



**APRIL 2012**

## New format of AIA 'Investor Update'

Welcome to the new format for our AIA 'Investor Update'. This newsletter is issued via email to all current AIA members, and the email gives an outline of the articles and allows for downloading the full newsletter as a pdf version. This pdf version will also be available on the AIA website. These updates will contain some original material, some reproduced material where we believe that it is worthy of reproduction, and general notes re investing matters. We hope that this provides value to our members and that you enjoy the articles

Graeme Bottrill – Vice President

## In this issue

- ◆ **Understanding the business cycle from an investing view point**  
- Simon Shepherd
- ◆ **The assessment of company management**  
- Owen Richards
- ◆ **Tax reforms deferred**
- ◆ **Low income superannuation contribution**
- ◆ **SMSF's investment in collectables and personal use assets**
- ◆ **Draw down relief for self-funded retirees**
- ◆ **Superannuation guarantee age limit**

## Understanding the business cycle from an investing view point

**Simon Shepherd, Dip FP, B.Bus**

A key driver of share market returns over the long term is economic growth. Understanding the direction the economy may be moving can greatly assist with the timing of investment decisions.

The long run patterns of expansion and contraction in an economy are known as the business cycle. The five stages of the business cycle are growth (expansion), peak, recession (contraction), trough and recovery. The business cycle always lags movements in share prices. This is because, share markets "look forward" and try to anticipate the future direction of the economy (and the impact on corporate earnings).

## Upcoming Events



**AIA Annual Investors Conference**  
29<sup>th</sup> July – 1<sup>st</sup> August 2012

**Adelaide Information Meeting**  
**SMSF Pensions & Tax Strategies**  
1<sup>st</sup> May 2012 7.00pm

**Brisbane Managed Investments**  
**Discussion Group**  
Carindale, 6<sup>th</sup> May 2012 7.00pm

**Sydney North Shore Group**  
**Investing in a crisis-plagued world,**  
**Ashley Owen**  
Chatswood, 16<sup>th</sup> May 2012 7.30pm

If investors expect an economy to grow, they will buy shares in anticipation of higher corporate sales, profits and, ultimately, share prices. This means that if you were to invest solely based on certain economic indicators or commentary, you may have missed the boat because share prices have already moved in anticipation of higher growth (and vice versa).

For a recent example, cast your mind back to mid January this year, The World Bank, International Monetary Fund and Reserve Bank of Australia all slashed their growth forecasts for the next twelve months, which made front page news. The main driver of those downgrades was concern about further deterioration in the euro zone debt crisis.

Now look at share market performance for the first quarter of 2012 – global shares rallied 11%, the best 1st quarter return since 1998! Australian shares rallied 7%, the best quarterly returns in 2 years! This is predominately because the euro zone debt crisis has stabilised (for the time being) and the US economic recovery appears to be gathering momentum. Had you sold your shares on the back of those sombre growth headlines in January, it would have been a costly mistake.

So, which economic data might help predict the direction of the economy, and of market movements? Economic data can be broadly separated into two categories, lagging indicators and leading indicators.

Lagging indicators move *after* changes in the business cycle. This is because it can take some months to gather and analyse data after the end of a quarter, and often that data is subject to further revisions, after a preliminary release. So, that data may not be a dependable guide to what's currently happening in an economy, or where it's headed. Some common examples are Gross Domestic Product (GDP), Consumer Price Index (CPI) and the unemployment rate. An important caveat – these data releases can still move markets if they end up being much larger or smaller than what the crowd expects (known as "consensus expectations").

Leading indicators attempt to point to the future path of the economy and give investors a guide as to what stage of the business cycle an economy is in. Leading indicators are not always correct, but when combined with other measures (for example, share market valuations) may give investors useful insights into the economy.

Interest rates (bond yields) can often be a useful guide because falling yields (interest rates) may suggest a slowing economy and lower inflation expectations and rising bond yields may suggest an expanding economy and higher inflation expectations.

