



DECEMBER 2015

Investor Update – December 2015

Welcome to our final Investor Update for 2015. The markets proved to be unpredictable during the year which has influenced the theme of the 2016 National Annual AIA Conference – Volatility, Risk & Reward – *Strategies for an uncertain world*. We will give you more details once we have finalised the program.

Our office will be closed from 21st December to 1st January. We would like to take this opportunity to wish you and your loved ones a very happy, safe and healthy festive season and we look forward to the challenges of 2016.

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Post it notes

Marcus Padley – Marcus Today

The neighbours turned on their Christmas lights last weekend, where did the year go?

I like the concept of a “New” year, for a stock market trader it's as good a time as any to take a moment to look back and torment yourself with all those things you didn't know but could have guessed that would have made investment so easy over the last 12 months, simple things that would have taken all the stress out of it, saved an enormous amount of time and helped us undeservedly, prematurely and gloriously retire.

Upcoming Events

AIA Annual Investors Conference
Volatility, Risk & Reward –
Strategies for an uncertain world
Save the date: August 7 – 10, 2016.

With 44 sessions and some of the most respected names in the financial industry, this conference is not to be missed. Details will be available early next year and we hope to see you at the Marriott Resort and Spa Surfers Paradise.

Canberra Discussion Group
Ginninderra Labour Club
14th December 2015 @ 7.30pm

Sunshine Coast Discussion Group
The Old Post Office, Buderim
20th January 2016 @ 6.30pm

Kew Discussion Group
Kew Library
27th January 2016 @ 7.00pm

Melbourne Bayside Discussion Group
Contact coordinator Kevin MacDonald E:
km.macdonald@bigpond.com
28th January 2016 @ 4.00pm

Post it notes (continued)

On the basis that anything that is known or expected will not move a share price you can see that investment comes down to anticipating the unexpected and every year there are a handful of these things that you needed to know that would have swept away all the bollocks, all the financial theory, all the research, all the complications and all the endless blah blah blah we were bombarded with. Things that made us money and let me tell you, it wasn't Asset Allocation, or Portfolio Optimisation, or lower fees. It was a few simple events, fads and trends that moved prices. A few words that we shoulda coulda didn't distill from the many thousands of unnecessary words that we read in their pursuit.

You don't have to wait for Christmas to do it, you can do it any day of the year, look back over the last 12 months and identify certain X factors that you needed to know. I like to call them Post-it notes, one line instructions that you wish someone had stuck on your trading screen at the beginning of the year that would have simplified everything.

12 months ago for instance the most valuable post-it note might have said "Baby Powder!" That's all you really needed to know in 2015 because, as they say in the stock-market, if you have one good idea a year, it's a good year.

But perhaps the easier Post-it notes to guess and the more important Post-it notes for a lot of risk intolerant retirees are not the unexpected ones that cover you in glory but the Post-it notes that reinforce common sense, that identify existing trends and stop you trying to be smart by betting against them. On that basis the most valuable post-it note this year was probably this one, "Continue to avoid Resources". Not so hard. As I write BHP is down 29% this year, Santos and Origin are down 44%. "The Australian dollar is going down" would have been similarly on trend. It is down another 10% this year.

Other Post-it notes that would have seemed unlikely included "Avoid Woolworths" which is down 21% this year, "Safe income is overpriced", Telstra and the big four banks are down 7%, 9%, 4%, 13% and up 0.3% before dividends and it would have been nice if we'd known that "The stock-market is going nowhere this year" although this bit of information has always been highly overrated because successful investment has always been about how good you are picking the stocks not following the market.

What about the year ahead? Your starting point should always be the themes that were running in the last 12 months. Continuation of the trend is the most likely outcome in the stock market and although the genius or gambler may foresee or fluke a change in trend probably best you respect the current themes and not bet against them until proved otherwise.

So start with the things that are expected and go from there. Here are a few obvious starters.

- "Don't buy resources unless they go up".
- "Australian dollar to keep going down".
- "Interest rates to stay lower for longer". US rates will go up but it won't matter.
- "Inflation is not coming back".
- "Property is fine".

Others might include:

- "Assume the market is not going to do anything again and work with that".
- "Good sectors: Housing, Accommodation, Tourism, Healthcare, Food, Agriculture, Education".
- "Beef and Dairy demand to froth".
- "International investment trend to continue" (MFG, PTM, MQG).



