AUSTRALIAN INVESTORS ASSOCIATION

Investor Update

Monthly updates on investment issues for AIA members

JANUARY 2013

AIA 'Investor Update'

Welcome again to 'Investor Update'. . We have an interesting article from Elizabeth Moran about Indexed Annuity Bonds, some thoughts and observations (and a book review) from Lee Spano, together with a discussion of ratings agencies and investor education with references to mortgage funds. Enjoy!

In this issue

Sydney One-Day Seminar – 8th March 2013

What do we do now?

Investing Successfully in 2013

A one-day seminar for **INTERMEDIATE** investors.

Businesses in many sectors are struggling, and unemployment may be on the rise, but the market powers on regardless. Where are we in the current economic cycle, and where are we headed? How do we succeed as investors in this climate? Where should we be looking for the best and safest returns? What are the merits of equities, hybrids, bonds, cash, etc., in this climate?

Come and hear from the experts about the factors affecting our current investment returns, and what will most likely affect these returns during 2013 and later.

Download brochure

Upcoming Events [view events schedule]

New Discussion Group formed in the Hills District, NSW

A new AIA Discussion Group has been formed in the Hills District, west of Sydney. An inaugural meeting of interested members, held on 23 October 2012, attracted a number of enthusiastic members with varied backgrounds and interests and a broad depth of experience. The Group meets on the 3rd Tuesday of the month in the Castle Hill RSL Club, from 7:00pm – 8:30 pm. Please contact Michael Tan for details. (mghtan@tpg.com.au) Ph; 0419 279 743

Canberra Discussion Group
4th February 2013 7.30pm
Southern Cross Club, Woden

Perth Information Evening
World and Australian Economic Update
5th February 2013 6.30pm
Wembley Downs Tennis Club

Adelaide Information Meeting
The Outlook for Australian Sharemarket
5th February 2013 7.30pm
The German Club, Flinders St Adelaide

South Sydney Discussion Group
Introduction to Fixed Income
5th February 2013 7.00pm
Miranda Community Centre

Brisbane Information Meeting
Broncos Leagues Club
6th February 2013 1.30pm

Blackburn Discussion Group
6th February 2013, 7.15pm

Indexed annuity bonds - "The next big thing"

By Elizabeth Moran (FIIG Securities)

What are indexed annuity bonds?

In exchange for buying an indexed annuity bond (IAB) with an up-front, lump-sum payment, you then receive a cashflow comprising both principal and interest, until the maturity date of the bond. So in effect you are purchasing a 'salary'; an attractive proposition for those in retirement. These bonds are 'annuity like' but the payment is indexed to the Consumer Price Index. That means IABs also offer protection against inflation, so that if inflation grows over time, so too will your cashflows.

The principal repayment schedule is calculated in essentially the same way as a conventional house mortgage. In the absence of positive indexation (inflation), each payment would be equal, consisting of part principal and part interest. This amount is also referred to as the base payment or 'base annuity'. The base payments are indexed (by inflation) over the life of the asset, resulting in a steady increase of payments over the term to maturity.

What is also evident from the cashflows is that, as principal is returned throughout the life of the bond under the IAB, the investor gets a much higher quarterly payment or income than a capital indexed bond (CIB). This is a key for investors when deciding whether their investment needs are better suited to an IAB or the more traditional inflation CIB. Investors looking for higher income (cashflow) may consider an IAB better suited to their investment needs, whilst investors looking for an inflation protected capital return at maturity may prefer a CIB.

An annuity is a series of regular future cashflows, due and payable to the investor in return for the purchase price paid.

Another interesting point to note is that by investing in an IAB, your exposure to the issuer decreases over time, as your investment is being repaid on a regular basis.

Key IAB strengths

- As an IAB is indexed to inflation, it will protect the purchasing power of your investment
- Tradeable, just like other fixed income securities
- Long terms to maturity which help lock in returns, especially in a low interest rate environment
- Can add diversification to your portfolio as there are many well-known issuers
- Paying real yields over and above inflation of CPI + 3%
- Low minimum investments given some bonds have repaid significant principal

IABs available now

All of these issuers in Table 1 have current research available and we are working to build the number of IABs we can show as DirectBonds.

Issuer	Maturity date	Real yield	Total return*	Notional value	Total value
JEM Southbank	01/06/2035	3.60%	6.10%	50,000	$52,726
Praeco	01/08/2020	3.55%	5.93%	50,000	$36,264
Civic Nexus Finance	01/09/2032	3.35%	5.84%	50,000	$55,650

Source: FIIG Securities

Table 1

Praeco, will be well-known to many of you, being the Department of Defence Headquarters development in Canberra. The Praeco IAB has a lower total value than the other two securities and that is because it has returned more capital to investors since its inception. This means there's a low minimum investment of $36,264, possibly making it a more attractive alternative. It also has a much shorter eight years to maturity compared to the other two securities that have an additional 15 and 12 years to run, which could be considered an advantage or a disadvantage. If you'd like a copy of the research, please click here.

JEM Southbank is the Southbank educational precinct in Brisbane. This security has 23 years to run and if you're wanting a very long certain cashflow, this security with its higher real yield is attractive. Please click here for retail research and here for the wholesale report.

Civic Nexus Finance is a subsidiary of Industry Funds Management Infrastructure Fund and was formed to design and construct Melbourne's Spencer Street Station. Again we have research available, please click here for retail research and here for the wholesale report.

