Switzer Super Report

Issue 138, 22 November 2012

Defining the Switzer Super Report

Recently I received a great question from a Switzer Super Report reader about stocks, so today I have taken the opportunity to define what the website and newsletter are all about.

Also in the Switzer Super Report, George Boubouras explains why investors should consider exposure to global equities in their portfolios. And Qantas versus Virgin, should you buy stocks in either of these airlines? James Dunn provides his views. Plus, Gavin Madson recommends the Sydney Airport inflation linked bond and Tony Negline answers the question of the week: do SMSF members now require insurance cover? Also, Ron Bewley turns his eye, and his charts, to the materials sector while Andrew Bloore explains how to apply the proportioning rule to your SMSF.

Have a great day!

Sincerely,

Peter Switzer

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Deconstructing a subscriber

by Peter Switzer

I received a great question from a reader named Alan, who provocatively posed the following: “Peter, I hope you’re going to give us more ideas of what stocks to buy apart from CBA and your target prices”.

This feedback has driven this piece today and permits me to really define what the *Switzer Super Report* is all about. And one assumption that has to be understood by all subscribers is that super fund investors are not a homogeneous lot.

A tale of two Alans

I suspect Alan wants to buy great stocks at low prices and sell them at high prices and, probably, he isn’t a long-term holder of stocks. On the other hand, he could be a long-term player with a core collection of great income payers but he has an allocation to more speculative plays on the side.

The first Alan is really a punter and could have some great runs and some shockers. Personally, I don’t like to play that game with my SMSF, preferring a strategy of collecting great companies that pay dividends, and buying them on the dips.

I have a colleague I’ve mentioned previously who retired with a portfolio worth about $5 million. He nets about 10% a year on that, meaning he’s on about $500,000 a year. In 2009 his return dropped to about $460,000 but rebounded in 2010. He doesn’t worry about his capital and has an allocation to cash, which he uses as a buffer if he needs it in down market times. I reckon this is a great SMSF plan but he does have a nice balance to play around with.

Back to Al’s letter

But Al, to be fair, since we started the *Switzer Super Report*, we’ve recommended stocks like Telstra when it was a $2 something stock. And we created a dividend portfolio in December 2011 that was up about 14% by October 2012, with 4% dividends on only half-a-year of distributions. We created the portfolio to return around 7-8% in dividends so the capital gain was great cream.

Over the past 12 months, we’ve given plenty of good recommendations. While some have not saluted the judge, this happens in the stock market punting caper.

Ausdrill is a classic, which Gary Stone of Sharewealth Systems says is now in the right buying zone, which he alluded to a few weeks back.

Stephen Thomas of Bell Potter, whose interview with me should be on the website today, is a big fan of Regis Resources. Being a gold stock, if we see the stock market head up after a fiscal cliff solution, then this could remain a good buy.

Then Peter Morgan, ex-Perpetual and ex-452 Capital has given us a real specky in Chalmers (CHR). He says this could be a winner small cap but concedes three out of his 10 stocks in this category could disappoint, though he does have a bit more faith in this one as a buy and hold.

By the way, Gary Stone’s technical analysis doesn’t give Chalmers the thumbs up but this kind of analysis is based on price momentum and so it needs to see a trend. Morgan’s analysis could be ahead of the trend.

The Buffett play

For those who want safe Buffett-style plays, we have provided them since the newsletter kicked off. Only a few weeks ago Paul Rickard went strong on Telstra again when it was under $4, and at $4.27 he has delivered a winner with a great dividend.

Alan, we have recommended some good hybrid and term deposit plays, but they won't always be in every newsletter because the opportunity won't always be there. But over a year we will deliver.

One final point

I have been a strong advocate for stocks since early 2009, when most experts were telling people to run to cash. I was in the vanguard of recommending buying the big four banks and great dividend stocks in 2009.

My opinions are there in print, in Google annals and in video on many servers. I've had a good run and hope I can keep it up. But let me assure you, I have a lot of skin in the game and the experts we have in the *Switzer Super Report* are not only doing it for you, Alan, they're doing it for me!

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Why investors need to hold Global Equities

by George Boubouras

Asset allocation is the core driver of performance through a portfolio's life cycle. It is no surprise that the appropriate asset allocation will differ for most investors, depending on their return expectations, risk tolerance (can you sleep at night?), time horizon and the stage of your life cycle (for an individual). We will review why an allocation towards Global Equities "within" an investor's equity weighting can benefit investors.

