SMSFs must know about zero rate loans

MONICA RULE

SERIOUS superannuation savers with self-managed super funds should be aware of the concept of zero interest loans, which they may make to their SMSFs under a limited recourse borrowing arrangement.

They were often raised and discussed with clients during my time as a technical adviser and senior compliance officer in the Australian Taxation Office, which I recently left, and more often since.

Section 109 of the Superannuation Industry (Supervision) Act 1993 (SISA) provides that a trustee must not invest unless the parties are dealing on arm's-length terms, or they are not but the terms and conditions of the transaction are no more favourable to the *other party* than if the parties were dealing at arm's length.

I have put emphasis on the words "other party" because the law is that where the trustee of an SMSF borrows from a related party (eg members of the SMSF) on terms that are not at arm's length but are no more favourable to the other party (the members), the trustee will not break the law.

So if the trustee of an SMSF enters into a low or no interest loan with the members of the SMSF to buy an asset under the limited recourse borrowing arrangement, it would not contravene the arm's-length provisions under the SISA.

To further demonstrate how this area of the law is interpreted by the ATO, you may wish to read the ATO publication ATOID 2010/162. In this document, the ATO considered the question: does a trustee contravene section 109 of the SISA if it borrows money from a related party of the SMSF under a limited recourse borrowing arrangement on terms favourable to the SMSF?

The ATO said: "No. The terms cannot be more favourable to the related party than would have been the case had the parties been dealing at arm's length, but there is no contravention of section 109 if the terms are more favourable to the SMSF."

This means the ATO only views a loan as an arm's-length contravention if the terms of the loan favour the lender, the related party.

The arm's-length provision may be a loophole that should not have been interpreted in this way. To me, trustees of SMSFs should always deal on commercial terms like those offered by a bank, for example.

If you are thinking of lending your money to your SMSF so that your SMSF can buy an asset under the limited recourse borrowing arrangement, perhaps you should get a recent confirmation from the ATO that a zero loan arrangement is allowable.

Having worked for the ATO for the past 28 years, I am aware of many situations where transactions that were previously allowed were no longer allowed at a later date.

Monica Rule is the author of The Self Managed Super Handbook — Superannuation Law for Self Managed Superannuation Funds in plain English www.monicarule.com.au

China and chickens? That's just half the agribusiness story

RENEE NOWYTARGER

Colonial First State's Skye McPherson, who runs its Wholesale Global Soft Commodity Share Fund

Investors can't ignore growing worldwide demand for food

ANDREW MAIN

IF you're investing in Australian listed companies for agricultural exposure, you're probably getting access to only $10 billion worth of the total $550bn universe of global agribusiness companies, according to Skye McPherson.

A Narromine farmer's daughter who can hold her own in such testosterone-driven places as a US tractor show, McPherson claims that "everything in agribusiness is now much more globalised than it was".

She says that while there are about 400 companies around the world in which to invest, there are only eight in Australia that fit her fund's criteria because so little of Australia's agribusiness is publicly listed.

McPherson runs the Colonial First State Wholesale Global Soft Commodity Share Fund, which sounds like a commodity fund but is actually invested in a wide variety of listed global agribusiness companies, ranging from fertiliser manufacturers to commodity traders.

Diplomatically refusing to comment on new Agriculture Minister Barnaby Joyce's concerns about the possible sale of Australian agricultural land, she points out that it's production rather than ownership that will be the big issue in years to come.

China and chickens? That's just half the story, she says.

"There's certainly a growth story in China and the humble chicken is the best converter of grain of all the major meat types," McPherson says. "But actually, the market for Australia's grain is growing faster in the Middle East than in Asia."

During 2010, Australia sent a total of 150 million tonnes of grain to the Middle East, she says, against 115 million tonnes to China, while over the five years to 2010, exports to the Middle East grew by 50 per cent, compared with 17 per cent for Asia.

"Everyone's talking about Asia, but there's been better growth in the Middle East and there are obvious limits to production there."

She also notes that the food business is relatively unmoved by civil upheavals of the type occurring in Egypt and Syria because "everyone's got to eat".