X Factors:

- "Baby Powder Bubble to burst".
- A lesson from a Glencore moment this year - "If you see a table highlighting who is owed money by BHP, sell everything!" - if resources do go over the precipice of debt and fall in a confidence hole it will take the banks and the whole market with it.
- "The US market is up 21% compound for six years on the trot - it could collapse".

I've always said there is no money in PEs or yields, there is money in sitting by a swimming pool and working out what nobody expects. On that basis the best way to spend your Christmas is not reading reams of research but sitting by a pool with a gin and tonic and thinking up a few Post-it notes of your own because that's where your money will be made or lost next year, having an opinion rather than following the crowds.

The emperor's new clothes or a suit of shining armour?

Rob Hay – Specialist Investment Sales, BT Investment Solutions, BT Financial Group

Nearly \$36B has been savaged from the value of the S&P ASX 200 index this financial year thus far, with daily swings in the local bourse above 1% becoming commonplace. Against this backdrop many investors have been looking at ways to opportunistically take advantage of short term pullbacks in the price of selected shares, frequently through listed warrants offering differing forms of leverage and protection structures in order to maximise their exposure.

However, whilst some investors have been able to leverage into the market and ride out the short term volatility, others have been sold out of positions at a significant loss under the warrant terms, sometimes only days after purchasing the warrant and frequently with limited opportunity to trade back into the market on the same terms they originally agreed to.

For this reason, it is important to be aware of how the protection in different warrant structures works so that investment decisions can be made in a manner consistent with the intended time frame and risk profile for the portfolio.

What are the main types of protection applicable to warrants?

The two main types of protection offered to warrant holders (to cover the loan component only) are a notional put option and a stop loss. The key differences between a notional put option and a stop loss are shown in Table 1

As would be expected, investors seeking long term exposure on a conservatively geared basis to a selected portfolio of large-cap Australian shares tend to prefer warrants with notional put options. This is because the notional put option provides greater certainty than a stop loss (with no risk of being sold out early due to market movements) and (particularly for clients looking to invest into ETFs) could be cheaper than the cost structure of a stop loss warrant.

TABLE 1

	Notional put option	Stop loss
Functionality	Protects the full loan amount throughout term and at maturity (currently up to five years, but historically has been up to ten years). Any short term volatility does not trigger a sale of the securities.	Protects the full loan amount throughout term and at maturity (often open ended or very long dated). Where the loan to value ratio becomes too high an investor can be sold out of their position (where shares are sold and the loan balance repaid with no notice).
Type of warrants	Typically investment warrants which are long only and are available over large-cap stocks and ETFs.	Typically trading warrants such as Minis which can be either long or short and are available over stocks, indices, commodities and currencies, but can be done over investment (self-funding) warrants as well.
Correlation between warrant price and share price	Variable throughout the life of the warrant, but typically >90% at the point of listing.	1:1 throughout the life of the warrant.
Cost	~6.15% p.a. - ~15.00% p.a. (depending on stock) on average, inclusive of loan funding cost (fixed annually and resetting every 12 months) and notional put option protection.	~6.7% - 7% p.a. (variable) inclusive of loan funding cost, uniform across all stocks.

Conversely, investors who have a shorter term investment timeframe, and who might be looking at riskier stocks (or asset classes such as currencies or commodities) that are often more expensive to protect via a notional put option (due to the heightened volatility), tend to prefer warrants with a stop loss feature. Such investors generally are quite active traders who are looking for high levels of leverage in their portfolios and who are prepared to assume the risk that their positions may be sold out through the stop loss mechanism even before the market opens on any given day.

In recent times, and in part due to concerns around the risk of long term investment portfolios being unwound by short term market movements, investors may be questioning whether or not warrants with a stop loss feature represent value for money. For example, notional put option warrants may be cheaper than stop loss warrants (as is currently the case with ASX top 20 / 200 / high yield ETFs and selected utility stocks), and some warrants with a notional put option are currently priced at only a 1% - 1.5% premium to the stop loss equivalent (as is the case with most financial and resource stocks).