Why do Global Equities belong in portfolios?

Given the relatively small size of the Australian equity market versus the global MSCI, it is important to have exposure to Global Equities for the diversification characteristics this brings. It is true that the dividend of other developed bourses is not as high as the local market, but there is a bias locally to financials and materials. Broadly the Australian equity weighting will have a higher dividend yield than global equities, which is an important characteristic. This is also before the franking. The exposure to Global Equities will however deliver diversified earnings via key global multi-national stocks.

What should investors look for in Global Equities?

When looking for exposure to Global Equities, Australian-based investors need to understand whether they require the same weighting to large material/resource companies in their global portfolios given they already have the leveraged exposure in their domestic equity weighting.

Further, exposure to the growth premium from the emerging economies can be seen in many companies that are not reflected locally. For example, technology (Apple, Google, Qualcomm), global payment systems (AMEX, MasterCard, VISA, EBay), core global luxury brands (Ralph Lauren, Hermes, LVMH) and other multinationals (Johnson & Johnson, Nestle, Procter & Gamble, Unilever, Danone, John Deere, Caterpillar) all have earnings linked to the strong performing emerging economies which is not replicated in our local market.

How to invest in Global Equities

A sample international equity portfolio that aims to deliver some diversified earnings attributes are listed in Table 1. The direct holdings aim to provide a portfolio of mega-cap, International companies with solid future growth prospects. Further, these "perpetual" global stocks have some good pricing power and growing earnings to both developed and increasingly the emerging economies. When determining companies to add to the International Equity Portfolio, some of the metrics to consider include ensuring a focus on sector representation that is not adequately represented on the Australian market, e.g. Information Technology, Global Industrials and Telecommunications, as well as companies with a globally recognised business line that provide an opportunity to participate in earnings upside in the years ahead.

Table 1: Sample International Equity Portfolio

Code	Company	Base Currency	Market Price (Base Currency)	P/E 13e	Yield 13e %	Market Cap ($B USD)
AAPL US	Apple Inc.	USD	560.91	10.9	1.94	535.8
CSX US	CSX Corp.	USD	19.52	10.2	2.92	20.4
DE US	Deere & Co.	USD	85.99	10.0	2.14	34.3
EBAY US	EBay Inc	USD	48.26	16.5	0.00	62.4
GE US	General Electric Co.	USD	20.62	11.8	3.78	220.4
GOOG US	Google Inc	USD	669.97	21.0	0.00	220.1
JNJ US	Johnson & Johnson	USD	69.67	12.8	3.49	190.1
KO US	Coca-Cola Co.	USD	37.25	16.8	3.17	170.8
NESN VX	Nestle	CHF	59.15	16.8	3.63	200.1
BAYN GR	Bayer	EUR	67.25	11.1	3.12	70.3
BN FP	Danone	EUR	48.80	15.6	3.18	37.9
MC FP	LVMH Moet Hennessy Louis Vuir	EUR	129.00	15.8	2.50	80.0
OR FP	L'Oreal	EUR	102.50	19.4	2.53	76.0
SAB LN	SABMiller	GBX	26.46	17.1	2.47	66.3
ULVR LN	Unilever Plc	GBX	23.48	17.1	3.28	106.3
13 HK	Hutchison Whampoa	HKD	77.70	12.3	3.01	42.0

Data Sources: IRESS, UBS Wealth Management — All Data priced as at: 21 November 2012

In summary

In summary, we have aimed to explore the basic concepts and investment opportunities for Global Equities within a portfolio context. It is quite clear that diversification across all the asset classes, and importantly within, are such key concepts that all investors need to be cognisant of in their wealth accumulation.

An investor's asset allocation must reflect their return expectations, the amount of risk they employ (volatility) to meet their objectives and their time frame (which reflects the stage of their lifecycle). An investment in Global Equities is an important investment decision for all investors, as it adds diversification to portfolios, thereby reducing risk and potentially increasing expected returns over time.

Qantas versus Virgin: should either be in your portfolio?

by James Dunn

The battle between the two big airlines listed on the ASX – Qantas and Virgin Australia – is hotting up, and it makes for one of the most interesting business stories in the financial press.

