the gold spot price? Sure, no problem. What about agricultural commodity prices like wheat and corn? Or how about world oil prices?

All these investments are now possible on the Australian equity market with a simple mouse click or phone call to your local broker. And as every investor should now know, the past decade has seen a fairly broad-based global commodity price boom – across both the agriculture and mining sectors – due to rising demand from emerging countries such as China and a slow supply-side response.



Given the strong growth outlook for emerging markets, global demand for both energy and food is likely to remain quite firm in the years ahead. In this regard, commodities are considered a play on emerging market success, as well as a good hedge should global inflation take off and a handy source of portfolio diversification given the often relatively low correlation between commodity prices and equity performance.

Avoid currency risk

What's more, the latest ETF commodity offerings from innovative local provider BetaShares also hedge away currency risk – meaning Australian investors don't need to worry about reduced returns from investing in US dollar-denominated commodity indices should the Australian dollar keep rising.

As seen in the table below, Betashares offers three Aussie-dollar hedged commodity ETFs covering gold, crude oil and agricultural prices. The latter ETF tracks an index with exposure to corn, wheat, soybean and sugar prices.

Selected $A Hedged Commodity ETFs

ETF Provider	ASX Code	MER (1)
BetaShares Crude Oil	OOO	0.69%
BetaShares Agriculture	QAG	0.69%
BetaShares Gold	QAU	0.49%

(1) management expense ratio

The steep rise of the Australian dollar in recent years has reduced the Aussie-dollar returns for unhedged Australian investors in foreign markets. But with a currency hedge, the impact of our currency's movements on offshore investment returns is largely nullified – giving investors purer exposure to world commodity price trends.

At present, hedging also provides an added bonus; with Australian interest rates now considerably higher than those in the United States, the currency hedge – effectively borrowing US dollars to buy Australian dollars – provides a modest positive yield return, on top of any return generated from the underlying movement in the commodity price benchmark.

Before you buy

That said, there are a few other considerations investors need to be wary of before ploughing into this relatively new area of the market.

First, due to the cost and impracticability of physical storage, some commodity ETFs – such as for oil and agriculture above – usually gain price exposure by investing in futures contracts rather than physical holdings of the commodities they track. Because of this, they are known as 'synthetic' ETFs.

When future prices trade at a significant premium to spot prices, known as 'contango', the result is that the price performance of synthetic ETFs can underperform spot prices over time. This is because futures contracts lose value relative to the spot price as they approach expiry and need to be sold or 'rolled' into new higher priced futures contracts over time.

By the same token, however, synthetic ETFs can outperform spot prices when the futures market trades at a discount to spot prices, known as 'backwardation'.

In recent years, for example, many US investors have complained that the oil price ETFs they were holding underperformed relative to the rise in spot oil prices – which, unbeknownst to many, was due to contango in the futures market.

Another often stated concern with synthetic ETFs is counter party risk – or the risk the future contract held could be rendered worthless by the failure of the counter party to the agreement. In the case of the BetaShares' oil and agricultural ETFs at least, funds are invested in cash that is held in a separate account by a third-party custodian – the value of which is adjusted daily in line with changes in future prices. So even if a particular counter party loses the ability to provide future contract returns at some point, the ETF's capital value is still preserved in the cash account and an arrangement could then be made to deal with another counter party thereafter.

Note: the BetaShares' gold ETF, moreover, is backed by physical bullion, that is, it's non-synthetic, meaning it's performance will more closely match that of the gold spot price, and it doesn't face the counter party risks associated with derivative contracts.

Commodity ETFs expand the investment choices for local investors. But while at face value they seem relatively easy in concept to understand, it pays to 'look beneath the hood' into how they are structured so as to fully understand their likely risks and returns.

Would you like to know more about ETFs? Read, What's an exchange traded fund? and How risky is your ETF?

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.*

Can I get paid for running my SMSF?

by Andrew Bloore

Trustees may be responsible for prudently managing their self-managed super fund, but it has long been recognised that an SMSF trustee can't be paid by their fund for performing these management duties.

Having said that, there are a number of relatively common situations where a trustee may seek to perform additional duties for their SMSF – typically professional services such as accounting work – which raises the question as to whether this could give rise to some form of remuneration.

This ability for trustees to be reasonably remunerated by their SMSF for these services has generally been accepted as the norm.

Now, a recent Tax Laws Amendment Bill, introduced into parliament on the 23 November 2011, seeks to enshrine into the law some clear guidelines that will need to be met before trustees are allowed remuneration for providing professional services. If this legislation is passed, the new rules will require that, in order for a trustee to be remunerated for professional services:

- A trustee is appropriately qualified and holds all necessary licenses to perform the particular service;
- The services to be performed by the trustee for the SMSF are services that the trustee provides to the broader public as a part of their business; and
- The remuneration they receive from their SMSF for performing these services is no more favourable than if they were performing the same services for an unrelated party.