By the way, she says, it takes only two kilograms of grain to rear one kilogram of chicken compared with twice that much for pork, at four kilos, and seven kilograms for beef. Bad news for chickens, clearly.

"It's all about volume, volume and more volume," she says, noting that populations — and, in particular, the middle classes — in developing economies have grown far faster than food production, and the only option available to those countries is to import.

"A lot of countries in Africa fall into that category, most particularly Nigeria," she says, noting that according to the Food & Agriculture Organisation, the total tonnage of meat and seafood consumed in Nigeria increased by 90 per cent between 2000 and 2009. "We live and breathe this sort of information because we are globally focused," she says.

And there are a lot of other global trends happening out there that local investors may not be noticing, such as the rapid lift in corn production in Brazil in response to the US drought of two years ago, something, she says, would not have happened so fast in previous years because information wasn't so freely available.

But that's old news now, according to McPherson. Over in the US, the price of corn might not be $US10 a bushel, as it was in the drought, but it's still around $US4.60 compared with the long-run average of about $US2.30, "and a lot of sons are going back to the land".

Given that corn and soybeans are the mainstay of US agriculture and prices are well above average, there's been a dramatic reversal of the younger generation's exodus to major cities.

"And that's good for the equipment manufacturers," she says, remembering seeing a Case tractor fan wearing a T-shirt that said: "If it's not red, It stays in the shed."

And, yes, she not only has her red Case hat but at least one green John Deere number.

Her fund is a small one at $86 million, but there are only two such funds based in Australia. Importantly for local investors, it is hugely diversified and has a minimal correlation to the performance of most local equity funds.

The fund has been up and running only since November 2009, but it has delivered net returns of 7.8 per cent a year in Australian dollars since inception, and a 12-month performance since July last year of 21.6 per cent net of fees. Retail fees are 1.2 per cent a year.

Clock ticks down to rising share prices for small-cap miners

UNDER THE RADAR

RICHARD HEMMING

SMALL-CAP portfolio manager Ben Griffiths senses that John Maynard Keynes's "animal spirits" are rising, indicating a growing confidence among both consumers and investors.

His fund stands to be a big beneficiary if he's right. Eley Griffiths manages $1.1 billion and invests in companies outside the S&P/ASX 100 index.

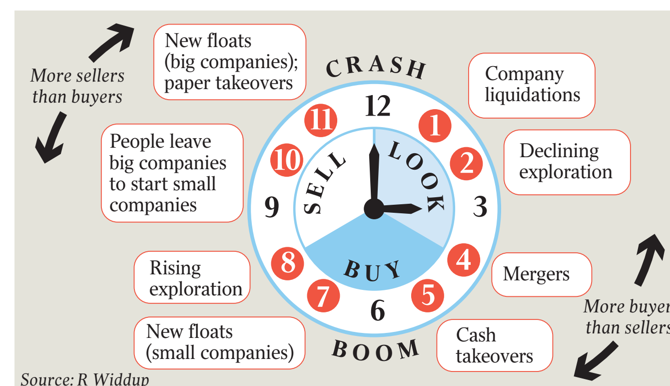
Says Griffiths: "Low interest rates have had the effect of fostering an early recovery, which starts off with increasing consumer confidence, then business confidence, and finally investor confidence."

Successful small-cap investing is about the market embracing risk. A good sign is that capital markets are reopening. In the past 12 months there have been the high-profile and successful floats of the insurance broker Steadfast and of the IVF provider Virtus. There have also been big sell-downs from founding shareholders of listed companies including NextDC, iiNet, and the Lowys in Westfield Retail Trust.

"In a weaker market these sell-downs wouldn't be doable because there would be too much cynicism attached," says Griffiths.

Lately his fund has started dipping its considerable toes into resources. The companies he will disclose purchases in are iron producer BC Iron (BCI), copper and gold producer Sandfire Resources (SFR), nickel and copper developers Sirius Resources (SIR) and Independence (IGO).

There are others his team is buying and researching, but he wouldn't say which. He is waiting for the bull market in resources to return.



On this front, he says a big help over the years has been the "resources clock" he hangs up on his office wall. The clock was invented by Robin Widdup in 1993, when he was a highly rated mining analyst with the broker JBWere.