But that is the only level on which an SMSF proprietor should be interested in the Qantas-Virgin arch-rivalry, because neither stock belongs anywhere near your SMSF.

In fact, it is possible to argue that unless you are a Persian Gulf country with a humungous sovereign wealth fund backed by oil revenue, you should not own an airline business.

According to industry body, the International Air Transport Association (IATA), since 2003 the global airline industry has finished in the red six years out of nine. (Global Gross Domestic Product (GDP) growth is the major driver of airline profitability.) And even in the profitable years, margins were alarmingly low.

Between 2003 and 2011, says IATA, airlines lost a total of US$47.9 billion, more than they had made in the good years.

Over the last 40 years, the global airline industry has been in the black – but with a pitiful 0.3% margin. As IATA director-general Tony Tyler has put it: "This industry is about turnover with very little left over".

In 2012, the organisation predicts carriers across the world to make total profit of about $4.1 billion, down from $7.9 billion in 2011.

Qantas

Qantas has traditionally been one of the few consistently profitable airlines, helped by its strong domestic market share of 65%. It has had a few free kicks along the way: in September 2011, when the rest of the airline industry was plunged into turmoil by the terrorist attacks on the USA, Qantas had its major domestic competitor at the time (Ansett) fall over.

The resources boom at home has helped it, as has exposure to the developing Asian economies. Also, the strong Australian dollar made Qantas' costs – for example aircraft purchases and leases, spare parts (including engines) and capacity hire – cheaper, and to some extent has ameliorated rises in jet fuel costs, the bugbear for airlines.

But Qantas has flown into turbulence in recent years, partly because of a long-running industrial dispute – with a range of unions that cover its workforce – and heightened competition from its arch-rival Virgin Australia, which is making a determined move into Qantas' lucrative business and leisure travel markets.

The cumulative effect of these pressures caused Qantas to report a net loss in 2011-12,of $245 million, a half-a-billion dollar turnaround on the previous year's profit. Before higher fuel, restructuring and industrial action costs, the company says it was profitable. On the back of the result, the company cancelled an order for new Boeing Dreamliners.

But the bottom line for Qantas investors is that the shares, which were trading above $6 in late 2007, plunged as low as 97 cents in June 2012. Qantas has not paid a dividend since 2008. An investor who bought the shares five years ago has suffered a return of -24% pa.

Qantas' international operations haemorrhage money: it is a high-cost operation, at the end of the line in geographical terms, up against deep-pocketed competitors with newer fleets operating out of centralised hubs. (Qantas has proposed a partnership deal with Emirates, to operate through the latter's

Dubai hub, but it has not yet received regulatory approval.)

Qantas domestic and Jetstar make money, but the company's most profitable business is actually its Frequent Flyer Program, which earned $230 million last year.

No capital gain, no dividend because of the massive spending requirements on new planes; and an eater of shareholders' funds. There is simply no reason for a SMSF to hold Qantas shares.

Virgin

The same goes for Virgin Australia, which has only paid a dividend in three of the nine years of its life as a listed company. (Virgin Blue was listed on the ASX in December 2003, majority-owned by Virgin Group of the UK: it changed its name to Virgin Australia Holdings in May 2011). Virgin Australia has also not troubled the dividend scorers since 2008. The stock has had a good 2012 so far – up from 28.5 cents to 46 cents – but its longer-term record is almost as bad as Qantas: someone who bought Virgin Australia five years ago has lost 23% a year.

Under former Qantas senior executive John Borghetti, who took over from founding CEO Brett Godfrey as CEO in May 2010, Virgin Australia has aggressively chased corporate and government customers. In October 2012 it bought a stake in low-cost carrier Tiger Australia from its parent, Singapore Airlines, and took over Perth-based Skywest. Virgin Australia now has its own brand taking on Qantas, Tiger Australia taking on Qantas' Jetstar operation and Skywest competing with Qantas' regional operation QantasLink.

Internationally, Virgin Australia has done deals with Singapore Airlines, Air New Zealand, Etihad and Delta Air Lines – all of which are shareholders –to give it the network reach business customers demand.

In the year to 30 June 2012, Virgin Australia made a net profit of $22.8 million, a much-improved result from the $67.8 million loss it reported a year earlier. Revenue rose almost 20% to $3.9 billion. But the nature of the airline business was starkly revealed when the company said when reporting its profit that "economic uncertainty" did not allow it to offer any profit guidance for 2012-13.