While this law isn't likely to represent a significant change for many trustees, it does provide confirmation of a longstanding view, and a greater degree of certainty for professionals with their own SMSF. In essence, it means that a trustee who isn't appropriately qualified, or who doesn't run a business providing similar professional services, won't be able to receive any sort of payment from their fund for this service.

For example

Take for example a public practice accountant who has their own SMSF. Assuming they are appropriately qualified and that they run an accounting business (independently of their SMSF), they could comfortably provide accounting services to their SMSF and be remunerated for this service to the extent that the remuneration amount is the same as that which would be charged to an arm's length client.

On the other hand, there are many other trustees who may currently provide a variety of services to their SMSF. This could include property investment or development services, rent collection, or even fund administration services. However, unless they meet the above requirements, they will be in breach of super law if they are remunerated by their SMSF.

So while providing services to your SMSF may seem like the right thing to do – and there is nothing to stop you from doing it – care should be taken before drawing that cheque.

Andrew Bloore is the chief executive of SuperIQ.

Should your SMSF invest in cheap US property?

by Tony Negline

Melbourne went through a spectacular property development bubble in the late nineteenth century. When the bubble burst there was gallons of blood on the floor and many prominent and well-respected people took the quick route away from their financial problems.

At the market bottom, it was possible to purchase whole streets of vacant blocks of land for a pittance in the now up-market Glen Iris.

You can read all about this property bubble in a fabulous book by Michael Cannon called *The Land Boomers*, which was first published over 35 years ago. I consider the book essential reading for anyone interested in markets and while it's out of print, it's still possible to find second hand and in libraries.

As SMSF trustees, our job is to invest in various financial markets and the more knowledge we can have about them, the better our investment decisions will be.

In a broad outline of human history, the widespread use of markets and free enterprise is a relatively recent phenomenon – in fact probably little more than the last 200 years. From this I conclude that our knowledge of markets and how they operate isn't much more than skin-deep. You can add to this humanity's constant inability to learn from past mistakes and the certainty that similar, but not exactly the same, problems arise.

I was reminded of this when reports began to emerge in the late 1990s that the US residential property market was going gangbusters. For over ten years property prices in other markets, for example Ireland and Spain, had also skyrocketed.

The US, Irish and Spanish property booms were never going to end well, but as the saying goes, one man's pain is another man's gain.

It hasn't taken long for SMSF investors to think about purchasing US property, especially since they have been more or less giving properties away in some places like Detroit, much like Melbournians did in the late 1800s. In Ireland, residential property is said to have fallen by over 50% from its peak in 2008 and Spain is in a similar house of pain, if you'll pardon the expression.

If you're interested in using some of your super fund's money to invest in overseas real estate, there are a number of issues you need to consider.

One

You must be prepared to own the property for many years. It'll take a long time before these markets stabilise and begin to grow again.

Two

Before purchasing a property make sure you understand the regulatory structure of property ownership in your chosen jurisdiction. Irish and US property ownership is based around land titles just like Australia but not all countries use this system. In any case, all jurisdictions have their own unique property ownership rules.

Three

Presumably you would like to rent out the property. But given there is a glut of vacant properties, it may be difficult to find a tenant. Whatever occurs with your own overseas property investments you'll need to make sure your fund's investment strategy reflects reality. If your fund needs income from the investment but you can't find a tenant, then how long would you hold the investment?

Four

In my view it's unwise to purchase real estate without seeing it firsthand. Unfortunately, I'm aware of many investors who have purchased poorly because they failed to visit the property prior to purchase. Real estate is always about location, location, location and you won't know the location unless you physically look at it.

A question here will be: can you visit your property using the resources of your super fund? Potentially yes, as long as the expenditure is solely to discharge your duties as a trustee. I suggest you seek SMSF Specific Advice from the Australian Tax Office (ATO) before proceeding.

Five

As you'll be an absent landlord you will need to make sure you have a local who will act in your best interests. Locals may not look after a foreigner's investment as well as they would a fellow citizen's property (Australian businesses wanting to expand overseas regularly find this problem with their staff).

And finally you need to understand the Australian tax laws for foreign property ownership. All income and capital gains will be taxed in Australia but any tax paid in the local jurisdiction will be taken into account if there is a double tax agreement between Australia and the country in question. The foreign income and capital gains must be converted into Australian dollars using exchange rates determined by the ATO.

Did you know?

Many SMSFs run into problems when defining beneficiaries, meaning that after the death of a trustee, benefits may be distributed in a way contrary to their wishes. To find out how you should define your beneficiaries, read How to define beneficiaries and Super polygamy: how to have multiple spouses.

Don't miss this!

ANZ Banking Group's annual general meeting on Friday, following Westpac's earlier this week and National Australia Bank's today, for another take on how Australia's banks are dealing with the eurozone crisis and their likely break with the Reserve Bank of Australia (RBA) over interest rates.