Switzer Super Report

Issue 47, 9 January 2012

Rates outlook

Europe remains the key concern for the markets as the New Year gets into the swing of things, and it's Europe that's been holding the markets back despite some promising jobs numbers out of the US last week. Europe is also a key reason our central bank has started to cut interest rates. But how low will rates go?

Paul Rickard brings you his outlook for interest rates and term deposits for 2012 in today's report, while I take a look at how Europe continues to affect our stocks. Also in the Switzer Super Report, Ron Bewley continues his portfolio-building series by charting how risk and return can help to diversify your portfolio, and Tony Negline looks at a problem that can stop you transferring your retail super pension into your SMSF.

I hope the New Year has been treating you well!

Sincerely,

Peter Switzer

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Euro pests to determine our DIY super returns

by Peter Switzer

Early stocks trade in January has started positively with the tech-heavy Nasdaq index up 2.65% since New Year, but will this be a new and more positive year for us? Last year the Yanks ended in positive territory but we were down over 12% for the calendar year.

It was a smaller drop for us of course when you throw in dividends, and anyway, I only care about my returns on a financial year basis, as that's when I pay tax on my SMSF's investments or pocket my tax rebate!

And by the way, even though it has been punishing watching stock prices over the last calendar year, we have had two positive financial years for stocks when you include dividends and franking credits. I know one of my colleague's portfolio returned a dividend yielded of 4.7% for the year, despite the fact he is fully invested in stocks that will roar back when the Euro-anxiety is eventually put to bed.

Optimists vs Pessimists

For the optimist, a local survey of investment managers showed 43% of professionals are optimistic about equity markets for 2012. Of course, that means 57% are not, but it's a much closer run than many so-called doomsday merchant experts would have us believe.

Over in the USA, a Goldman Sachs' survey of investment strategist saw the prediction that Wall Street key indexes are heading for a 7% gain this year. But that said, in the first two weeks of the year, investors are ditching stocks for municipal bonds.

So while the professional experts think stocks are the place to be in 2012, the amateurs — the retail investors of the USA — won't cop the tip. This is the European black cloud effect and it will rain on our parade this year until a credible set of policies from regulators and European Union (EU) governments are in place. That will take time but I reckon we will see it before mid-year and that will help out stocks.

If it doesn't happen, then stock prices will be pressured by that old cliché (which works so often): "sell in May and go away".

Underlining the role of Europe on share prices was a comment last week from the new Italian Prime Minister, Mario Monti, who warned about a lack of teamwork from EU regulators and that sunk Wall Street after the good job figures should have taken the market up.

The European recession

Another challenge for stock prices will be how many EU countries go into recession. This will be a running tally that will be a negative force pulling down stock prices and that's why we need to see the US remain stronger than expected. We also need to see China's economic data come in on the high side as well.

Last year I was always confident on my economic calls but I was never happy about making market predictions based on the pesky and self-interested politicians of Europe.

I expected the US to avoid a recession and grow pretty well and I terrorised the Reserve Bank of Australia over their silly interest rate policy, considering how challenged our economy was, especially with a weakening world economy. However, my economic and financial training never qualified me to understand European politicians.

We are in their hands again this year, and with the Yanks set to go to the polls in November, Barack Obama – who is ahead in the polls against the

Republicans at this stage – doesn't need a European recession hurting the US economy.

Watch this level

We are in a work-in-progress situation now and the level on the S&P 500 I will be watching is 1,300, which is now at about 1,278. If the Yanks can bust that level, we could see some investors come back to the market and upwards momentum could start.

By the way, this index is up around 19% from its low last year and that at least shows that US markets have become a more positive over the course of 2011. Against this, our market has only come back around 6.5% and that's why I'm hoping on something big and positive by June 30.

But as I have argued — we are in the hands of those pests in Europe and there's a fair bit coming out of that place this week that could move the market.

How low will the RBA go?

by Paul Rickard

The interest rate bulls are running hard. The market is factoring in two further easings by the Reserve Bank of Australia (RBA) by March, a third by June and a fourth by December 2012. This would take the cash rate down to 3.25% by year's end – a big change from the 4.75% cash rate the RBA stubbornly held onto for most of 2011.

Somehow, I just can't see this sort of change.

More cuts?

