Switzer Super Report

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Golden opportunity

The stock market has had some good days this year, but days like today where negative news out of Europe scares it into retreat remain the key risk. But while the market continues with its emotional swings, the charts are starting to plot out something very interesting - a golden opportunity - and I tell you about it in my column today.

Also in the Switzer Super Report, we explain three strategies for trading options, which are a good way to hedge your bets in uncertain times. Plus, we highlight some good defensive and aggressive ETFs for your portfolio, and demonstrate how cash can be used to diversify and reduce volatility in your SMSF.

Have a great week!

Sincerely,

Peter Switzer

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A golden opportunity for stocks

by Peter Switzer

Right now the future of stocks is caught between the good reasons for being optimistic about the USA's outlook and the fear the European Union will come up with a crazy decision or a shocking economic figure that could derail the building positivity.

However, there could be something better than a silver lining inside this dark cloud that hangs over our stocks and it's called a golden cross!

Now, this kind of lingo is the domain of those that live in the technical world of charts and predictive wriggly lines.

Chris Johnson of the Johnson Research Group was interviewed on CNBC recently and he explained that a golden cross event was looming with the S&P 500 index. This is a very bullish sign and one that has a nice strike rate for those in the prediction or forecasting caper.

The golden cross

A golden cross happens when the 50-day moving average crosses over the 200-day moving average to the high side. This action has the impact of dragging up the 200-day moving action and history says when this happens markets go into positive territory.

Johnson says you can expect something like a 6% increase over six months and the positive correlation of golden crosses leading to good times for stocks is in the order of 80-90%.

So it is interesting that this emerges at a time when the positives from the US economy and company reporting are battling the negatives from Europe.

If the US was still battling the false claims by experts that it would be heading into a double dip recession, and you then threw in the uncertainty that is Europe, I could have easily argued that a golden cross lift could be a long shot. However, provided we don't get a big and unplayable curve ball from the EU, we've got a reasonable chance of seeing a golden period for stocks.

Johnson says he expects the cross to happen in the next three to four weeks and if it happens it will spark confidence resulting in a lot of money parked on the sidelines in cash to come back to stocks.

For the historians, a golden cross of this kind has happened 21 times since 1970, according to Johnson.

The risks

I would suggest there are a host of factors that could determine whether the cross turns up and if it can have a solid impact on stock prices. These would include:

- How US company reporting goes over the next few weeks, especially the banks this week.
- The impact of the S&P downgrades for nine eurozone countries, including France.
- Whether or not the eurozone moves into recession and how bad it would be. S&P says there is a 40% chance of eurozone gross domestic product (GDP) contracting by 1.5%.
- The calibre of EU negotiations about managing debt and deficits.
- The fear that fiscal responsibility will weaken demand further and worsen any upcoming recession.
- The bond auctions for these countries (which improved last week).
- Whether Greece defaults, creates contagion and dumps the euro.

Of course, I could go on and even focus on the positives, but the real challenges are potential negatives that could tarnish the glitter of this looming golden cross.

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Three popular strategies for trading stock options

by Paul Rickard

With the outlook for the US economy starting to look positive, I'm a little more optimistic than most about the direction for our share market. That said, it's hard to see a big rally until the "Euromess" shows signs of being under control, and in these challenging times, exchange-traded options could have a role to play in your self-managed super fund – either to boost returns, or allow you to sit out and wait until confidence returns.

Before you consider trading options, you will need to do two things:

1. Make sure that your SMSF's written investment strategy allows you to trade options, and if not, modify it and then authorise via a Trustee Resolution. The investment strategy should briefly substantiate how the use of options will help enhance or protect your portfolio's returns.
2. If you haven't got an options account with a broker, you will need to open one. Most advisory and online brokers such as CommSec offer these services, and as there is not quite as much competition here on brokerage rates, it may pay to shop around.

So, to the strategies. Let's look at three popular ones (there are scores of them): the 'long call and cash', the 'protected put plus stock', and the 'covered call' or 'buy and write'.

Long call and cash

Construction	Buy equity index call options. Leave portfolio invested in cash
Your market outlook	Bearish – although feel market could turn around if confidence returns
Upside	If market falls, opportunity to buy equity portfolio at much lower cost. Protection against a major market rally.
Downside and costs	If market stays flat, will lose premium. Options will expire – so protection only provided until option expiry.
Notes	Index is S&P ASX 200. Option value $10 per index point. European.