Widdup is now managing director of listed investment company Lion Selection. He says that when the time is 12 o'clock, we're in a resources crash, while at 6 o'clock it's a boom. Right now, we're at 3 o'clock, which means that exploration is in decline and mergers and cash takeovers in the mining sector are about to take off. "Investment in mining goes in cycles of five to 10 years as far as you can go back. People always think it's different this time but it always follows the same trajectory," says Widdup.

The different points on the clock represent the liquidity, or money, invested in the mining sector at the various points in the cycle, which reflects sentiment.

Activity is exacerbated at the smaller end of the mining spectrum. For example, BHP Billiton had a high of $50 and a low of $10 in the past five years. A small mining stock might have had a high of $1 or low of 10c.

But now Widdup says that the time might be right to start looking at those small miners: "Being at 3pm means we're at the start of a new cycle, which means you can get a tremendous uplift in equity valuations from here. History proves that the movement of boom to bust can happen very quickly, whether you look at 1974, 1980, 1987, 1997 or 2011."

www.undertheradar report.com.au.

Richard Hemming is an independent analyst who edits a fortnightly newsletter He does not own shares in the companies mentioned.

What if web giants merged?

Webjet and Wotif seem intent on stealing markets from each other

ROGER MONTGOMERY

WEBJET and Wotif have revolutionised the way Australians organise their travel arrangements. Webjet is the leading aggregator of flight information while Wotif is the go-to site for booking accommodation.

The strength of their networks has created high barriers to entry. In turn, these barriers afforded Webjet and Wotif the opportunity to grow at attractive rates while increasing market share. For many years the companies were content to play in their own backyards and leave each other to their own devices.

But the growth in their core divisions has reached maturity, and the companies need to find a way to satisfy shareholders' insatiable demands for earnings growth. The natural path for each to take with their existing infrastructure is to increase their range of booking services. By providing solutions for every segment of the travel market, the companies can provide packaged deals, which not only increases the transactional value per existing customer, but also entices new customers to visit their respective sites.

Both companies are intent on becoming the leading travel websites in the region. Webjet describes itself as "Australia and New Zealand's largest online travel agency" while Wotif describes itself as "Australasia's leading travel website".

But there can only be one leader, and in order to become that leader the two companies must steal market share from the other — and this is easier said than done. You see, even though each company has built a large customer base, it seems that users are unwilling to switch. In the consumers' eyes, Webjet is for flights while Wotif is for hotels, and both are struggling to shake this perception.

The natural outcome . . . is that one winner will eventually emerge

Webjet management has been frustrated by the lack of impact their hotel division has had on Wotif's domestic market share while Wotif is booking only 18 per cent of the airfares that Webjet does. The network effect has allowed Wotif and Webjet to grow into the companies they are today, but it is also proving to be a worthy barrier against each other's advances.

We believe one will ultimately emerge victorious, however, it will take time for a foothold to be gained.

While the stalemate continues, the companies are attempting expansions into Asia to offset their mature domestic earnings profiles. And this is where their strategies diverge.

Earlier this year, Webjet acquired Zuji, a complete online travel agency in Singapore and Hong Kong. The acquisition sidesteps the branding issue that Webjet is experiencing domestically. Zuji is perceived as a one-stop site to organise all travel arrangements rather than a singular booking service. Wotif, on the other hand, has expanded in accordance with its core competency, choosing to acquire accommodation sites rather than online travel agencies.

Webjet's strategy appears to be more successful, with Zuji expected to contribute to earnings next year. Conversely, Wotif has considerably underperformed overseas, with travel bookings into Asia declining in each of the past four years.

But while Webjet appears to have its nose ahead of Wotif at this stage, neither company reported meaningful earnings from packaged deals in their recent full-year results.

The natural outcome with any network economy is that one winner will eventually emerge. A positive feedback loop is created when users are attracted to a site, which in turn attracts other users, until the site becomes the preferred choice in the marketplace. Both Webjet and Wotif know the exponential benefits that arise from this phenomenon, and they will be conscious of each other's position in the race to become the region's leading travel website.

With such complementary services and a shared long-term vision, you would think the companies could merge rather than compete for market share, but it seems that both are intent on a long, drawn-out battle.

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