The interest rate bulls are driven by the expectation that the Euromess will continue to make liquidity very tight, and as fiscal stimulation is off the political agenda, the RBA will be forced to aggressively lower interest rates.

While a further easing of 0.25% in February or March is probably on the cards, renewed enthusiasm for the strength of the US economy, together with ongoing Australian wage inflation and concerns about a weak minority government, will temper the RBA's hand. Moreover, a leopard doesn't change its spots that quickly, and while the RBA listened to the manufacturing and retail lobby (and the market) at the end of 2011, it's not about to go overboard.

When will the hikes start?

If anything, I think we will see interest rates on the rise by the end of 2012.

Government Treasury bond rates have continued to fall – three-years are down to 3.25%, five-years to 3.4% and 10-years to 3.85%. The government bond/bank bill yield curve kinks at around the one-year mark – that is, it is downward sloping out to 12 months (reflecting expectations of further RBA easings), before taking on a more normal upward sloping shape as the maturity lengthens. As the banks price their term deposits off this curve, the term deposit market follows suit. The latest term deposit rates are as follows:

Term deposit rates

	3 months	6 months	1 year	2 years	5 years
Majors					
ANZ	5.50%	5.60% [1]	5.00%	5.30%	5.80%
Commonwealth	5.40%	5.20% [1]	4.90%	n/a	5.60%
NAB	5.50%	5.50% [1]	5.00%	5.10%	5.80%
Westpac	5.50%	5.60% [2]	5.00%	5.30% 4	5.90%
Regionals					
BankWest	5.70%	5.60% [1]	5.05%	5.05%	5.55%
BOQ	3.20%	5.70% [3]	5.30%	5.50% 4	5.00%
St George	3.25%	5.65% [2]	5.10%	5.30% 4	5.90%
Others					
ING Direct	5.70%	6.00%	5.30%	5.30%	n/a
RaboDirect	5.40%	5.40%	5.20%	5.25%	6.00%
U Bank	6.01%	6.11%	5.41%	n/a	n/a

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Rates current as at 6 January, 2012 for term deposits of > $10,000, with interest on 3 and 6 month TDs paid on maturity, interest paid annually on 1yr, 2 yr and 5 yr TDs. CBA offers an extra 0.10% for deposits of $50,000 or more.

[1] ANZ, Commonwealth, NAB and BankWest rates are for 5 months. [2] Westpac, St George rates are for 5 to < 6 months. [3] BOQ rate is for 6 to 7 months. [4] Westpac, BOQ, St George rates are for 24 to < 36 months.

As I mentioned, I think we will be seeing rates on the increase before year's end – probably in the third quarter. However, there is an easing or two to get through first. Now is not the time to be locking in for long terms.

In the term deposit market, there are some reasonably attractive rates on offer in the six- to nine-month part of the curve – ING's 6% for six months or UBank's 6.11% rate really stand out.

Deposits of up to $250,000 per investor, per bank are government guaranteed – so it makes up for the effort of opening another account. The major banks can probably be squeezed, so a rate of 5.6% should be readily achievable.

Important information: *This content has been prepared without taking account of the objectives,*

Portfolio building: allocation and diversification

by Ron Bewley

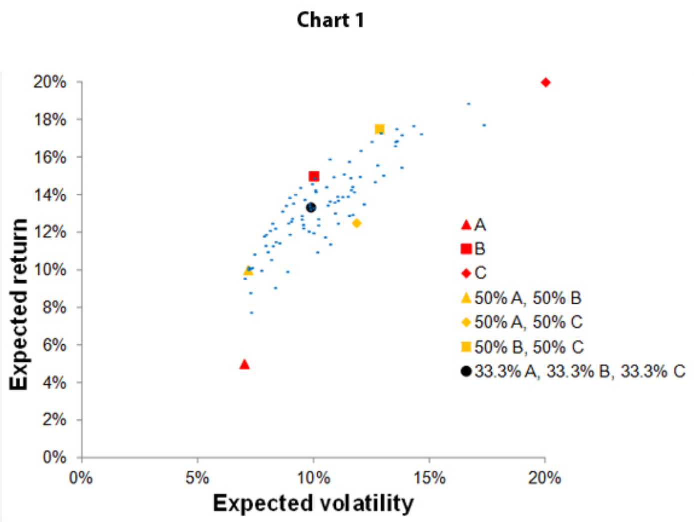
I often find new investors think of choosing a basket of equally weighted stocks as being diversification – it ain't necessarily so! Risk and return should also be taken into account.