Surveys of consumers, small business or managers about their spending, hiring, borrowing and investing intentions are also leading indicators. The surveys are typically reported as an index number, with a number (such as 50 or 100) as the base for whether sentiment is improving/declining or that sector of the economy is in expansion/contraction. An example is The Westpac–Melbourne Institute Index of Consumer Sentiment, published monthly. The index fell by 5.0% in March to 96.1 from 101.1, with a reading below 100 indicating more people are pessimistic than optimistic about the future.

Some also consider the Baltic Dry Index a useful indicator. The index is measure of shipping costs of dry bulk commodities including iron ore, coal and grain. The theory is that movements in the index provide a guide to global supply and demand for major raw materials used at the beginning of the production chain, and therefore offer some insight into global economic growth and production. A rising index would suggest future economic expansion. However, the index can be extremely volatile.

Copper prices are another popular predictor of shifts in the global economy. Copper is used extensively in many industries and sectors, including the building and construction industries, infrastructure (e.g. electricity production and transmission) and electronics. If prices for copper are rising due to strong demand, this is considered a leading indicator of economic activity.

By understanding that the business cycle and share market move at different times, you will be a more attuned investor. Economic data is an important input in the investing decision process and knowing which data is a better predictor of the economy is another useful tool in your investing toolkit.

*This article does not consider your personal circumstances and is general advice only.*



## The Assessment of Company Management

**Owen Richards**

Someone once told me that the thing he liked in company annual reports was the photographs of the board members and the management team. This enabled him, “to check how dorky they look”. I’m not sure whether this is particularly helpful in share selections for investment purposes, but in an oft-quoted statement by the US investor Warren Buffett, he says that his preference is always to choose companies that he understands, that have an able and honest management and that are being offered at reasonable price.

If we were to take his advice, we should find it fairly simple to meet his first criterion and to make a judgement as to whether the price on offer is reasonable. However, it is a more difficult matter to assess management, although a start point is to look at the quantitative aspects of their effectiveness from their financial reports. Probably the most common measurements of how well a company is being run is to determine its Return on Equity (ROE), Return on Assets (ROA) and Earnings per Share (EPS) growth.

These are simple ratios to calculate and their expected amounts should then be related to the company’s market cap (i.e. capitalisation) and the industry that it is in. In all cases, it is important to establish the ratios first and then, as far as possible, to compare them with companies which are in the same industry and have a similar cap. Some suggested ratios for a healthy, well-run company is an ROE of greater than 10% and rising, an ROA of greater than 15% and rising and an EPS growth of about 10% over the past year and rising for the last eighteen months. Low-cap companies, such as software companies and consultancy firms that are well-run, will probably have much higher ratios.

But we should now be familiar with the mantra of, “figures don’t lie, but liars can figure”. Investors should always treat any numerical representation with some caution. While ROE is probably the most popular quantitative measure of management effectiveness, this ratio (like any other) can be manipulated. Companies can artificially maintain a healthy ROE by increasing debt leverage and using share buybacks funded through accumulated cash, to mask a deteriorating performance. No single metric is ever perfect and different approaches are always appropriate to get a more accurate representation.

It is a more complex task to make a qualitative assessment of management (that it meets Buffett’s “able and honest” criterion), but essentially it is critical that management’s interests are aligned with its investors’ interests. As this is being written, there is substantial general interest in the

resignation from a famous US investment bank by a senior executive after twelve years with the company. What’s different in this case is that his letter of resignation was effectively printed in the New York Times.

The executive describes the culture of the company as “toxic and destructive” and lays the blame for this on the current CEO and President who have “lost hold of the firm’s culture on their watch”. He cites their major failing as essentially focussing only on “...how can we make the most possible money”. Some commentators have expressed surprise and said that this is what an investment bank is supposed to do.

And of course this is true but, as the executive points out, this can’t be at the expense of their clients whom (as well as being referred to internally as “muppets”) are allegedly being sold expensive products which are not appropriate to their needs. Nor is this fair to the shareholders who must see the company’s value deteriorate over time as the client base inevitably declines.