With market volatility having fallen, this strategy is now less expensive. An at-the-money March 4,200 call (ASX code XJOLZ7) will cost around 112 points ($1,120), a June 4,200 (XJOW17) 210 points. If that is too expensive, the out-of-the-money 4,400 Mar call (XJOM47) is around 37 points, the 4,400 June call (XJOW97) 118 points. You will need around 2.38 option contracts per $100,000 of equity portfolio protection – and remember, the protection is time limited.

Protected put plus stock

Construction	Buy 100 underlying shares (e.g. CBA) or use existing portfolio, and buy 1 CBA put option
Your market outlook	Cautiously bullish – feel share price will rise but are concerned about market sentiment and want some protection
Upside	If stock price rises, profit from an increase in the share price. If market falls, exercise put option (i.e. sell stock) at strike price
Downside and costs	Premium paid for option. Options will expire – so protection only provided until option expiry.
Notes	100 shares per option contract

Unlike the index options above, taking protection over a portfolio of stocks will involve multiple stock options. Volatility across most stocks has also fallen, so this strategy is now less expensive to implement.

Covered call (buy and write)

This is probably the most popular strategy for long-term share holders such as SMSFs because it can be used to enhance the income return on your portfolio and is particularly suitable to a range-bound market. Some insulation against a rising market can be achieved by selling out-of-the-money strikes – although this obviously reduces the income return.

Construction	Buy 100 underlying shares and sell 1 equity call option. Alternatively, sell 1 equity call option against every 100 shares you already own
Your market outlook	Neutral to slightly bullish – expect market to be range bound. Objective is to earn income from the sale of the call
Upside	Premium received, plus potentially any difference between strike price and the price you acquire the stock
Downside and costs	If market rallies, option will be exercised by buyer. You will sell the stock at a lower price than you may have otherwise achieved
Notes	100 shares per option contract

If you are interested in the covered call strategy to boost income on your portfolio, be mindful that share options are 'American style', which means that they can be exercised at any time. Dividends can have a big impact – and if they are fully franked, they will be worth a lot more to an SMSF than they will be to the market.

For example, Commonwealth Bank (CBA) is due to go ex-dividend on 20 February and is expected to pay a fully franked dividend of $1.42. February CBA options expire on 23 February, so if your written call option is at or near the money as the 'ex-date' approaches, there is a strong chance that it will be exercised. While on paper this shouldn't be a problem, it is unlikely that when CBA trades ex-dividend, the new CBA stock price will fully adjust for the grossed-up value of the imputation credits. One way to lessen this risk is to stick to option series well away from ex-dividend dates – for example, the March series rather than the February series.

The ASX has some great resources on options trading. If you want to learn more, the '[Understanding Options]' booklet can be downloaded is a good place to start.

For more advanced option strategies, the ASX's '[Options Strategies]' booklet is also available.

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Aggressive and defensive ETFs for your SMSF

by JP Goldman

With the global financial crisis and Europe's sovereign debt problems, volatility in global financial markets has picked up in recent years. It begs the question: how can risk-seeking investors best exploit such volatility, or risk-averse investors protect their portfolios?

In other words, which investments on the Australian market provide the most aggressive and defensive opportunities?

As is usual, I'll concentrate on the opportunities in the exchange-traded funds (ETFs) area, which now enable investors to tap into a variety of international markets and sectors.

Defensive ETFs

Let's start with defensive investments – or those that are likely to fall by less, or even potentially gain in value should overall Australian market conditions deteriorate. In this regard, holding defensive investments can greatly help diversify one's portfolio, and help protect the downside in times of trouble.

It may surprise some to know that – thanks to the general pro-cycle behaviour of the Australian dollar – most international equity markets offer useful defensive properties.

To date, all international equity ETFs available on the Australian market are valued in Aussie-dollar terms, or unhedged, meaning you take on the currency risk of the offshore market one invests in. If you invest in the iShare's S&P 500 ETF (ASX code IVV), for example, you not only have exposure to America's S&P 500 index but the bilateral exchange rate between the Aussie and US dollars. As has been evident in the past two years, if the Aussie dollar rises relative to the greenback, it reduces the Aussie-dollar value of your US ETF investment – and vice versa.