Take for example the situation of Russell and Iris* who in November 2008 invested \$40,000 into a longer dated self-funding instalment warrant over the National Australia Bank (NAB) with a ~60% loan to value ratio in order to accelerate their potential for wealth creation inside their self-managed superannuation fund over the medium to long term. By the time Russell and Iris sought to exit their investment 6.5 years later, their capital had grown by over 254% in nominal terms to nearly \$142,000, excluding any tax benefits derived from deductible interest expense or surplus franking credits (which can potentially add an extra 1% - 2% per annum to total returns) along the way.

As impressive as these returns may appear (and there is no guarantee these returns can be repeated in the future), the additional risks they assumed by incorporating leverage into their portfolio saw the value of their holding swing aggressively over time, with their original purchase price per warrant of around \$7.60 dropping as low as \$4.50 in January 2009, before recovering to nearly \$27 when they ultimately redeemed.

Had Russell and Iris not opted for the warrant with the notional put option and instead used a stop loss warrant, they most likely would have been sold out of their position on a number of occasions (particularly if they were rolling a smaller amount of equity into a more highly levered warrant in order to maintain the original exposure) where the NAB share price fell significantly, as shown in Table 2 below:

Time period	Approximate % fall in NAB share price
2 January 2009 – 6 March 2009	20%
16 October 2009 – 5 February 2010	21%
6 May 2011 – 23 September 2011	26%
10 May 2013 – 7 June 2013	13%
10 April 2015 – 15 May 2015	11%

Conclusion

Not every warrant structure will suit every investor as we all have unique investment views, risk profiles, investment timeframes and need for leverage. For that reason it is important to ensure that the structure of any warrant portfolio is suited to the investor's circumstances and represents fair value for money for the level of leverage being sought and for the quality of protection being offered.

^ Any views expressed in this article are those of the author and do not necessarily represent the official views of BT Financial Group or Westpac Group.

*Names have been changed for privacy reasons.

Passive investing is a waste of time

Alan Hull - Educator

This article is based on one of my early encounters with a Superannuation advisor. Whilst it makes for amusing reading it also contains a serious lesson about reading fine print and constantly monitoring your investments...even managed investments.

At the fertile age of 20, just several months short of my 21st birthday, I received a phone call from a man who said he was a financial advisor and that he would like to set up a consultation with me to discuss my financial future. It was at no cost to me and he was very flexible as to where and when we should meet. Due in large part to his apparent altruistic intentions and concern for my future welfare, I agreed to meet with him. At the time of the consultation I found myself in the presence of a tallish man, dressed in a very impressive double breasted three piece suite, sporting just a touch of Grey at his sideburns and wearing a friendly, obliging grin. My first thought was, having just left home and the watchful eye of my parents, how lucky am I.

Here was this obviously important man that I warmed to immediately who was going to look after me by taking care of my financial future while I worried about more immediate problems like girls and cars. He asked me, with an authoritative tone, if I had a superannuation policy as it was vital to my future wellbeing in retirement. He added that all sensible and mature people who didn't want to become a burden on their friends and family when they stopped working had one.

He then handed to me a document containing national statistics on the aging population proving that reliance on

the pension in retirement was futile. Fear shot through my mind as it dawned on me that I couldn't even spell, 'Superannuation' and I felt my face flush with embarrassment. Add to this my shame at being a future burden on the ones I loved and my confusion at the word 'Demographic' written on the piece of paper in my hand. I'd been on my own in the big bad world for a few brief months and look at the damage that I could cause by simply not knowing about something like, 'Superannuation'.

I uttered in a whimper, 'What should I do?' He had prepared an important looking document with my name at the top of each page that contained the most fantastic news. If I contributed just \$700 a year, BEFORE TAX SO I WOULDN'T EVEN FEEL IT, to a superannuation fund then I would have over \$300,000 to play with in retirement. I nearly kissed the man as I realized that not only was financial Armageddon going to be avoided but I was going to have enough money to help others in retirement. The tone of the meeting relaxed and I blurted out a whole lot of meaningless stuff like, 'What's a demographic?' as you tend to do just after a near death experience.

But just as I was running out of things to say to this patient listener, he asked me with a hint of concern in his voice when my 21st birthday was. My eyes widened as the stiffness returned to my body and I replied, 'In 2 months...is that a problem?'. To cut a long story short, with parental like concern he explained to me that it was very necessary that I start the policy before I turned 21.

