Switzer Super Report

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I've been warning for quite some time that this rally will be tested and with concerns about Europe and China, we're seeing this come true. The retail sector has been hit hard as a result, but have they bottomed? And are they good value? I focus on this in today's note.
Also in the Switzer Super Report, Rudi Filapek-Vandyck turns to the history of bull and bear markets to find out where the current rally is running. Plus, Paul Rickard takes a look at ASIC's comments about hybrid securities and casts his eye over two new issues. And finally, are super fund with no contributions caps possible? Tony Negline answers this question, and more.

Sincerely,

Peter Switzer

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A roundup of selected retail shares

by Peter Switzer

To set the current scene, I've been warning that a rally testing time would eventually happen and now it has started. Undoubtedly, the professional traders who determine short-term market direction are using Spain's leadership procrastination as well as street protests, Germany's slowdown and weakish China data to question the market. Of course, sensible profit-takers will be saying it's time to sit on the sidelines on a pile of cash until buy signals re-emerge. And they will eventually show up.

So back to the retail story that doesn't look too promising, given the latest report from David Jones (DJS). The retailer saw a 40 per cent fall in profit for the full year and didn't even have a shot at guidance! That's a bad look.

Against that, if it can't sell clothes and homewares to Aussie shoppers, it will sell real estate, with the Sydney and Melbourne CBD properties looking likely to be flogged for a figure speculated to be $612 million.

Retailers in this country are behind the 8-ball and are being snookered from all directions from the high dollar, relatively high wages, new online rivals and a de-vibed consumer who is saving like never before! There have also been some second-rate management issues as well and it showed in DJ's results, which slumped from $168.1 million last year to $101.1 million this year. And the company's share price has been virtually halved over two years. But is it time to buy the troubled retailer or any other player in this space?

Trying to get a leg up from avid market watchers, I went to FN Arena's Rudi Filapek-Vandyck and this was his summary: "There is not one bricks and mortar retailer that is being generally liked as the best one." He says some like Super Retail Group (SUL), but it is believed "to be a bit on the expensive side".

However, he has another worthwhile view:

"Of course, if you broaden the term 'retailer', then you'll find that a stock such as Breville Group is universally liked, even after the impressive gains booked already this year."

On DJ's price targets and forecasts, the experts on FN Arena are all negative! For Myer (MYR), it's fairly similar but Rudi does point out the following: "Look more closely and you'll spot a few brokers being very positive."

Meanwhile, Gary Stone of Share Wealth Systems was also reluctant to give us a "buy" on retail stocks "but if I had to choose between only these two, then technically the DJS chart looks better over the last three months. Even though, since listing, DJS has slightly underperformed MYR on the charts."

That said, Gary did give us a tip for one retail stock: "The Reject Shop (TRS) is looking quite good but we should expect a retracement maybe down to the $11.20 area, which should offer a good buying opportunity."

I don't think there is a need to rush to retail as the likes of DJs and Myer will need the dollar to fall big time to give them a free kick and that could be a year or two off.

They could be dividend plays but that could easily be stripped down further if these retailers don't lift their game.

Buying big retailers is a speculative play but I do think they'll eventually find a better game plan, though it could take longer than we would want.

If you want to use Buffett's advice — be greedy when everyone is fearful — remember he generally goes for businesses that everyone uses and needs every day.

Myer and DJs were once like that but have they lost it and can they find it? That's what your gamble will be based on.

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Are the bulls on the run?

by Rudi Filapek-Vandyck

I'm sure the question has crossed your mind in weeks past: is this it? The moment when we'll all look back next year, and the years after and say: hey, that was when the 2012 bull market started!