In my previous column, I mapped out the risk-return characteristics of the 11 sectors of the ASX 200, the index itself, and the characteristics of a particular portfolio of sectors. This week I aim to show you that there is so much more to diversification than just selecting a bunch of stocks or sectors. I propose to demonstrate this using two charts, hypothetical data and the term 'risk' rather than 'expected volatility' for brevity.

So let's begin. In Chart 1, I have plotted three red symbols: one for each of the hypothetical stocks A, B and C.

Decoding the chart

In the chart of stylised risk-return, 'C' is the high risk/high return stock, 'A' is low risk/low return and 'B' is medium in terms of both risks and returns. The yellow symbols represent three equally-weighted 'portfolios' of each pair of stocks (ie, A and B, B and C, and C and A), while the black circle is an equally weighted 'portfolio' of all three (A, B and C).



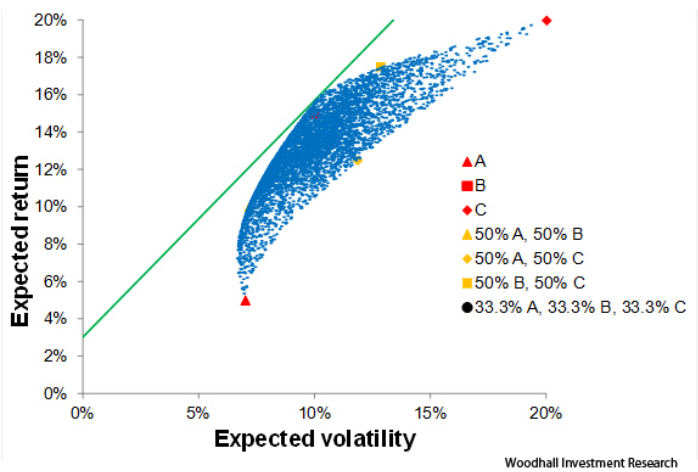
Let's calculate the return of the yellow and black portfolios. To do this, one simply takes a weighted average of the returns of each individual stock, and this will put the yellow diamond halfway up (in a vertical sense) between A and C's return. Note: the risk in this framework is not an average of the individual risks. It also depends on the correlations between the stocks or sectors. In this hypothetical example, I have set all correlations to 0.4, which means there is some degree of co-movement – but not a lot. Negative correlations are the best to gain risk benefits from combining stocks, but they rarely exist. There is a market effect that is common to many stocks and that is what I am trying to capture by the 0.4 assumption.

Notice that stock B has a higher return than the portfolio of A, B and C (the black dot) and just about the same risk. If the risks were identical, B would dominate the portfolio, as I discussed in my previous column. Obviously, the portfolio is inferior – in that sense – to having not 'diversified' by just holding stock B. Similarly, the A, B portfolio dominates A alone, etc.

The opportunities

If we start to think about not having equal weights, the opportunities to diversify increase dramatically. To start this thought process, I have 'randomly' created a number of 'blue dot' portfolios in Chart 1 to give some impression of how the process works. I take this to an extreme in Chart 2 by adding even more blue dot portfolios.

Chart 2



The blue dots start to form a cloud that will eventually get filled in as I add different portfolios. It hopefully doesn't take too much imagination to see that two curved (continuous) lines – one on the top of the cloud and one on the bottom – envelope all of the portfolios.

Understanding domination

All portfolios on the top curved line to the right of where it starts to bend under near stock A dominate all of those vertically below them in a risk-return sense. The ones on this top portion of the curve are all 'efficient' in a mean-variance sense (see the previous issue) and, because they each have a different risk, each portfolio is suitable for an investor with a different risk profile.

I don't have the space in this issue to discuss in detail where the green line comes from – but it is a straight line from the 'risk-free return' (like a bank bill rate) – which in this example is about 3% – that just touches the cloud. The portfolio at that touching point has the highest risk-adjusted return of them all. There are complicated mathematical procedures that 'optimise' this process using equations and computer programming methods.