With this revelation out in the open I nearly climbed onto his lap, trying to get my hands on the superannuation policy that would change my life back to what it was the day before. Whilst this anecdote is based on a real event in my life, I have exaggerated it for the purpose of illustrating a point. I was dealing largely with a salesman and not a man with purely altruistic intentions. I do recall that I was curious at the time as to why he required no payment for his services.

Now to the policy in question and the absolute facts regarding its performance over the next decade. The lesson here, in advance, is to read the fine print. The short version is that the printout I was shown containing figures that would have made Donald Trump drool at the time, bears scant resemblance to the actual performance of the policy. It was based on 15% annual interest compounding over forty years.

My contributions, included in the printout, started at \$700 per annum but increased over time in line with the then annual CPI figure. The 15% annual growth figure

used was the current performance of the superannuation fund. Like most individuals at the ripe old age of twenty something you tend to leave the superannuation policy in the bottom draw and simply go about life with the comfort of knowing it's there.

After ten years of dutifully making the compulsory contributions to the fund and now having the option of not having to make any further payments I decided to fish out the policy and the original printout to see if I was still on target for my Villa in the Bahamas. The decision was also prompted in part by the constant increases in the annual contributions that were becoming a perpetual annoyance.

You can imagine my surprise when the actual performance of the fund, according to my annual statement, was approximately half the projected figure on the printout. I will demonstrate in simple form what happened to me and the power of compound interest.

The following table shows the difference between the guaranteed performance of the fund and the performance used on the printout using 15%. For illustration purposes I have excluded my contributions and the funds administration fees and simply used a starting figure of \$1,000 in both cases.

<i>Year</i>	<i>Guaranteed Performance (9%)</i>	<i>Projected Performance (15%)</i>
1	\$1,090.00	\$1,150.00
2	\$1,188.00	\$1,322.00
3	\$1,295.00	\$1,521.00
4	\$1,412.00	\$1,749.00
5	\$1,539.00	\$2,011.00
6	\$1,677.00	\$2,313.00
7	\$1,828.00	\$2,660.00
8	\$1,992.00	\$3,059.00
9	\$2,172.00	\$3,518.00
10	\$2,367.00	\$4,046.00

My first point is that the interest rate is absolutely critical when you are compounding it over time. If I continue the above table for another 30 years to my retirement, the final figures are;

My figures were muddled by other factors such as my annual contributions, the actual CPI, increases to the administration fees and the actual performance of the fund. Regardless of this I was looking at a similar scenario and, as if by magic, I found myself with the phone at my ear, dialling a number that was also buried in the reams of paper. I had prepared my questions and the conversation went something like this;

Me The growth on the fund doesn't match the figure used on the printout I was shown when I joined the fund...what's the story?

Consultant The figure used for the projections was the most accurate figure available at the time you joined the fund. Have you been reading your annual statement and the annual report that we've been sending you every year?
(Pregnant pause)

Me No, but I assumed that if there was...
(Cut off by the consultant)

Consultant I do recommend that you take the time to read it, even if its not straight away.
(With an incredulous tone in my voice)

Me So you're telling me if I don't have enough money to retire, its my fault because I haven't read the material you've sent me? Surely there's some kind of guarantee on the performance of the fund?
(With an indignant tone in his voice)

Consultant Of course there is. Its in your original policy document ...haven't you read that either?
(With the sudden realization that my situation was largely due to my own neglect)

Me 'no'
(With the sudden realization that my situation was largely due to my own neglect)

Consultant I SUGGEST THAT YOU READ IT AND THEN CALL ME BACK.

Me 'thanks.....bye'

I now went back to the reams of paper that were sent out to me each year...not to mention the original policy document that I neglected to read in the first place. It was all there in black and white. The minimum annual growth guarantee of 9%, notification of changes in administration fees for the forthcoming period and changes to my contributions based on the CPI including a complete explanation of the calculation being employed.