The bitter – and intensifying – competition between Qantas and Virgin Australia is great for Australia's flyers, in all categories; and it makes for riveting reading in the business pages. But these businesses cannot be sure they will be profitable in a given year, let alone pay a dividend. These stocks might make good trading opportunities for those so minded, but they should not be core holdings within a SMSF portfolio.

Sydney Airport inflation linked bond recommended

by Gavin Madson

One of the chief concerns of many investors is the effect inflation will have on their retirement savings. With their value linked directly to the Consumer Price Index, Inflation Linked Bonds offer investors the opportunity to protect themselves from inflation whilst earning some of the best returns in the bond market.

What are inflation linked bonds?

Inflation Linked Bonds (ILBs) are bonds which have returns directly linked to inflation. The most common form is the ‘capital indexed bond’ where variations in inflation during the life of the bond are applied to the capital price of the bond.

A simple example would be:

- A bond, with an original face value of $100, has three years to maturity and inflation is 3% per annum for the three-year period. The capital price would thus rise from $100 to $103 in Year 1
- Then in Year 2, the adjusted capital price would be $103 + $3.09 = $106.09 and in year three $106.09 + $3.18 = $109.27 (rounded to two decimal points)
- The issuer would therefore repay the bondholder $109.27 at maturity. While the coupon (interest) margin over CPI does not change throughout the life of the bond, it is paid each quarter on the adjusted capital price. So, your effective cash income increases with the underlying increase in adjusted capital price.

The capital price is adjusted quarterly in line with the Consumer Price Index so ILBs offer SMSF investors an effective way to protect their capital against the ravages of inflation.

ILBs are offered by a variety of issuers including governments and banks, however their generally long dated nature makes them perfect for infrastructure companies whose regulated revenues are often also linked to inflation.

Sydney Airport ILB

Since the start of the GFC, long dated bonds have fallen out of favour with institutional investors. This has provided investors happy to take a longer-term view with their investments the opportunity to take advantage of strong returns over a longer period. Currently, long dated corporate inflation linked bonds are presenting some of the most outstanding value in the market, and Sydney Airport ILBs are currently my preferred choice.

Sydney Airport currently has two ILBs available, one maturing in 2020, the second maturing in 2030. The bonds are offering ‘real’ returns of 4.00% and 4.45% respectively. This means they are offering 4.00% and 4.45% above the rate of inflation:

- If inflation is 2%, the 2020 bond would return 6%,
- If inflation were 3% the 2020 bond would return 7% and so on.

Based on the midpoint of the RBA inflation target (the RBA seeks to maintain inflation between the band of 2% and 3%) the Sydney Airport 2020 ILB would return 6.5% for investors. The 2030 would return 6.95%. Should inflation break out beyond the target band, investors will continue to enjoy a return above the prevailing inflation rate – offering investors a true protection from the effects on inflation on their capital.

The Sydney Airport bonds are ranked at the top of the capital structure being senior secured, backed by this critical investment grade infrastructure asset.

Sydney Airport

Sydney Airport delivered another strong performance in its most recent results with revenue, EBITDA and passenger numbers all increasing. Kingsford-Smith Airport remains the premier air transport hub in Australia and enjoys the most diversified airline client base of any of Australia's airports. Sydney remains the gateway for international travel to Australia and this, in addition to the largest catchment of any of our capital city airports, underpins the assets' performance through the economic cycle.

Infrastructure New South Wales recent report "First Things First – The State Infrastructure Strategy 2012-2032" further highlighted the importance of Sydney Airport and it proposes a number of infrastructure projects, which will be positives for the airport and its customers.

One concern I often hear from potential investors in Sydney Airport is the often mooted "second Sydney Airport". I remain unconcerned with this 'threat' for a number of reasons:

- The need for a second airport would only be driven by the full utilisation of the existing facilities,
- The current operators of Sydney Airport retain an option on the development of any second airport
- A second airport will be built in Western Sydney, one of the key strengths of Kingsford-Smith is its proximity to the CBD
- The timing of any second airport would be beyond the 2020 maturities and have minimal effect on the 2030 maturities
- Whilst all levels of government have opinions on the need for a second airport, there remains no motivation to actually fund it.

For investors concerned with the effects of inflation on their investment nest egg, inflation linked bonds offer a true protection, and the Sydney Airport ILBs currently offer some of the best value in the Australian bond market.

