Switzer Super Report

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Is doomsday coming?

If the media headlines are to be believed, we're about to enter a global financial crisis worse than the first. I'd like to point out that the source of this doom and gloom is none other than the World Bank, and I tell you what I think of them in my column today.

Also in the Switzer Super Report, Charlie Aitken has three stock recommendations from three different market sectors. Plus, we explain why a corporate trustee structure is best for most DIY super funds, and we look at the issues raised when including children in your SMSF. And, you can also search our new term deposit rate comparison table, which we'll update for you weekly.

Enjoy today's report!

Sincerely,

Peter Switzer

Inside this Issue

Three stock recommendations
by Charlie Aitken
04

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Please ignore Freddy Krueger and the World Bank

by Peter Switzer

Now that most of us are close to being back to work for 2012, I thought I would lay down my expectations – not my predictions – for the year.

I thought it was the least I could do when I saw the Sydney Morning Herald's headline: "Financial Crisis: get ready for next wave!"

This came out of a World Bank warning that a downturn was coming that was going to be so severe it would be worse than what followed the collapse of Lehman Brothers. This, in a nutshell, would be global financial crisis (GFC) Mk II.

After teaching economics at such august places as the University of New South Wales, and writing as well as analysing finance and economic matters for major newspapers and other media outlets for over 27 years, I have learnt a thing or two about what the media can do with the warnings of impressive sounding bodies such as the World Bank, the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD).

Bad track record

Let me say, straight up, this mob have the tipping credentials of trainers and jockeys who are about as reliable as a taxi turning up on time on a wet day.

When it comes to tipping a GFC Mk II, I go back to an old Billy Joel line with a twist: "They may be right. They may be crazy." In fact, I think they have gone over the top and Wall Street, at least for most days this year, have agreed with my more cautious view on what lies ahead for the world economy and stock markets.

I reckon Westpac's chief economist, Bill Evans, put this World Bank warning story into a sensible context when he pointed to the World Bank's actual forecast for the global economy over 2012. The Bank has peeled back its old forecast from 3.6% to 2.5% and while some alarmists call anything under 3% growth for the world economy a recession, the fact is that when the global financial crisis happened, the world economy actually went into a real recession and contracted!

Economics and economic forecasting are complex games and that's why the Treasury, the Reserve Bank of Australia and most banking economists have been way off the mark with forecasts for inflation, economic growth, the stock market, unemployment and interest rates. Then throw in that the media has been trained to jump on bad news with glee and treat good news with suspicion and you have the reason why newspapers run with scary headlines that will spook investors.

I blame the media and a few well known people, one of which I tag as the Freddy Krueger of finance commentary, for scaring people into cash and out of sensible investments in the stock market. I hope these guys can warn people when the next big bounce of the market happens ahead of the start of the inevitable bull market.

If he can do that, he is not Freddy Krueger, he is God!

A look at the numbers

I reckon it's worthwhile to review what has happened with stocks since the GFC and even since the market crash before — the dotcom bust in 2002.

Let's just look at the recent GFC. Using S&P/ASX closes we can see what happened to many investors' and super trustees' nest eggs. Their share wealth peaked on 1 November 2007 with the index at 6,828.7 and by 6 March 2009 it had more than halved to 3,145.5.

In that month the first big bounce happened and by 11 April 2011, the index climbed to 4,971.2. We are now at 4,217.9, so with this info we can have a look at how risky shares are and whether the media is too misleading for investors to rely upon.

If we start at 13 March 2003, which was the index closing low of 2,700.4, by 1 November 2007 the index had grown to 6,828.7. That's a 152% gain in just four and a half years! So if you had $100,000 invested over that period it would have grown to $252,000.

Even if we look at where we are now at 4,217.9, the jump from 2003 when the index was 2,700, is still pretty good. It is about 56%.

That means if you have $100,000 in stocks over that time you would now have $156,000, but if you had it in a 5% term deposit, it would only be $140,000.

Investing in term deposits gives you peace of mind, but you won't get the highs of seeing the stock market zoom ahead when the worst is behind us.

So is the worst behind us?

I suspect there could be some dramatic moments ahead linked to Europe, but I think they will manage it. I expect the European Union to sign up to more fiscal discipline and the European Central Bank to help the banks, the governments and Europe's economy.

I expect the Yanks to keep growing better than the doomsday merchants have been predicting, and they were wrong about a double-dip recession in the USA.

I expect the stock market to end higher this year in Australia and that we will see a big bounce.

Of course, I could be right, I could be crazy, but I know I'm not a lunatic and history shows me that stocks eventually come through and if you can endure losses, they will reward you for the faith you show them.

But make sure they are good stocks worth holding over the course of a stock market cycle.

One final comment for those who hate the memory of the market falling by more than half — the 6,771.9-level was outrageously high built on too easy money. Possibly, it should have been more like 4,000 or so and then the fall to 3,145.5 would not have been so great. And by the way, if we had never gone so high, we would never have fallen so far.

When you live in cloud cuckoo land, the fall to earth can come with a really big thud.