By burying it all in the proverbial bottom draw I hadn't lost a single cent and I was even showing a profit...but it certainly wasn't the sort of profit I expected after ten years. So I vowed from that day forth never to be a

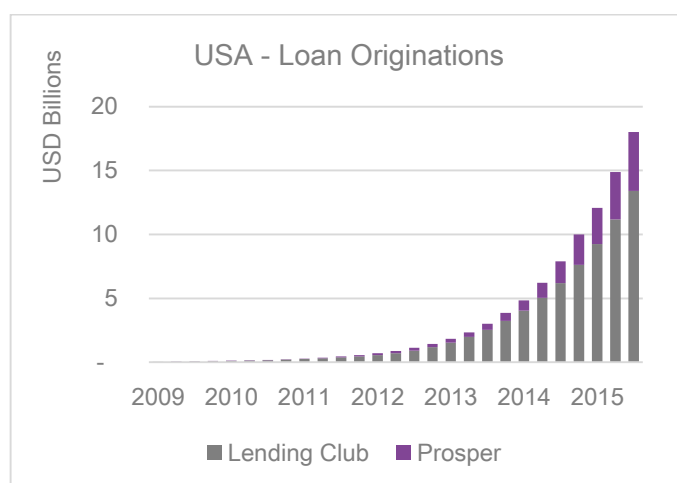
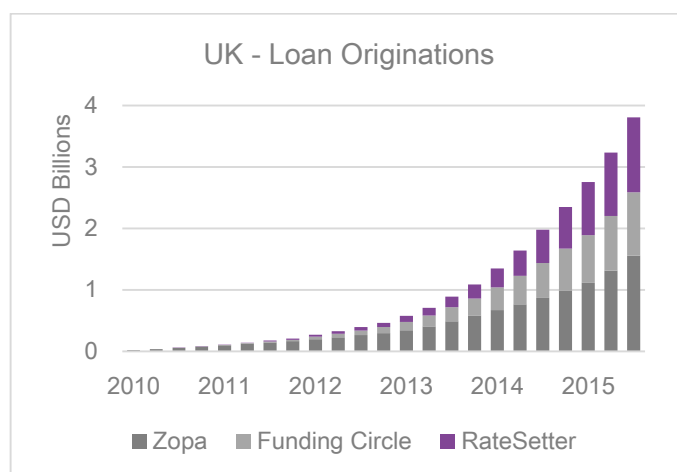
passive investor again...my time, where time is money, is too valuable.

Peer-to-peer lending

Andrew Jones - an employee of RateSetter Australia

When Vanguard's Chief Economist, Joe Davies, calls for a greater allocation to fixed income it's time to start listening. He recently told SMSF Advisor, "Over long periods of time cash... is a very poor core holding because your expected real rate of return is ... lower than ... fixed income".

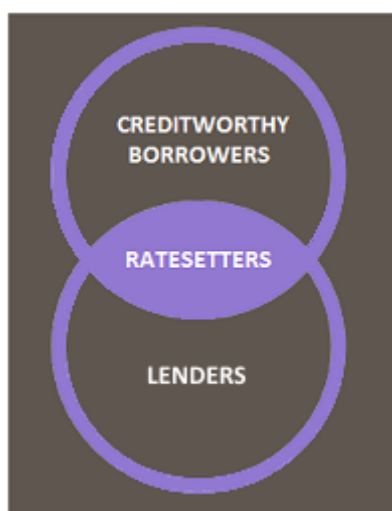
Peer-to-peer lending presents an interesting addition to your options for a fixed income allocation. In the USA and the UK, peer-to-peer lending has become very mainstream with over \$20 billion dollars lent in 2015.



Source: Zopa, Funding Circle, RateSetter, Lending Club and Prosper websites

In a nutshell, peer-to-peer lenders match people looking to borrow money with people who have money to lend. Most peer-to-peer lenders have chosen to focus on personal loans up to \$35,000. Small loans like this allow greater diversification and lenders benefit from substantial data available to the peer-to-peer platforms which allow them to make informed credit decisions.

In addition, the big banks have been steadily increasing their interest rate spread on personal loans despite dropping default rates, largely due to lack of competition. This provides an excellent opportunity for new entrants to shake up the market.



Generally speaking, peer-to-peer lenders target the top tiers of creditworthy borrowers. They are competing against the banks (not payday lenders) for borrowers. Rates offered to borrowers are often lower than what that borrower would pay to a bank. This is largely due to the lower business costs of peer-to-peer lenders – an online business model, no expensive branch network and no million dollar bonuses for management.