There is no doubt that a company’s board acting through the company’s management (collectively, “management”) will largely determine the shared attitudes and beliefs of the company and how well this aligns with the interests of all of its stakeholders and especially its shareholders. While there is no fixed template, there are some characteristics which investors can look to for guidance as to how well they can assess their interests will be best served.

Good management should have substantial ownership in the company (“skin in the game”) through share holdings or options. This indicates the belief that there’s no other better alternative for their money and should provide some security for investors in knowing that management is unlikely to perform foolishly in the long term with their own wealth at stake. Keep an eye on major purchases or sales by board members. If a number are bailing out of the company within a reasonably close time frame, look for reasons why; but always be mindful that individuals have to buy houses, educate children and diversify their own holdings.

You should look for management that acts as a steward of your interests. The worth of management is not necessarily related to a strong performance within a short time frame and a good share price doesn’t necessarily indicate a high quality company. You want people that can invest in projects and activities that create value for the shareholders in the longer term. Still, where the Chairman or CEO of a company is also the major shareholder, there is always a possibility that deals may be done that are more in their personal interest than that of the company. The classic example is the very well-known West Australia entrepreneur and businessman who was convicted for

putting his own interests ahead of those of his publicly listed company and had a history of doing so.

Excellent management surely increases investors' value, but excellence must be paid for. You don't want management that unreasonably increases their bonuses at the expense of the shareholders or pays their top people outrageous salaries. Diverse industries offer diverse amounts but you should look for companies that reward its officials with compensations that roughly match similar industries.

Honesty takes a number of forms. What you want in a CEO is someone who is not afraid to admit that they have made mistakes. If something like an earnings disappointment occurs, you deserve an honest explanation as to why it happened and what is planned to overcome it. Too many companies provide only excuses for poor performance and blame external factors, such as the government or the economy as the cause. It can also be useful to check the tenure of management. Look for rock solid management that has been with the company for years.

You should read the section on management's discussion and analysis over the last couple of annual reports and make an assessment on how thoroughly they follow through on their planning and their promises. You may often find that many of the plans of management were never implemented. You want a management that is consistent with both their words and actions. Look at the company's mission statement and its effectiveness. Good mission statements create efficient managements and usually good returns for shareholders. If all that you read is corporate jargon and buzz words, management is not being honest with you.

In many ways, if you are interested in a company where the directors are people of known probity and the company is generally acknowledged as well-run, your requirement for assessment may be minimal. If business scandal has touched any one of them however, exercise caution. It is rare for any leopard to change his spots. Meanwhile, viewing the financial statements every six months is essential. However, they do not always tell the whole story. In the last analysis, companies are staffed and run by people and it is the wise investor that checks out as best as possible the people who set out these financial statements.

### Tax reforms deferred

To return the Budget to surplus in 2012/2013, the government has announced that it will defer previously announced tax reforms by one year;

- The start of the standard deductions for work related expenses will be deferred until 1 July 2013,

- The start of the 50% tax discount for interest income will be deferred until 1 July 2013,
- The start of the phase down in interest withholding tax for financial institutions will be deferred until 2014-15.
- The start of the new tax system for managed investment trusts will be deferred until 1 July 2013, allowing more time consultation.

The government will pause the indexation of the superannuation concessional contributions cap until 2013/2014.

### Low income superannuation contribution

The government had previously announced that individuals earning up to \$37,000 will effectively pay no tax on their superannuation guarantee contributions from 1 July 2012. Under the low income super contribution rules, the 15% contribution tax will effectively be refunded into their superannuation accounts.

The government will verify an individual's income using its available data, so eligible individuals will not need to complete any application forms.

To be eligible, individuals must receive more than 90% of their income through employment or business related work.



### SMSF's investments in collectables and personal use assets

From 1 July 2011 rules were introduced for self-managed superannuation fund (SMSF) investments in collectables and personal use assets. The rules apply to all collectable and personal use asset investments made by SMSFs on or after that date. If your SMSF held an investment in a collectable or personal use asset prior to 1 July 2011, it has until 1 July 2016 to comply with the new rules. This transitional period provides SMSF trustees with existing investments in collectables and personal use assets time to comply with the rules.