Three stock recommendations

by Charlie Aitken

Flight Centre (FLT) – Buy

Flight Centre offers good value, unless you expect both domestic and global growth to deteriorate rapidly.

The Australian business contributes 82% of group earnings predominantly through the leisure segment (retail stores) with around 70% of leisure revenue derived from flight bookings.

The market appears to have discounted the stock excessively based on an assumed material slowdown in growth impacting its corporate and leisure businesses. But the market has underestimated the strength of the local Flight Centre brand and positioning, together with the potential for the Australian economy to continue to outperform.

Flight Centre has a limited presence in the Australian online flights segment, which although relatively small (10% of flights bookings), has superior growth prospects to bricks and mortar. The company has recently flagged plans to materially expand its capabilities in this segment and we think it has the potential to be a serious online player, provided it can first deal with the delicate issue of how retail consultants will be rewarded for online-only clients and those requiring service within the retail network.

- Wednesday's close: $18.36
- Target stock price: $22.10

BHP Billiton Ltd (BHP) – Buy

BHP Billiton remains cheap and we continue to rate it as a Buy. It has a strong platform of capital expenditure expected to total some US$80 billion over the next five years and this will underpin organic growth for the next decade. The US$10 billion share buyback program was completed six months ahead of schedule and we expect its strong cash flow could enable further buybacks to be announced. BHP stands out as one of the best-managed companies in the Australian market, which is matched globally with a market capitalisation ranking in the top 10 in the world.

There are, of course, risks to our valuation, which are:

1. Weaker than expected iron ore, copper, coal and aluminium prices.
2. Fluctuations in exchange rates.
3. Lower than expected production levels for iron ore, petroleum, coking coal, and energy.
4. Coal, given that the group's earnings are biased towards these commodities.
5. Achieving target margins.
6. The proposed mining tax. Our initial estimate is that this should have a minimal impact on our valuation, and earnings should not be impacted in the forecast period.
7. The proposed carbon tax. Our initial estimate is that the carbon tax should have a minimal impact on our valuation, and earnings should not be impacted in the forecast period.

- Wednesday's close: $37.00
- Target stock price: $52.83

ANZ Banking Group (ANZ) – Buy

We've upgraded ANZ from Hold to Buy. We had concerns about ANZ's accelerating expenses in the short-term that were not matched by revenue growth. However, the bank's recent cost initiative to potentially reduce its workforce by up to 1,000 should address this issue and ensure a sustainable return on equity.

ANZ aims to be a super-regional bank with 25-30% of its underlying earnings coming from the Asia-Pacific by 2017 – that's up from 13% currently – making it a valuable growth option in the region. This target will likely only be met by a few large acquisitions.

The regional focus would enable the bank to achieve growth rates far superior to those in Australia and New Zealand. But on the flip-side, the bank also represents a higher risk/higher reward proposition.

The risks:

1. Overweight New Zealand.
2. Continuing conduit asset exposure, largely involved in back-to-back credit intermediation trades (ANZ acts as both protection buyer and protection seller in generating a spread, with a US$2.2 billion contingent liability under the sold protection at present that is only partially offset by purchased protection) – although the risk appears to be lessening.
3. Wealth returns still sub-optimal.
4. Needs clearer strategy in Asia with some perceived friction between ANZ and its joint venture partners.

- Wednesday's close: $20.79
- Target stock price: $22.75

Why your SMSF should have a corporate trustee

by Tony Negline

More than 90% of self-managed super funds (SMSFs) set up in recent years use an individual trustee structure, Australian Tax Office data shows. But while it's the most popular option by far, it's not necessarily the wisest choice for running your fund.

It's difficult to know precisely why some people elect this option instead of a corporate trustee, but I suspect some people are keen to keep costs down and, in their own mind, can't see the benefits of using a specially created corporate entity to act as trustee of their SMSF.

I spend considerable amounts of my life working with SMSFs and I see a wide range of problems with individual SMSF trustees.

The problems with individual trusteeship

The first problem is asset ownership. All super fund assets must be in the name of all trustees. Ideally, the investments will be held in a name structured like this: "Mary Jane and Robert James Smith as trustees for the Smith Superannuation Fund". The reason for denoting official asset ownership in this way is to avoid confusion. When an auditor checks over the fund each year, they are expected to confirm that this has been done and demand that errors are fixed.

Every time a member of a fund with an individual trustee retires, dies, loses capacity, leaves the fund, or a new member is added to the fund, the trustees are required to correct the ownership of the investments.

If your fund has many investments, then a change in the fund's membership will take considerable time and effort as well as incur considerable cost. All share registries, banks and managed fund providers need to be advised of the change. And changing these details for real estate causes considerable hassle and cost.

Our second problem involves trust law. When a member leaves an SMSF, it may cease to be a trust because a trust doesn't exist when the sole trustee is also the sole beneficiary. The super laws cater for this problem by demanding that there must be at least two individual trustees, and they allow six months to fix this problem. However, this six-month timeframe doesn't solve the problem that under trust law a trust may have ceased to exist.

