Switzer Super Report

Issue 48, 12 January 2012

Pension matters

The stock markets have been giving off some positive signs as the US economy emerges from behind a dark cloud. But will the US have enough steam to survive a eurozone recession? I take a look at what's ahead in today's report.

Also in the Switzer Super Report, Charlie Aitken names the stocks he believes will benefit from changing attitudes towards Australia in the global economy. Plus, we examine whether it's best to hold term deposits inside or outside of super, and whether or not you should take out lump sums when you're in the pension mode – you may be surprised to learn such an action could cost you later.

Good luck on the market front!

Sincerely,

Peter Switzer

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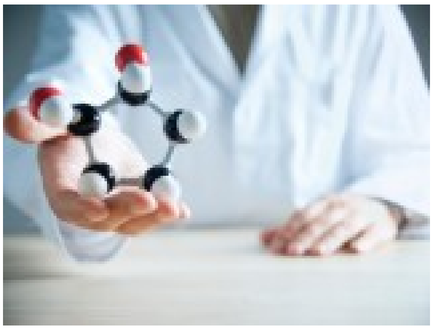

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Is the US economy decoupling from Europe?

by Peter Switzer

The first trading days into 2012 look positive but unconvincing and some big call merchants still have a lot of us spooked. Against the tentative optimism, Europe remains a massive question mark that will ultimately keep investors on the sidelines refusing to swap their cash or bonds for stocks.

Meanwhile, after six straight days of Wall Street finishing in positive territory, a new question has been posed that has important consequences for anyone trying to build wealth through stocks. That question is: "Is the US stock market decoupling from Europe?"

US resilience

Of course, the real decoupling issue gets down to whether the US economy and its key companies can weather a eurozone recession. Right now, some positive signs are coming through but they are not strong enough to take the S&P 500 through the 1,300-level. This has become a resistance point and, in order to push past it, a lot more positive stuff is needed to bank up against the negative news flow out of Europe.

This week we learnt that US consumer credit for November was up by $20.37 billion, against economists' forecasts of $7 billion. This was the biggest gain since 2001!

This follows US unemployment falling to 8.5%, confirming that their economy is a lot better than the doomsday merchants wanted us to believe last year.

Another nice sign was Alcoa's better-than-expected company reporting this week as earnings season kicks off in the States. The overall picture of company profits and sales has been downgraded recently by the experts, but if these important barometers of US economic health come in better than expected once again, then this will be another force to work against European fear and loathing.

China easing

Critical meetings over the next couple of months out of Europe, as well as recession readings from the continent will be potential curve balls for stock markets going forward. I reckon the stronger US will be buttressed by a China that now looks set to cut interest rates and add to global demand.

This is the way CommSec's Craig James saw it: "The latest Chinese trade data gives authorities further reason to ease monetary policy and boost economic growth. While export growth was in line with market forecasts, import growth fell well short of expectations. With inflation under control and numerable risks from abroad, China is well justified in seeking to stimulate the domestic economy – most likely through a reduction of bank reserve requirements. The healthy trade surplus is further reason to stimulate the economy and therefore head off US rhetoric about the need to boost the yuan (renminbi). The yuan was the third strongest currency in 2011."

One final observation could be both timely and significant. Lately we have seen negative news as a reason to buy stocks; it happened when China's import bill weakened, indicating that the economy had been slowing. This then led to expectations of easing monetary policy and that resulted in more optimistic views on future demand, commodity prices and stock prices for related miners.

Buying the dips

I haven't seen enough positive signs to advise everyone to buy stocks and wait for the gains — though I personally have been buying the dips — but what we are seeing is the day-to-day experience of the muddling through thesis.

If the Europeans can keep getting decisions more right than wrong, as they have been doing lately, then stocks will take off sometime this year.

The Yanks haven't decoupled from Europe yet — it's simply a case of the US economy being better than expected and the eurozone isn't scaring the pants off investors.

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Aussie stock opportunities

by Charlie Aitken

Since the early October lows the S&P500 is up more than 19% in raw terms and about 26% in currency adjusted terms. I think the performance of the US economy and US equity markets is the most under-reported story in all of finance. The US Dollar has bottomed for the cycle.

On the other hand, the most over-reported story is the negative one which remains Europe. There's no denying that all data from Europe remains horrible.

The euro itself continues to be de-rated, with money flowing back into US Dollars. Our target on the Euro remains US$1.20, and on that basis we can see the Australian dollar buying 85 euro cents in the not-too-distant future.

So at the global macro level we have good news from America being offset by continuing bad news from Europe. China is the global macro wildcard, but I expect a continuation of better data from China and even some more action from the PBOC to stimulate the economy now that inflationary pressure has eased.

Unfortunately Australia is just stuck in the middle of this global macro tug of war. Recent price action in Australian equities has been feeble, with that feeble price and volume action exacerbated by summer holidays.

The opportunities

Yet my view is if the world gets comfortable that China isn't headed for a hard landing, and commodity prices aren't going to collapse that Australian equities will catch a global rotation bid. Surely, surely, surely Australian equities and the Australian Dollar are more attractive than anything in the eurozone.