Question of the week: compulsory insurance?

by Tony Negline

Q: *I have heard that there has been changes to the regulations of an SMSF that now require its members to have insurance cover. I would be most grateful if you could shed some light on this matter as I think that it is an unnecessary expense if they have sufficient funds in the fund to cover them in the event of an incident.*

A: A new requirement for self-managed super funds (SMSFs) to consider insurance was introduced in August. However, the key word here is 'consider' – there is **no** requirement for your fund to 'purchase' insurance.

Instead, the new rule demands you 'consider' if your fund should have insurance over at least one member of your super fund. After having demonstrated that you have considered this, your fund may decide not to buy any life insurance.

The new super laws don't specify which member or the type of insurance that might be necessary. You'll need to consider the type and level of insurance you need for a particular fund member. In most cases, this might be death, total and permanent disability and salary continuance insurance. It probably won't be trauma insurance because super is often not the best vehicle for this type of insurance.

Further, these laws also don't say how often you have to consider the need for insurance. It might be whenever you consider your fund's investment strategy, which also has to be reviewed 'regularly'. This probably means at least annually.

This rule has been put in place because less than 15% of SMSFs purchase life insurance. Perhaps SMSF trustees are purchasing insurance outside super, or using the insurance option provided by a retail super fund or industry fund or deciding they don't need insurance.

You can show you've considered this issue in documented changes to your fund's investment strategy or in the minutes of your trustee meetings held throughout the year.

Eye on the materials sector

by Ron Bewley

The Materials (Mining) Sector

Continuing my sector review theme, I now turn my attention to the Materials sector that is an unusual mix of mining and building companies – but that is how the GICS (Global industrial Classification System) defines this one of 11 major sectors. Since there are 22 companies in the top 100, I am splitting the analysis into two parts: one for mining stocks and one for the others. That leaves 11 stocks in my 'unofficial' Materials (Mining) sector. For brevity, readers should refer to my last piece on the Energy sector and the previous piece that compares all 11 sectors for details.

The table contains much of the information I use in stock selection. These stocks account for 76.7% of the market capitalisation of the ASX 200 Materials sector – the sum of the column headed 'Market cap. share'. The non-mining sectors accounts for 14.4% and the remaining 8.9% is the lower 100 of Materials stocks in the ASX 200.

Table: Data on companies in the ASX 100's Materials (Mining) sector

Company name	Ticker		Price growth over		Price target			Concensus	No. of	12-month forecast		Market cap.
		Price	quarter	year	low	median	high	rec.	brokers	yield	P/E	share
BHP BILLITON	BHP	32.93	-5.9%	-8.9%	31.74	39.14	52.67	2.1	18	3.7%	11.8	48.3%
RIO TINTO	RIO	56.90	-3.8%	-15.1%	60.49	74.57	104.84	1.8	16	3.0%	10.2	11.3%
NEWCREST MINING	NCM	24.57	-10.7%	-31.5%	25.00	30.00	39.10	2.5	17	1.8%	14.4	8.6%
FORTESCUE METALS GP.	FMG	3.90	-7.8%	-19.6%	3.13	4.70	8.20	2.2	21	2.1%	8.1	3.3%
ILUKA RESOURCES	ILU	7.79	-27.9%	-50.5%	7.00	10.95	16.80	2.7	17	8.9%	5.6	1.3%
REGIS RESOURCES	RRL	5.41	0.4%	63.9%	4.00	5.65	7.56	1.9	16	2.6%	10.1	0.9%
OZ MINERALS	OZL	7.31	-13.9%	-32.9%	6.25	9.15	12.00	2.9	20	3.1%	14.4	0.8%
PANAUST	PNA	3.16	-9.7%	-4.2%	2.73	3.85	4.34	2.1	19	2.5%	8.8	0.7%
ATLAS IRON	AGO	1.45	-13.9%	-52.6%	1.30	2.10	3.61	2.1	20	2.1%	12.3	0.6%
LYNAS	LYC	0.56	-19.0%	-54.1%	0.65	0.88	2.44	2.8	9	0.0%		0.5%
PERSEUS MINING	PRU	2.33	-12.7%	-21.8%	2.50	3.27	5.80	1.8	17	4.7%	7.6	0.4%

Note: the estimates in the Table are current to the close of business 16th November 2012. They are based on Thomson Reuters Datastream. The price target is the brokers' forecast of where the stock price is heading – often considered to be in the next 12 months.