The third problem is the death of a member. Sometimes with individual trustees, almost insolvable problems are created that effectively stall the SMSF. A good example of this is the Katz vs Grossman case, which we've highlighted before, involving a deceased father's SMSF and the distribution of his super assets. Mr Katz and Mrs Grossman were son and daughter of the deceased. I'll have more to say about this case in another article.

The benefits of a corporate trustee

By using a corporate trustee, you're less likely to mix your non-super and super assets together. This final problem is quite common with individual trustees.

You might look through this list of potential problems and conclude that they're unlikely to ever happen to you and your SMSF. Fair enough. I'm sure people who have fallen prey to some of these issues might have had similar thoughts.

For what it's worth – most of these problems don't exist for corporate trustees and some of my colleagues earn a handy revenue stream from fixing many of these problems for individual trustees.

From a purely mercenary point of view, I suspect that some super lawyers think individual SMSF trustees are a great idea. From a professional point of view, however, I'm yet to meet anyone who recommends this option to their clients.

One submission to the Cooper Review recommended that all super funds, especially SMSFs, should have to use a corporate trustee. I very much agree with this sentiment. Unfortunately, the Cooper Review and the Government decided that individual trustees should continue to be allowed.

If you now think that you should convert your fund to a corporate trustee, please be aware that it can incur legal and administration costs. There are also a number of steps you must go through. I'll address these issues in my next article.

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Can a child be a member of my SMSF?

by Andrew Bloore

The decision to set up a self-managed super fund (SMSF) is one that is often followed by a decision surrounding the fund's membership. While almost anyone can be a member of your fund, this decision needs to be carefully considered because it may influence the fund's structure and potentially introduce additional risks by providing decision-making powers to children.

As a high level starting point, the superannuation rules are relatively simple in this area. That is, there can only be a maximum number of four members in any one SMSF.

To that end, SMSFs typically consist of two members, and statistics released by the Australian Tax Office in September confirm that close to 70% of all SMSFs have two members, while almost 23% are single member funds.

However, as we dig deeper, the rules do become a little more complex – particularly if you are considering a child as one of these members!

That's because a critical requirement of SMSFs is that all members of the fund must be accountable for the running of the fund, and this means they are duly given a level of decision-making power to carry out this responsibility.

So, in general terms, superannuation rules require all the fund's members to either be appointed as individual trustees of that fund or, where the fund has a corporate trustee, all members must be directors of that corporate trustee.

In many cases, where the fund only consists of a husband and wife as members, this is a relatively simple requirement to satisfy. A choice is made regarding the preferred trustee structure – individual or corporate (read, Why you should have a corporate trustee) – and appropriate appointments are made.

John and Mary's SMSF

John and Mary are married and would like to set up an SMSF. They have decided against using a corporate trustee structure and instead appoint themselves as the individual trustees of their fund.

In some circumstances, fund trustees may wish for their children to also join the fund.

Where this path is chosen, it must be remembered that the child will also need to be appointed as an individual trustee or director. This fact in itself is one that should be carefully considered prior to admitting a child as a member because it provides that child with a degree of control over the direction and decisions made for the fund – something that is not always desirable, particularly when family disputes arise.

Notwithstanding that, when these children are adults (aged 18 years or older) they can quite simply become an additional trustee or an additional director.

Adding an older child

John and Mary would like for their 19-year-old son Frank to join their SMSF. As such, Frank is appointed as an additional individual trustee and the fund now has three members and therefore three individual trustees.

Children under the age of 18 introduce additional complexities to running an SMSF. Predominantly, this is because, due to their age, they are under a legal disability and not legally allowed to act as a trustee or a director of a corporate trustee.

Fortunately, superannuation laws allow a parent to act as a trustee on behalf of the child to counter this limitation.

Adding a younger child

John and Mary would also like for their 16-year-old daughter Sophie to join their SMSF. As Sophie is under 18, she will not be allowed to act as an individual trustee. However, Mary may be appointed to act as a trustee for Sophie, as well as continuing to be an individual trustee in her own right – the fund will now have four members, and effectively three trustees (albeit, one of these trustees is wearing two hats).

Note: the ability to appoint Mary as Sophie's representative hasn't been available to funds that adopted a corporate trustee structure. However, a recent Tax Laws Amendment Bill, introduced into parliament on the 23 November 2011 will (once passed) rectify this anomaly.

Interestingly, the only people who are actually precluded from becoming a member of an existing SMSF are those who are employed by an existing member of that fund (unless they are related).

Example

John and Mary also run a corner store that employs Sue. Sue is not related to either John or Mary and therefore can't be a member of the same SMSF as John or Mary.

Did you know?

You can find a comparison table of the latest term deposit rates on the Switzer Super Report website, updated weekly, so you can stay on top of the best deals in town. We even have a comparison table of SMSF service providers to make it easier for you to find the people you need.

Don't miss this!

The consumer price index is out this Wednesday. CommSec's Craig James expects inflation for the fourth quarter of 2011 to rise by 0.2%. The cost of living rose by 0.6% in the third quarter.

"With consumers reluctant to spend, putting pressure on retailers to discount prices, inflation should have been similarly well restrained in the December quarter," Mr James says.

We'll have the results up on the Switzer Super Report website on Wednesday.