My theory remains that when global money comes for Australia on the China soft-landing view, it will come into resources first. That's why I am maintaining a strategic focus on the entire Australian resource and resource service stocks spectrum.

I also think global money will come for Australian biotech shares. While that seems a somewhat strange call, note very well that the mergers and acquisitions (M&A) cycle we predicted in global biotech is occurring as big pharma stares down the patent cliff. In Australia our top three biotechs with corporate appeal remain **Mesoblast** (MSB), **Bionomics** (BNO) and **Phosphagenics** (POH). You should have some biotech exposure in portfolios as a call option on further M&As.

What else is catching my eye? Copper. It is making higher lows and rallying despite the US dollar strength. I think that is bullish with copper seemingly now starting to be supported on the view US housing starts have bottomed. **Sandfire** (SFR), **OZ Minerals** (OZL), **PanAust** (PNA), **Discovery Metals** (DML) and **BHP Billiton** (BHP) are the way to play copper outperformance in Australia.

I also just keep looking at this Australian 10-year Government bond chart. My view remains that long Australian bond yields have bottomed for the cycle and will gravitate towards a yield of 4.50% over 2012. When the day comes that money flows out of the over-crowded and over-priced long bond market the beneficiary will be higher yielding Australian industrial equities, led by **Telstra** (TLS) and the banks.

And finally, it is time to take some trading profits in **Suncorp** (SUN). Suncorp has been a star outperformer in the financials yet unfortunately we have run into a 10-12% downgrade of short-term earnings due to weather related insurance claims. Suncorp failed at technical resistance at $8.70 and I wouldn't be surprised to see it pull back under $8 on the back of this downgrade. On that basis, trading profits should be locked in.

Forge Group (FGE) – Buy

In the past month Forge has announced a further $126 million in contract awards for fiscal 2012-13. On the back of these recent contract wins and scope expansions on previously announced work we now expect fiscal 2012 revenue to be about $550 million. With scope for fiscal 2013 revenue coverage to lift substantially (on the back of Roy Hill) the outlook for forge remains positive. FGE generates an exceptional return on equity, sits in a net cash position, with very high operating cash conversion and a cashed up corporate holder on the register (in CLO). Trading at 5.4-times fiscal 2012e EBITDA valuation is relatively undemanding and we retain our Buy rating and target price of $6.50 per share.

- Wednesday's close: $5.19
- Target share price: $6.50

Ausdrill Ltd (ASL) – Buy

Ausdrill has provided net profit after tax (NPAT) guidance of $48-50 million in the first half of fiscal 2012, with strong operating conditions generating about $500 million of revenue. Ausdrill is a late-cycle mining services play extracting 80% of revenues from the production phase of the cycle. It offers a relatively high level of revenue coverage and has the balance sheet leverage to capitalise on growing demand for contractor services. We retain our Buy rating and at 4-times fiscal 2012 EBITDA, we see valuation as undemanding and continue to see the scope for further contract awards underwriting additional growth in earnings.

- Wednesday's close: $3.21
- Target share price: $4.00

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Lump sum or pension? Choose at your peril

by Andrew Bloore

As our population ages, it's becoming increasingly common to see retirees with account-based pensions being paid to them from their superannuation fund. One of the attractions of these types of pensions is the flexibility that they provide.

More specifically, they provide retirees with the ability to increase the level of income received, or instead, to take additional lump sum amounts when required. When combined with the tax-free status of these payments for people aged over 60, it isn't hard to see why they are so attractive.

The sting

Interestingly though, the way in which additional money is taken from a pension could come with a sting in the tail if the retiree is also a Centrelink pensioner.

In short, when applying an income test assessment of these pensions, Centrelink recognises that some of the amounts received by a retiree are actually a return of that person's capital – this amount is aptly referred to as a non-assessable amount by Centrelink. As such, it's only in situations where a retiree receives pension income that exceeds this non-assessable amount that any income will be assessed under the Centrelink income test.

Also, additional lump sum withdrawals are not assessed as income. So, when requesting additional money from a pension, some retirees may choose to take these amounts from their pension as a lump sum withdrawal rather than as a pension payment.

However, a potential trap lies in the way that a retiree's non-assessable amount is calculated.

That's because each time a lump sum withdrawal is made (often referred to as a commutation), the non-assessable amount is reduced – and in time, particularly if regular withdrawals are made, this could lead to adverse Centrelink outcomes.

Fortunately though, in many cases, retirees will be receiving regular pension amounts that are less than their non-assessable income portion. And in these cases, it could be advantageous to maximise their income-free limit before treating amounts as lump sums.

For example:

David is 65 and started a pension two years ago using his superannuation, which was worth $250,000 at the time. He has also been receiving an Age Pension from Centrelink.

He currently receives a regular superannuation pension of $10,000 a year and his pension account balance has fallen to $200,000.

Based on his circumstances at the time, Centrelink determined that the non-assessable income from this superannuation pension is $15,423 a year. As such, none of his annual pension income has been assessed because it falls below this amount, and as he is aged over 60, the withdrawals have been completely tax-free!

However, this year David will need an extra $5,000 to pay for a holiday.