The top three stocks (BHP, RIO and Newcrest) all have reasonable to very good ratings with a Consensus Recommendation ('Consensus re.') of 2.5 (market outperform) or less. I believe that many investors favour Newcrest because they see it as a 'gold play' without resorting to buying the commodity. However, the correlation between the gold price and NCMs price is not that high. Apparently, gold miners extract from more difficult, hence costly locations when the price is high. I have a personal aversion to anything associated with gold!

Atlas and Lynas

I have held Atlas (AGO)(and Lynas (LYC) for some time to accompany my BHP and RIO holdings. When I first purchased AGO and LYC they were not in the top 100 but they had excellent ratings. I chose to use these stocks as my Small Cap exposure and have added to and sold during the time since my first purchases.

AGO, a Western Australian iron ore miner had looked promising until the middle of this year when the negative stories about China emerged in great numbers. The price fell sharply but the rating – at 2.1 – remains firm. Since I always believed that the China in slowdown story was well overdone, I have not sold recently since I am not fleet of foot enough to be a trader. I believe in the long run prospects.

LYC was the market darling of 2011. It mines rare earths that are used in many high tech products – and China produces about 95% of world output. The price rocketed up from under 20 cents to nearly $3. I sold nearly half of my exposure to lock in a guaranteed profit even if the price of my remaining holding falls to zero. Therefore, I felt it reasonable to hold on to the stock during the protests in Malaysia that have been trying to prevent LYC from processing there. There is the danger that the plant will not go ahead but the rare earths are still owned by LYC in Australia – but the share price would no doubt fall. Given the Malaysian government signed off on the plant and it has withstood a couple of appeals, there is scope for a potentially very valuable stock. Its current rating of 2.8 is not impressive and reflects the political nature of the stock.

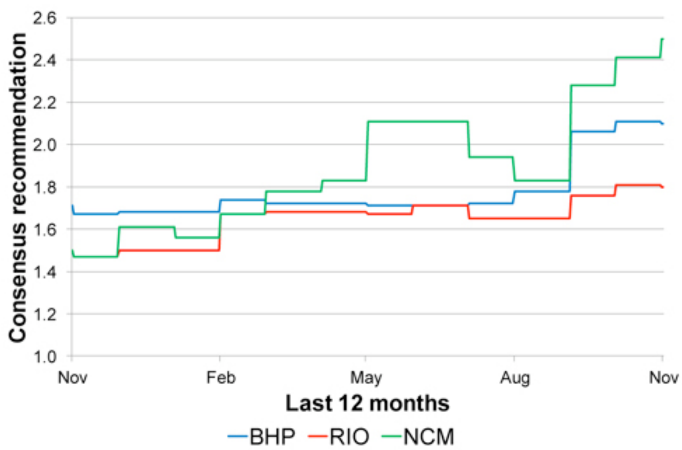
Iluka, Ozminerals, Panaust, Perseus and Fortescue

The ratings for Iluika (ILU) and Ozminerals (OZL) are too poor for me to consider buying at present and Panaust (PNA) and Perseus Mining (PRU) are too dependent on exploration for my liking. Regis Resources (RRL) is dependent on gold mining and so is not one for me. Fortescue (FMG), the iron ore miner, went through some well publicised debt negotiations recently, but my reason for not holding it is because its fortunes seem to be too linked to the charisma (and ability!) of its chairman, Andrew Forrest. Too much key man risk for me.

BHP, Rio and Newcrest

Turning back to the big three stocks in the sector, the last 12 months data on their recommendations are shown in Figure 1. All ratings have deteriorated – along with the controlled slow-down in China but NCM has taken a bigger jump recently – adding to my lack of interest in the stock. RIO looks to be preferred to BHP not only because of its current rating but the widening gap.

Figure 1: Variation in consensus recommendations for selected stocks



Note: the estimates in the Figure are current to the close of business 16th November 2012. They are based on Thomson Reuters Datastream. The price target is the brokers' forecast of where the stock price is heading – often considered to be in the next 12 months.

We currently have the whole Materials sector predicted to have the best capital gain of the 11 sectors over the next 12 months of 27.5% and, from Figure 2, the sector is well underpriced (-6.8%). We did have the sector very overpriced in 2009 and sufficiently overpriced for a correction in late 2010.