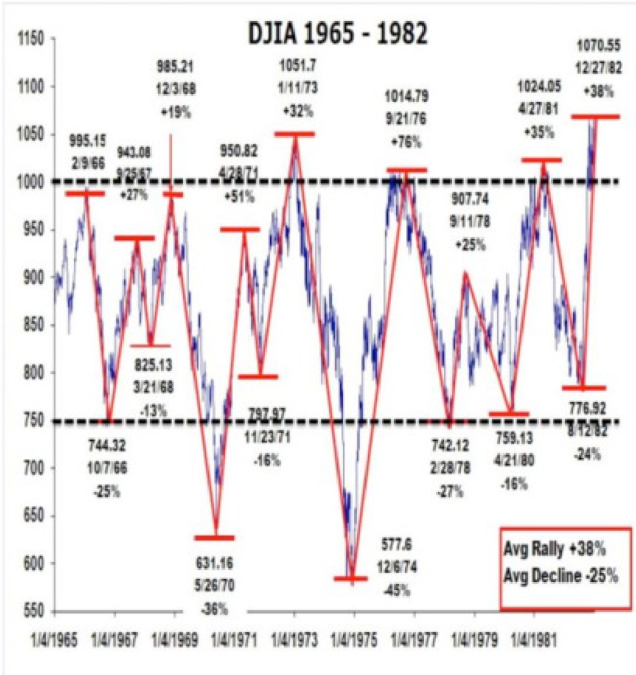
Bell Potter's managing director of wholesale, Charlie Aitken, certainly thinks this is the case. So does Morningstar's old hand Ian Huntley. Clifford Bennett, nowadays of White Crane Group, has been screaming, "bull! bull!" from the top of his lungs ever since global equity markets started rising in March 2009.

The rhyme of history

But before we look into the merits of these predictions, let me take you all back to my favourite reference for what we're experiencing today: the sixties and seventies. Not that history can provide us with all the answers about the future (it can't), but it does provide us with a framework, and with some ideas about what's possibly happening now. To quote Mark Twain: "History doesn't repeat itself, but it does rhyme".

As you can see from the chart below, things weren't exactly running smoothly between 1966 and 1981. We had several strong rallies of 20% and more during those 15 years – one year we even had a rally of 76% – but these upswings were all followed by sell-offs of up to 45%. At the end of the period, in 1981, the Dow Jones Industrial Average had once again sunk well below the level of 1966. Finally, it took one more Big Rally of 38% to push US equities through resistance and never look back again.

In 1979, *Time* magazine published its now forever famous "The Death of Equities" edition. If you look on the chart below, at the time of the *Time* magazine death cover, US equities had just finished yet another rally of 25% and were heading back to the bottom of the range. It would still take more than two more years before that bear-market ending rally in 1982.



Charts: Bloomberg and WJB Capital Group, Inc.

How the '60s and '70s panned out

Here are a few easy to draw conclusions from the sixties and seventies:

- By the end of that period, the general appetite for investing in equities would have been ab-so-lu-te-ly dismal, as the extreme volatility throughout those years, without making any noticeable progress, would have worn out the last remaining snippet of hope and gutted even the last few standing perma-bulls. That infamous *Time* magazine cover is all the proof we need to support that statement.
- But also: every time the share market would go through yet another rally, or make a fresh new start after yet again bottoming out at the lower end of the range, we can all be 100% certain there would have been at least a handful of commentators and equity strategists on the sidelines calling the advent of the next Big Bull Market.

20th century bear markets

Even scholars of the 1930s acknowledge things had started to appear much better by 1935 and equities had actually staged somewhat of a come-back in the form of a 900-day rally before the overall environment unexpectedly turned sour again. This is why some experts maintain the 1930s period actually consists not of one, but of two separate bear markets. Just like some experts believe, the bear market that started in the mid-sixties ended in 1976.

What all this analysis about these two reference periods has in common is that conclusions are being drawn many years later, in hindsight. One famous saying about the thirties is that, ultimately, those investors who managed to pull out in time during the first bear phase, later got sucked in again and were then taken to the slaughter. I can only assume the same thing happened again in the seventies. It seems but a fair assumption to make.

In hindsight

Which takes me to the point I wanted to make: the conclusion whether a new bull market has started and whether the bear market that started in late 2007 (or March 2000 – depending where we put the starting point) has finally ended will only be made at some point in the future, in hindsight. Because at the start of market turnarounds, and during the upswings that ensue, nobody can comfortably predict what will happen at the end of the ride, when momentum slows and things turn sour again.

One thing history shows, though, is that pullbacks outside the bear market (i.e. in a bull market) are more benign in nature and merely a pause in a long term, continuous uptrend. In a bear market, however, those pullbacks are more vicious and stronger in nature and tend to push back equities to the bottom of the range, if not lower.

It seems rather futile trying to announce the next bull market and the death of the bear, without knowing what the next serious correction will look like. Things are not made easier by the fact that upswings can last for a while, sometimes one full year or even longer, and so can subsequent downswings.