Option 1: lump sum

Now David could withdraw this entire $5,000 as a lump sum commutation amount and pay for his holiday, and because it is a lump sum withdrawal, none of it would be assessed. However, the withdrawal would cause his ongoing non-assessable portion to be permanently reduced to $15,114 a year.

While this will not be immediately problematic, it may result in more pension income being counted by Centrelink in future years – particularly if David continues to reduce his non-assessable amount by making further lump sum withdrawals.

Option 2: additional income payment

On the other hand, David could have chosen to take the entire $5,000 as an additional income payment. As this amount would not have exceeded his non-assessable amount for the year ($10,000 pension + $5,000 additional payment = $15,000, which is below his original non-assessable amount of $15,423), none of it would be assessed. But more importantly, his existing non-assessable amount would be protected.

What should you do?

It's important to find out what the impact of any additional withdrawal – lump sum or additional income – will have on your non-assessable amount so that you can work out the longer-term impact of your decision.

In many cases, it will be best to have some of the additional withdrawal amount treated as additional income payments and some of it treated as a commutation.

So, what would seemingly appear to be a simple question on a Centrelink information request form, could lead to longer-term negative impacts for many retirees that can be easily avoided with some careful planning.

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Should I hold term deposits in or out of my super?

by Tony Negline

Imagine you're retired with $400,000 in investable assets and you think you need about $24,000 a year on which to live.

These assets are currently in super and you're wondering what to do with it; should you leave the money there, or take it all and invest in your own name somewhere else?

At the end of last year, Peter Switzer's *The Super Show* on 2GB and 3MTR took a call from an investor who had found herself in this situation and had actually decided to take all her money out of super and put it into term deposits.

She wanted to know if she'd done the right thing. She wasn't terribly happy with her super fund and was concerned her account-based pension would run out of money. She reasoned that since she had a good idea of her expected income – which was being satisfied thanks to current reasonable term deposit rates – she would have greater control of her future spending needs by using term deposits.

Was it a good idea?

There are a lot of pros and cons in owning assets in your own name. For example, one pro is that it's simple and provides for complete control. Also, where relevant, capital gains tax (CGT) concessions are available, such as a 50% reduction when the asset is held for more than 12 months.

The cost of administering all personally held assets will depend on whether you employ someone to do this for you or you do it yourself.

However, a disadvantage is that time has to be allocated to collate financial information (there are some administration services, sometimes called Wrap Accounts, which will do this for a fee but only for certain types of assets such as widely held managed funds and ASX listed equities). Further, income is taxed at personal income tax rates and there are often limited options to reduce this tax, especially in retirement.

Assets aren't protected from creditors and can also be subject to Family Court action. Most assets held in your personal name are counted for Age Pension purposes and may therefore limit the potential for accessing social security payments and various associated tax concessions.

Further, from an estate planning perspective, it's easier for the surviving family to challenge estate plans for assets held in a personal name. This is the case even with a specific will and these situations can be tied up in the courts for years.

Reduced Centrelink payments

From a Centrelink perspective, term deposits held outside of super are not only counted under the assets test but also under the income test. That is, the assets are deemed to earn a certain level of income. For a single person at present, the first $44,600 is deemed to earn 3% per annum and the remainder is deemed to earn 4.5% a year.

For Centrelink purposes, therefore, our caller will have earned $17,331 a year, which is equal to $666.58 per fortnight.

(44,600 x 3% + ([$400,000-$44,600] x 4.5%) =
$17,331 ÷ 26 weeks = $666.58)

The net result is that the investor's Centrelink Pension will be reduced under both the assets test and the income test.

Term deposits in super

What about super? Well, I wonder if our caller has made the classic mistake of thinking super is an investment, just like term deposits, rather than an investment structure where investments are held. It's possible, subject to your super fund's trust deed, to invest the fund's money into a term deposit. This way you can get the security of a term deposit as well as the benefits of superannuation.

What's more, there are Centrelink advantages in using super, especially from an income test point of view.

The income test

The amount counted under this test is the pension income less an amount called the deductible amount (DA). The DA is calculated as follows for account-based pensions:

Purchase Price ÷ Life Expectancy

The DA is calculated when the pension commences and will not change.

So, if our caller was aged 65 when her account-based pension commenced, she would have a life expectancy of 21.62 years (click here for a guide on life expectancy). The DA would have been $18,518.

($400,000 ÷ 21.62 = $18,518.52)

If her pension paid her $24,000 in income, then only $5,498.61, or $211.48 per fortnight, would be counted in the test.

($24,000 – $18,518.52 = $5,498.61 ÷ 26 weeks = $211.48)

She will, however, have to count the pension assets under the assets test.

Clearly, doing the number crunching and comparing your options are important.

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Did you know?

Rudi Filapek-Vandyck, one of our stock experts and the editor of FNArena, says there are two factors that will need to turn in order for stocks to go higher in 2012. Click here to read what they are

Don't miss this!

Monday's Australian economic data, which will show the latest inflation and housing finance figures. Craig James from CommSec says inflation is expected to remain under control, while a 3% rise in housing finance is likely. Controlled inflation and a rise in housing finance would be good signs of growth for the Australian economy.