Collectables and personal use assets may include artwork, jewellery, antiques, artefacts, coins, medallions, bank notes, postage stamps, rare folios, manuscripts or books, memorabilia, wine or spirits, motor vehicles, or recreational boats.

The regulations require that:

- collectables and personal use assets must not be leased to any related party of the funds,



## Australian Investors Association – Investors Update

- collectables and personal use assets must not be stored or displayed in the private residence of any related party of the fund,
- trustees must make a written record of the reasons for the decisions on where to store the collectables and personal use assets and keep the record for 10 years,
- trustees must ensure that collectables and personal use assets are insured in the name of the fund within seven days of acquisition,
- collectables and personal use assets cannot be used by any related party of the fund, the transfer of ownership of collectables and personal use assets to a related party of the self-managed super fund must be done at a market price determined by a qualified independent valuer.

### Draw-down relief for self-funded retirees

Changes were made in previous years to reduce the pension drawdown percentages. The government had previously announced that this drawdown relief would be phased out over the coming years.

Regulations will now be made to extend the drawdown relief for self-funded retirees with a 25% reduction in the minimum payment for account-based, allocated, and market linked pensions for the 2012/2013 financial year. This is an extension to the 50% relief for the 2008/2009 to 2010/2011 financial years. The government had indicated previously that the minimum payment amounts would return to normal in 2012/2013.

### Superannuation guarantee age limit

(from the March 2012 newsletter of the Hon Bronwyn Bishop)

The Coalition took to the 2010 Federal election the promise that, if elected it would abolish the Superannuation Guarantee Age Limit to enable all employees over 70 to receive their superannuation entitlement like every other worker.

As the current law stands once an employee reaches the age of 70 it is optional for the employer to choose whether to pay superannuation. Once an employee reaches 75 it is illegal for the employer to pay superannuation.

Having an age limit on Superannuation Guarantee unfairly discriminates against mature age workers. Under the Coalition's plan, any worker, no matter their age, will be guaranteed to receive super contributions from their employer.

This publication has been prepared as information without consideration of any reader's specific investment objectives, personal financial situation or needs. No reader should rely upon the information and/or recommendations contained in these publications. Readers should, before acting on any information contained herein, consider the appropriateness of the information, having regard to their objectives, financial situation and needs.

The AIA believes that the material contained in these publications is based on the information from sources that are considered reliable and is accurate when issued. However, the AIA does not warrant its accuracy or reliability. All views and information expressed by the AIA, its officers, agents, representatives, and employees are for the purposes of discussion only.



Sun 29th July  
to  
Wed 1st Aug

Mariott  
Resort & Spa  
Surfers  
Paradise

HURRY  
Register by  
31st May to receive  
the early bird  
discount of  
\$100!

This conference is an independent conference for investors across all asset classes. It is designed to be of value for all individual investors, whether novice or experienced, who wish to take control of their investments, whether it be through financial advisers, brokers or totally DIY.

If you want high quality, value for money, truly independent education that will make you a better investor, attendance at this conference is a must.



#### SPEAKERS INCLUDE

Jonathan Pain, Editor of The Pain Report  
Chris Caton, Chief Economist, BT Financial Group  
John Abernethy, Managing Director, Clime Asset Management  
Roger Montgomery, Founder, Montgomery Investment Management  
David Chia, Co-Founder of Relate Empower Deliver  
Marcus Padley, Author, Marcus Today Daily Stockmarket newsletter  
Colin Nicholson, Investor and Author

learn more  
earn more!

You don't need to be an expert investor to attend  
This conference is for everyone!

Australian Investors Association Ltd

PO Box 7439

Gold Coast MC QLD 9726

Tel 1300 555 061

Fax 07 5538 8376

Email [aia@investors.asn.au](mailto:aia@investors.asn.au)