It cannot be denied, however, that there are some good arguments in favour of a new bull market. Overall despair among investors is high and market participation is very low. Even in the US – imagine! – as major indices are back at levels from early 2008 and within reach of their all-time record highs (including the Nasdaq), investors continue pulling money out of the market and out of managed funds, and they have continuously pulled funds since the uptrend began in 2009.

No sellers left

Here's one thought that has remained on my radar throughout 2012: it really feels like there are not enough sellers left to push equities much lower.

Most investors who don't want to participate in today's market, no longer are. They have sold whatever there was to sell. They sit on the sidelines and wait, if they haven't abandoned the share market altogether. But the traders, and the optimists and those funds managers who allocate Australia's super funds to equities, will push up prices, even at low volume. To get this market into a serious downward spiral again, we first need to see some serious volumes moving back into the share market. This might just be another reason as to why the next downtrend will be more telling than what is happening right now.

There's anecdotal evidence that suggests equities are most definitely out of fashion. Historically, this has been the ideal platform from which new bull markets emerge. What needs to be kept in mind, however, is that we can be pretty certain that when the market bottomed in April 1980, the situation wouldn't have been different and yet, after a rally of 35% over the subsequent 12 months, equities again sold off by 24% in 1981. I'm even willing to bet the situation would have been pretty similar in 1978 when the Dow bottomed at practically the same level as it did two years later in 1980.

US vs. Australia

There's also another approach that can't go unmentioned in this context — while the US share market tends to go through extended bear market phases post periods of excess, historically the pain that trickles down onto the Australian share market is not as extensive as the US experience. Former Wilson Asset Management stock picker Matthew Kidman, in his book "Bulls, Bears & a Croupier", argues that bull and bear cycles in Australia seldom run parallel with those in the US. The best evidence is the US equities' bull market ended in March 2000, while Australia's bull market started in 1992 and didn't end until November 2007.

Historically, writes Kidman, bear markets in Australia don't seem to last longer than five years, which would put the start of the next bull market at around later this year/early 2013.

I'd argue the past years certainly have shown US equities and the ASX200/All Ordinaries don't always trend in lock step. But this can also mean that while US equities could well officially rally above their previous bull market highs before year-end (which would make it, according to a widely used definition, no longer a bear market) this does not automatically translate into good news for Australia. Chinese equities, at the other end of the spectrum, still look very much in bear-territory and very ill indeed.

The key element

To make this matter even more complicated, consider the following: according to most experts (also my view) US equities entered a new bear market in March 2000. Yet, with ultra-low interest rates and ultra-loose monetary policy, global equities, including in the US, managed to squeeze out four years of renewed investor exuberance, until reality kicked in again. The key element, just as was the case in the 1970s, is that underlying problems hadn't been addressed properly (it can even be argued things got worse instead).

And *that* about summarises my view for where we are today. Yes, we've had four years of sideways, going-nowehere-in-a-hurry share markets after the 2008 disaster (at least: outside the US), but it's not like we have solved all our problems. In fact, it can be argued we haven't solved much, except that we discovered the virtue of excessive liquidity and we've started using it in spades. I still expect that at some point, the cans that have been kicked further down the road will come flying back into our faces. By then, all shall be dependent on where we are in the economic cycle and with financial valuations, etc.

Which is why investors should participate in the share market according to their own level of risk appetite.

Look for dividend payers

Don't forget: compounding growing dividends is the key to true investment success in the longer run, while "All-Weather Performers" offer the best risk-reward in the share market when purchased at reasonable value. Mining and energy stocks, including industrial cyclicals, can be ideal to find higher rewards in a shorter time-span. Unless we're at the beginning of a new, sustainable bull market, of course, or a repeat of 2004 to 2007.

Whenever in doubt: see all the above.

Is ASIC right to slag hybrids?

by Paul Rickard

In a week when ASIC suggested that the term 'hybrid security' should be replaced with the words 'capital note', regional banks Suncorp and Bendigo and Adelaide have announced new issues. These issues follow the very successful jumbo issue from CBA (PERLS VI), and will also qualify as Tier 1 capital for the banks under the new Basel III capital adequacy framework.