The efficient frontier

All of the portfolios in the cloud below the 'efficient frontier' (as the top curved line is called) might be diversified in that sense that they contain more than one stock (except for the portfolio just with B) but they are inefficient. We always prefer a portfolio with a higher return for a given risk, and these lie along the efficient frontier. And we prefer a portfolio with a lower risk for the same return.

Not only is the maths complicated, but one has to forecast risk and return! I'll discuss that later, but it was precisely because my risk forecast for Consumer Discretionary stocks (like Harvey Norman and JB Hi-Fi) jumped enough to take me out of that sector in May as I discussed in one of my early columns. My optimiser chose a zero weight for that sector. And after recent days in the market, I couldn't be happier about that decision.

Ron Bewley is the Executive Director of Woodhall Investment Research.

Case study: I can't move my pension to my SMSF

by Tony Negline

Let's say you currently receive a pension from a retail super fund and you want to move it into a self-managed super fund, but you've hit a significant roadblock. This is quite a common issue, and one that was faced by a listener who called us on Peter Switzer's *The Super Show* on 2GB and 3MTR late last year.

Our caller Isabel wasn't sure what she should do and asked for our thoughts.

The problem

Let's say the pension account's balance is worth $400,000 and a small percentage of this – less than 5% – is in an investment that pays an intermittent income, but lump sum withdrawals aren't allowed from this investment.

The restricted investment is an unlisted Australian Real Estate Investment Trust (AREIT) that had been having liquidity problems for several years. Isabel is permitted to take some of her capital out of the investment once a quarter.

She wants to transfer her pension to an SMSF that she has established with her son, but the retail super fund says they can't move the account balance because of the restricted investment. How can this problem be solved?

The solution

One way of solving her problems is as follows:

- Ask the fund to rollover the pension account balance minus the illiquid AREIT investment to her SMSF. Before performing the rollover, the super fund will have to check that at least the pro-rata minimum pension has been paid. If there is any shortfall, it will make sure this income is paid before performing the rollover. The retail super fund will also want confirmation that her SMSF is legitimate – I described this process in this article last year.
- This will mean that her current retail super pension will be left with a small account balance represented by the AREIT investment balance. Isabel should tell the retail super fund that she wants to commute this pension and move the money back into the accumulation phase. This should not be a problem, but paperwork will have to be completed.
- Once the money is back in the accumulation phase, Isabel should request lump sum withdrawals when they're permitted. Our caller is aged over 60, so lump sum and pension income withdrawals from taxed super funds will not be taxed. She could consider these lump sum amounts income or, if possible, contribute them into her SMSF.
- Once the rollover arrives in her new SMSF she can commence her new Account Based Pension (ABP), which must be documented properly with pension application forms, pension agreements, Product Disclosure Statements, etc.
- Between the date when the retail super pension ceases and the new SMSF pension commences, Centrelink will treat the super assets as a deemed asset. In other words, if relevant there will be a different income test assessment. Centrelink will use Isabel's revised life expectancy for its income test for the new pension.

That's the first part solved.

We now need to turn our attention to parents and children in the same SMSF. In many families, this will produce a very satisfactory outcome. But there are a few issues that investors need to consider before running an SMSF with family members.

Unfortunately, there is an Administrative Appeals Tribunal (AAT) case called Triway Super Fund which was decided last year. Mum, Dad and their drug-addicted son were members of an SMSF and the son either stole or gave away all the money in the SMSF. The Tax Office penalised the super fund trustees including Mum and Dad and the AAT agreed with the ATO. More details about this sad case can be found in When kids and SMSFs go horribly wrong.

In every SMSF it's essential that all trustees are signatories of the fund's bank account and nominated as owners of the super fund's assets. This is not guaranteed to stop all fraud of theft, but it will hopefully stop some.

The week ahead

Australia
Monday 9 January: Retail Trade (November)
Monday 9 January: New Home Sales (November)
Tuesday 10 January: Building Approvals (November)
Wednesday 11 January: Job Vacancies (November)

Overseas
Monday 9 January: Start of two days of Chinese trade data (December)
Wednesday 11 January: US Beige Book of economic conditions across Fed districts
Thursday 12 January: US Retail Sales (December)
Friday 13 January: US Trade Data (November)
Friday 13 January: US Consumer Sentiment (January)

Did you know?

In case you missed it, Peter made 10 predictions for 2012 in last week's Switzer Super Report. Read it here on the Switzer Super Report website.