As in recent years, the Aussie has tended to rise when global equity markets are rising – and the reverse is also true – so the effect has been to dampen the volatility of Aussie-dollar returns, as through an unhedged ETF, when investing offshore.

For example, between 2003 and 2011, the standard deviation of annual price returns for the S&P 500 index in US-dollar terms was 19%. Yet in Australian-dollar terms, the standard deviation in S&P 500 returns was only 9%.

Over this period, every 1% annual price change in the S&P/ASX 200 index has tended to be associated with a 0.3% gain in Aussie-dollar terms for the S&P 500 index – in other words, the S&P 500 has a 'beta' of only 0.3 against the Australian market.

Defensive gold

But there have been even better defensive investments than the S&P 500 index. The beta for Australian-dollar gold returns (ASX:GOLD) over this period was minus 0.3, which means the gold price in Aussie dollars tended to rise by 0.3% for every 1% fall in the S&P/ASX 200 index. And it's now also possible to hedge currency risk when investing in gold through another ETF (ASX:QAU) – and even on this basis the correlation with the Australian market in recent years has been fairly low.

iShares also offers (unhedged) ETFs in relatively defensive global sectors such as healthcare, telecommunications and consumer staples. Again, the correlation in returns between these sectors and the Australian market in recent years has been fairly low.

To my mind, while gold has been a good defensive play in recent years, valuations for the precious metal are now so high that there's a risk of a significant price correction over the next few years –

undermining its defensive qualities. If you're looking for defence at reasonable value, the iShare's S&P Global consumer staples may be the ticket (ASX:IXI).

Aggressive ETFS

For those wanting to chase the upside, probably the more aggressive plays would be in emerging markets (ASX:IEM), or even narrower BRICc ETF (ASX:IBK) covering just Brazil, Russia, India and China. Between 2003 and 2011, the betas for IEM and IBK against the Australian market were a reasonably high 1.2 and 1.5 respectively. Local resource sector ETFs (RSR, QRE or MAM) also enjoyed high betas and offer similar upside potential if the commodity boom returns in earnest.

But, if you really want to chase risk, you really can't go past China itself, through iShares ETF (ASX:IZZ). China's stock market has gone nowhere in recent years and is now quite cheap by historic standards. With China's economy cooling and policy makers inching toward an easing in tight credit policies, China's stock market may be poised to take off once more – especially if local Chinese investors redirect their speculative energies from the overheated property market to the long neglected equity market.

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Portfolio building: diversification with cash

by Ron Bewley

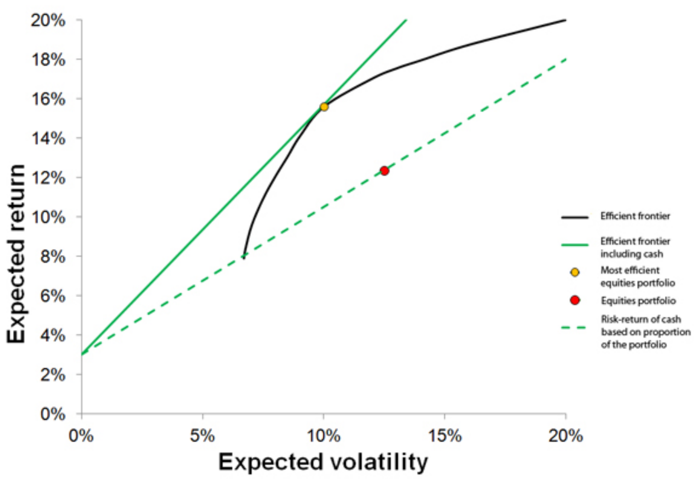
Last week I wrote about how all equity portfolios are not the same – some are more efficient – that is, they offer a better expected return for the same expected risk. And there are different sorts of efficient portfolios for investors with different appetites for risk. This week, I will add cash into the mix to show how cash opens up even more good choices for investors.

Cash and risk

We usually assume there is no risk in holding cash so that cash has zero volatility associated with it. Carrying over last week's stylised discussion, cash was assumed to earn 3%.