ASIC Commissioner John Price warned: "An expectation that at the end of a set period an issuer will definitely redeem the hybrid so that investors get repaid in full is very dangerous". He is right of course – however, this just reiterates the importance of looking at the issuer and their underlying business, and the terms of the note. I can't see what is wrong with the term "hybrid" – it implies exactly what it is, a security with both debt- and equity-like features.

The issues

Bendigo and Adelaide Bank is issuing $125m of convertible preference shares (CPS), which includes a re-investment offer to the holders of the existing Reset Preference Shares. These are being redeemed on 1 November.

Suncorp is issuing $350m of convertible preference shares (CPS2). Details of the issues, and a comparison with the recent CBA PERLS VI issue, is set out below.

	Bendigo CPS	Suncorp CPS2	CBA PERLS VI
Issuer	Bendigo & Adelaide Bank	Suncorp Group Ltd	Commonwealth Bank
Issue Size	$125m, with more or less	$350m, with more or less	At least $750m, probably $1.5 to $2.0bn
Legal form	Preference Share	Preference Share	Perpetual Note
ASX Code	BENPD	SUNPC	CBAPC
Margin	5.00% to 5.50%	4.65% to 4.85%	3.80%
Dividends	• Floating rate • Semi-annual • Non-cumulative • Discretionary • Dividend stopper on ord shares	• Floating rate • Quarterly • Non-cumulative • Discretionary • Dividend stopper on ord shares	• Floating rate • Quarterly • Non-cumulative • Discretionary • Dividend stopper on ord shares
Conversion	Mandatory conversion into ordinary shares on 13/12/19 (7 years), provided ord shares > $4.40 approx	Mandatory conversion into ordinary shares on 17/12/19 (7 years), provided ord shares > $5.10 approx	Mandatory conversion into ordinary shares on 15/12/20 (8 years), provided ord shares > $30.50 approx
Conversion Discount	2.5%	1.0%	1.0%
Issuer Redemption	Issuer option on 13/12/17 (5 years)	Issuer option on 17/12/17 (5 years)	Issuer option on 15/12/18 (6 years)
Capital Trigger Event	Yes – Common Equity Tier 1 Capital < 5.125%	No	Yes – Common Equity Tier 1 Capital < 5.125%
Non-Viability Trigger	Yes	Yes	Yes
Offer Opens	2 October	3 October	Open
Offer Closes	25 October	30 October	5 October
ASX Listing	8 November	9 November	18 October

Institutional bookbuilds over the weekend will determine the final margins, which will be announced on Tuesday for Bendigo and Wednesday for Suncorp. With the 90-day bank bill around 3.39%, the grossed up distribution for the first quarter for Suncorp will be in the range of 8.04% per annum (pa) to 8.24% pa. For Bendigo, with the 180-day bank bill around 3.36%, the distribution for the first half-year will be in the range of 8.36% to 8.86%pa.

Dividends on these issues are fully franked. The cash dividend payment is adjusted for the franking credit benefit by multiplying the nominal distribution by 0.70. For example, if the final margin for Suncorp is set at 4.65%, and the 90-day bank bill rate is 3.39%, the dividend in cash for the first quarter will be (4.65% + 3.39%) x 0.70 = 5.628% pa.

Credit ratings

While the issues are not individually rated, the issuers (or their subsidiaries) are rated by Standard & Poors as follows:

Commonwealth Bank: AA-

Suncorp Group Subsidiaries: A+

Bendigo & Adelaide Bank: A-

Suncorp uses the 'Non Operating Holding Company' structure, and each of its three major operating subsidiaries is rated one notch lower than the CBA. Bendigo is a further two notches lower than Suncorp.

Pricing

The prospective margin reflects the financial institution's credit strength, issue size, expected investor demand and alternative capital raising opportunities and costs. As I have said on many occasions, while an issue of hybrid securities to a retail market can be viewed as "opportunistic" behaviour by the issuer, that doesn't mean the issue is underpriced.

The key risk investors face is that the issuer is not capable of (or not allowed by the Australian Prudential Regulation Authority (APRA) to redeem the security on the optional redemption date, or even worse, a 'non-viability' trigger event or 'capital trigger event' occurs. While Bendigo had a higher Level 2 Common Equity Tier 1 Capital Ratio of 8.09% than CBA's 7.50%, Bendigo's surplus capital above the 5.125% trigger is only $839 million compared to CBA's circa $8.0 billion. Arguably, Bendigo is more exposed to a potential shock or single event risk.