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There are two broad peer-to-peer models that have developed, one from the USA and the other from the UK.

Key features	Resulting Dynamics	Open to	Leading Australian platforms
UK Model Simplifies the investment process, lenders choose the amount and the term (1 month to 5 years) and they bid a rate at which they are willing to lend. Peer-to-peer platform does all the credit analysis and maintains a cash buffer to protect investors from default.	Majority of investors are retail RateSetter UK has originated ~\$2b of loans and no lender has suffered any loss to date	All investors aged 18 or older Minimum investment \$10	RateSetter
US Model Investors select individual loans from a comprehensive 'menu' Loans are selected based on factors such as risk rating, loan purpose, location, amount and serviceability Lenders should aim to have a highly diversified portfolio of loans to minimise the impact of defaults	US model is dominated by wholesale investors (hedge funds and banks) due to the analysis and diversification required to minimise risk	Wholesale or sophisticated investors with net assets of at least \$2,500,000 or gross income >\$250,000 for more than 2 years	SocietyOne MoneyPlace

Investors with RateSetter choose their investment term, 1 month, 1 year, 3 years or 5 years and the rate they would like to lend their funds at. Each of these investment terms operates as a market, a little like the ASX.

The lowest lender bid gets matched to borrowers first. Each borrower pays a risk fee to RateSetter's provision fund at the beginning of their loan. If a borrower defaults and there is money in the provision fund this is used to compensate investors. Effectively this shares the downside risk amongst all lenders.

SocietyOne and MoneyPlace have adopted the US peer-to-peer loan selection model. Investment terms are normally 3 or 5 years. Investors choose individual loans that they would like to invest in. They can invest in whole or parts of a loan. Investors have learned early that diversification is your friend when using this model. 1000 x \$10 loans are much better than one \$10,000 loan. An investor's return will be the actual interest rate earned from the loans less any losses suffered from defaults.

Regulation

All peer-to-peer lenders are regulated by ASIC. They need an Australian Financial Services Licence and an Australian Credit Licence to operate legally. As such they are subject to the same responsible lending rules and regulations as the banks.

Rate Setters 5 year market

5 Year Income		
Borrowers	Rate	Lenders
	>>9.9%	\$76.4k
	9.8%	\$143.0k
	9.7%	\$58,750.71
\$102,712.72	9.6%	

RateSetter and MoneyPlace have received approval from ASIC to take investments from retail investors.

What returns can I expect?

For platforms with provision fund protection (eg RateSetter) returns range, based on the term of the investment.

1 month	4%	Principal and interest repaid at the end of the month
1 year	5.5%	Interest paid monthly, principal repaid at the end of the term
3 years	8%	36 equal monthly principal and interest payments
5 years	9.8%	60 equal monthly principal and interest payments

Source: RateSetter website, 20 November 2015

Platforms without a provision fund lend at rates which vary based on the risk rating of the borrower. The table below shows the ranges of rates for Society One.

Investors need to net off their expected default rate to get an expected return.

Society One: Loans from 3 to 5 years

Credit Grade	Lower Band	Upper Band
AA	9.25%	9.95%
A	9.77%	10.48%
B	10.25%	11.69%
C	11.23%	13.68%
D	12.89%	18.69%

Source: Society One website, 20 November 2015

2016 will be an exciting year for the peer-to-peer lenders in Australia as they grow in size and the public become increasingly aware of the benefits of taking the traditional middleman out of the equation. Peer-to-peer technology is likely to do to lending what Uber is doing to taxis and Airbnb is doing to accommodation.

What to look for in a P2P lender?

- **Track record**
How long has the business been operating? Is it a proven model?
- **Availability**
Is it available to retail or only sophisticated investors?
- **Transparency**
Does the platform provide detailed information on loans being matched, default rates, size of provision fund?
Industry leading peer-to-peer lenders will allow download of their entire loan book.
- **Diversification**
Is there a risk sharing mechanism (ie provision fund or ability to buy a diversified portfolio)?
- **Regulated**
Does the platform hold an AFSL and ACL issued by ASIC
- **True peer-to-peer**
Peer-to-peer lenders are not to be confused with online lenders operating a fixed income fund on the lender side to finance loans. The risks involved in an online fund are quite different to peer-to-peer lenders and require careful consideration.

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