Let us now assume that the investor is considering holding the equity portfolio denoted by the red circle in the chart below. That portfolio happens to have an expected return of 12.375% and an expected volatility of 12.5%.

Chart 1: Stylised efficient frontier with cash



If the investor chooses to hold a proportion of his or her wealth in cash (say 20%) and the rest in the red portfolio (80%), the expected return of the equity portfolio and cash falls to 10.5%, a simple weighted average.

$$(0.2\ (3\%) + 0.8\ (12.375\%) = 10.5\%)$$

Reducing volatility

Since the volatility of cash is zero, the volatility of this new cash/equity portfolio is equal to 80% of the volatility of the red equity portfolio alone, which works out to be 10%.

$$(0.8\ (12.5\%) = 10\%)$$

If we choose proportions in cash other than 80%, the risk-return alternatives follow the green dotted line in the chart. The line cannot go to the left of the returns axis, that is, negative volatility is not possible.

However, the green dotted line goes on forever towards the right. At any point to the right of the red circle on the green dotted line, the proportion of cash is negative – that is, the portfolio is geared by borrowing to invest.

Although standard gearing (or a margin loan) is not allowed in an SMSF portfolio, let me temporarily sidestep that one for a paragraph or two. From last week's column we know that the portfolios above the dotted line and up to the black efficient frontier are not as efficient as those on the black line itself.

Preferable portfolios

However, had the investor chosen the yellow circle portfolio (the equities portfolio with the higher risk-adjusted return), we can see that all portfolios on the solid green line (being combinations of cash and the yellow portfolio) are preferable to those within or on the efficient frontier – except for the yellow portfolio itself which has no cash. If the green line was steeper there would be no feasible portfolio with which to blend it with cash.

The new efficient frontier

If the green line were shallower – say the dotted line – there is always a portfolio with higher expected returns, but with the same level of risk vertically above the dotted line on the (extended) green line. The yellow portfolio is the maximum Sharpe-ratio portfolio, so named after the Nobel Laureate who constructed the theory. The green line is the new efficient frontier when cash is included.

It follows for investors outside of super that there is only one equity portfolio for them if they are prepared to hold cash or borrow on loan. On the geared side, both expected risk and return climb up the green solid line as the investor swaps the risk inherent in the portfolio for the gearing risk that is amplified by borrowing. It makes no sense to gear up a portfolio that carries more expected risk than the yellow portfolio. Equity portfolios can carry too much risk – particularly if they are geared!

Using the strategy

For the SMSF investor, holding some cash is usually very wise. Since gearing is not allowed, the efficient frontier is the solid green line from the vertical axis up to the yellow circle – and then it follows the black line to the right.

Importantly, there are many opportunities for SMSF investors to hold cash and make significant gains in expected returns for the same level of risk on the dotted line as the equity portfolio directly below it on the black line – and there is nothing in between! So, if the SMSF has low volatility stocks and no cash, it might be worth exploring swapping some of the low equity return for riskless cash! It all depends upon expectations.

In the next set of articles, I will explore how one might choose the number of stocks an investor might hold in an SMSF.

Ron Bewley is the Executive Director of Woodhall Investment Research.

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The week ahead

Australia
Monday 16 January: Monthly inflation gauge (Dec)
Monday 16 January: Housing finance (November)
Tuesday 17 January: Lending finance (November)
Wednesday 18 January: Car sales figures (November)
Wednesday 18 January: Consumer sentiment (January)
Thursday 19 January: Employment / unemployment (Dec)
Friday 20 January: Import & export prices (December qtr)

Overseas
Tuesday 17 January: Two days of Chinese economic data (December)
Wednesday 18 January: US Producer prices (December)
Wednesday 18 January: US Industrial production (December)
Thursday 19 January: US Consumer prices (December)
Thursday 19 January: US Housing starts (December
Friday 20 January: US Existing home sales (December)

Ex dividend
Wednesday 25 January: Westoz Investment (WIC), 1 cent
Wednesday 25 January: OzGrowth Limited (OZG), 0.2 cents

Don't miss this!

Have you missed some of Ron Bewley's portfolio-building series? You can look back over past editions in the [Switzer Super Report archives](#).