With the consensus target price range of $31.74 to $52.67 with a median of $39.14, BHP stock price makes it worthy of consideration. For RIO the range is $60.49 to $104.84 with a median of $74.57 making it more attractive than BHP, which is consistent with the ratings differential. Clearly the risks associated with these forecasts – in particular – should be taken into account and the possibility that any of these data points/forecasts may change rapidly, and often do.

Figure 2: Exuberance in the Materials (Mining) sector

Note: the estimates in the Figure are current to the close of business 16th November 2012. They are based on Thomson Reuters Datastream. Please go to www.woodhall.com.au for more information on the assumptions behind the estimates.

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Proportional drawdown of superannuation benefits

by Andrew Bloore

The proportioning rule was introduced on 1 July 2007, and ensures that a benefit to a member is comprised of a taxable and tax-free component, which is in proportion to the taxable and tax-free components of a super interest.

To apply the proportioning rule, the following steps need to be followed:

- Work out the taxable and tax-free proportions of the current super interest in the fund
- Apply these proportions to the benefit that is being paid.

How is the tax-free component of a super interest calculated?

The tax-free component is the portion of a super benefit that is tax-free. Ordinarily this includes non-concessional contributions and certain pre-July 2007 benefits.

How is the taxable component of a super interest calculated?

The taxable component is the taxable portion of a super benefit. An individual pays tax on this component if she receives a benefit under the age of 60 or receives an untaxed benefit.

Applying the proportioning rule when paying a benefit

When a super benefit is paid out the benefit will include both the tax free and taxable components in the relevant proportion. The proportioning rules apply to lump sum payments, rollovers and pensions

Drawdown of super benefits as a lump sum

The apportionment for lump sum drawdowns will be based on the proportions of the total benefit at the time of payment.

Investment earnings will be added to the taxable component.

Example

On 1 September 2012, Ben wants to withdraw $100,000 as a lump sum from his super fund. Prior to the withdrawal, his super account comprised 70% of a taxable component and 30% tax-free component.

Ben's partial withdrawal would consist of $70,000 taxable component ($100,000 x 70%) and $30,000 tax-free component ($100,000 x 30%).

Drawdown of super benefits as a pension

A pension which first pays income on or after 1 July 2007 will consist of taxable and tax free components in the same proportion that those components made up of the total benefit immediately prior to the commencement of the pension. Likewise the tax free proportion of each income payment will reflect the proportion that the tax free component was of the total purchase price.

Investment earnings generated by assets supporting a pension will be attributed to both the tax free and taxable component based upon the proportion of the total benefit which each component comprised as at the date the pension became payable.

Example

John, aged 56, has a super interest with a value of $400,000. The interest includes a tax free component of $100,000 and a taxable component of $300,000. John uses all his super interest to purchase a pension on 1 August 2012.

The tax free percentage of John's super interest when the pension commenced would be:

Tax free component = $100,000 = 25%

Value of interest $400,000

The taxable percentage of John's super interest would therefore be 75%.

If John receives a pension payment of $2,000 on 1 September 2012 the tax free component of this would be $2,000 x 25% = $500

The taxable component would therefore be $1,500 ($2,000 – $500).

The proportioning rule ensures that all SMSF members receive consistent and equal treatment when accessing benefits.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*

Upcoming economic and financial market events

Australia
Tuesday 27 November: Balance of Payments (Sept Qtr)
Wednesday 28 November: Construction work done (Sept Qtr)
Thursday 29 November: Business investment (Sept Qtr)
Thursday 29 November: New home sales (October)
Friday 30 November: Private sector credit (September)

Overseas
Tuesday 27 November: US Durable goods orders (October)
Tuesday 27 November: US Case Shiller home prices (Sept)
Tuesday 27 November: US FHFA home prices (Sept)
Tuesday 27 November: US Consumer confidence (November)
Wednesday 28 November: US New home sales (October)
Wednesday 28 November: US Beige Book
Thursday 29 November: US Economic growth (Sept Qtr)
Friday 30 November: US Personal income (October)

Did you know?

Rob Jackman from the Rare Coin Company spoke with Peter Switzer about rare coins, which are considered to be a tangible, low risk, liquid investment. Do they belong in your SMSF portfolio?