While the Suncorp issue doesn't have a capital trigger event, the Suncorp business includes banking and some of Australia's leading insurance brands with names such as GIO, AAMI, Vero and Apia. This leaves it vulnerable to a catastrophic insurance event such as the Brisbane flood, and while it takes out re-insurance to minimise any impact, investors should be mindful of business risks such as these.

Overall

There has been some commentary that the margins might be a little skimpy. With the 'headline margins' and small issue sizes, we expect investor demand to be quite strong. At $125 million, the Bendigo issue looks too small for satisfactory post market liquidity. A measured investment in Suncorp as a "yield play" would suit many portfolios.

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A super fund with no contributions caps? It's possible

by Tony Negline

Today I'm going to discuss an interesting contribution strategy that has been getting airplay recently. But first up, to put you in the picture more clearly, I need to discuss some background information.

Your super fund will be entitled to tax concessions if it's a *resident regulated superannuation fund* and a *complying super fund* at all times throughout a financial year. These are both legislative terms.

If you set up your fund after June 1994, one step you completed would have been to elect that your fund was a regulated super fund. This election is prospective (not retrospective), irrevocable and, in effect, means you've elected to forever be regulated under the Superannuation Industry (Supervision) legislation, or whatever its legislation is in the future. Your fund can't get the super fund tax concessions unless it makes this election. If you don't make this election, your fund is taxed at 46.5% of the fund's income, including realised capital gains.

The concept of complying and non-complying super funds has been around for at least 30 years.

Prior to Peter Costello's contribution caps, Paul Keating had allowed unlimited amounts into super but put in place tax penalties when you wanted to pull out too much.

Costello changed Keating's design to effectively restrict the amount of money you could put into super. The specific design of Costello's policy is that we all contribute money into super during our working lives.

The advent of contribution caps and non-complying super funds needs to be explored. Put simply, the contribution caps only apply to a complying super fund, which means regulated super funds only.

So what does this all mean?

Does this mean therefore that you can establish a super fund, contribute above the contribution caps (whilst it's a non-complying super fund) and then elect to make it a regulated super fund?

In simple terms, yes. However, employer contributions made to non-complying super funds will incur Fringe Benefits Tax. Personal contributions claimed as a tax deduction and employer contributions will be taxed at 46.5% in the year they're made.

But this tax rate rule doesn't apply to personal contributions not claimed as a tax deduction.

So the strategy works something like this:

1. During a financial year, create a super fund, which you don't elect to be regulated by the super laws in that year.
2. You make personal contributions that aren't claimed as a tax deduction to that super fund. Those contributions could technically be for any amount, including above the relevant personal contribution cap that applies to you.
3. In the next financial year, elect for the fund to be regulated by the super laws. As mentioned, this election is prospective not retrospective.

So what are the risks?

I can think of several and maybe others will think of more:

1. Income tax anti-avoidance provisions – this is a very complex area and one that requires careful analysis.
2. I won't go into specific details here but about

15 years ago, the black letter law technically allowed you to avoid contributions tax and the dreaded super surcharge that applied at the time. To correct this loophole, the Government changed the tax laws, and the Tax Office successfully took several people to court. In every case, the taxpayer lost, even though the black letter law allowed the transaction.

3. In 2001, the Administrative Appeals Tribunal heard a case that involved an unregulated fund that had been created. Certain transactions were performed in the fund that would have breached the super laws if the fund had been regulated under these laws. Once these were completed, the fund became a regulated super fund. The ATO made the fund non-complying and the taxpayer appealed, but lost.

Should you implement this strategy? That is for you and your advisers to decide. This article is not saying this is a legitimate strategy for anyone. You need to carefully consider all the relevant issues involved.

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Did you know?

Monday is a public holiday in NSW, ACT and SA. If you're in these states, I hope you get a chance to put your feet up and relax. We'll be taking a little break too, so you'll receive your next edition of the Switzer Super Report when business resumes for us on Tuesday.

Don't miss this!

Switzer Financial Planning will be in Melbourne on October 3 to talk about self-managed super. If you're down that way and interested in attending, you can find more information at www.switzer.com.au/smsf