Other issuers

Other issuers include: Australian National University, Royal Women's Hospital, MPC Funding (Melbourne Convention Centre), Progress Health, NSW Schools and Newcastle Hospital.

Thoughts from Lee Spano, AIA Member

What Fiscal Cliff? Debt Ceiling Now

The Fiscal Cliff issue of 31 December 2012 came and went with a minor impact on markets, except a pre Christmas rally, which suggests the markets knew all along a decision would be made in time. This now leaves the $16.4 trillion borrowing limit issue for Congress. Last time round of course, we saw protracted negotiations again to the twelfth hour finally produce a deal. You might recall, this resulted in a downgrade of the US credit rating. So perhaps this time round we might see less theatre. In any event, watching the markets closely will be the key.
Kind regards Lee M. Spano, Private Investor & Trader, AIA Member

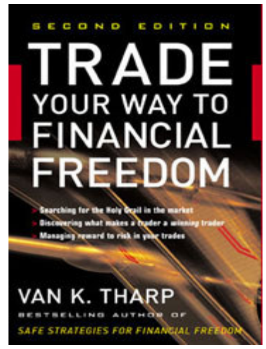
China steaming along in 2013?

Recent manufacturing numbers now over the critical 50.0 level, coupled with a strong trade balance of $31.6b on 10 January 2013, up from the previous $19.6b, gave the Australian markets particularly continued strong positive sentiment. At present there appears to be two schools of thought for China in 2013. The pessimists tell a story of a major contraction, yet the optimists suggest improved GDP at or above 8% pa. The truth probably sits somewhere in between. However, we should remember to never predict a market, and work on probabilities, both at the fundamental and technical levels.
Kind regards Lee M. Spano, Private Investor & Trader, AIA Member

Europe out of the woods?

In recent days comments by Draghi and other officials have been mixed in regards to whether Europe is out of the woods. Most of these comments seem superficial when there still is no long-term debt solution for several EU member states on the table. Markets have been volatile and enduring trends are difficult to find. Hopefully, we will see some clarity, either on the long or short sides after the usual January 'settling' period.
Kind regards Lee M. Spano, Private Investor & Trader, AIA Member

Book Review: Van K. Tharp, 'Trade Your Way To Financial Freedom', Second Edition, 2007.



This is a must have for any serious trader or investor. Van Tharp sets out key principles for systems development, especially dealing with the often-overlooked area of setting position sizing. He deals with the myth of the 'Holy Grail', something all newcomers have to get out of the way early.
From our own extensive research and experience in the markets, being able to develop and manage a *personalised* trading or investing system is a key, rare skill.
Kind regards Lee M. Spano, Private Investor & Trader, AIA Member

It's all about the business plan and quality of the analysis

By Richard Woodhead – CEO GPS.

Voicing my concerns about rating agencies

The control that rating agencies have over fund managers in all investment sectors has always been of concern to me. The rationale is that without a good rating the fund manager will not be able to raise moneys and so funds have to be designed to run to meet the criteria which they set.
Additionally, if a fund does not have a rating which a financial planner can use as their research, they will not include the product on their approved list. If the criteria set by an analyst at a rating agency is not best practice for achieving optimal risk/return then, too bad, as if you do not have investment funds you do not have a business.

How I learnt my lesson

I operate mortgage funds through my company, GPS Investment Fund Ltd (GPS). In the late 1990s I enquired about obtaining a rating. While not actually stated, I left the meeting with it very clearly instilled in my comprehension that a better rating could be achieved from the payment of a higher fee. I subsequently turned my back on rating agencies and financial planners to develop a direct investor base.

The market power of rating agencies is, in my view, fuelled by investor ignorance, apathy and prejudices. This is not necessarily the fault of the investors but is more an indictment on the available education process. In my view, I prefer all parties to engage communication practices that are more transparent and informative for the benefit of the investment industry

I applaud the AIA for its modern approach to informing investors and this is why I gladly accepted their invitation to become involved in their education programs by writing articles and presenting papers at seminars.

I personally stopped going to Law Society run continuing legal education seminars as I tired of presenters effectively saying "this is really complicated stuff, but don't worry, you can engage me to handle such matters". I was pro-education, not self-promotion.

Whilst I may sound candid in my comments, I would like to declare that I do not have a particular barrow to push. As I am not driving for fund growth through my business I can afford to be more open about my beliefs, but I should mention that care has to be taken with some of the other impediments to investor education, which is legislation and defamation. I would like to declare that I am not licensed to give financial advice, but what I am able to do is to look at a failure and comment on what can be learnt.

Learning from the failures - Debenture Schemes vs Mortgage Funds

Banksia Securities recently failed. Most of what I have read in the media seems to me to take the soft option of simply bundling it all up as a mortgage scheme, making reference to other mortgage schemes which have failed, and perpetuating the prejudice.

While it will take some time to closely analyse Banksia Securities, it seems from my industry knowledge and what I have read, that it was a debenture scheme and not a mortgage fund. The investors lent money (secured by a debenture note) to the company, which then carried on the business of lending moneys. Mortgage funds have a quite different structure (you can read more on this at my website) and, in my view, an investment in a Banksia Securities debenture note was more akin to an investment in a company.

Finding a niche gives you strength

If I invest moneys into a company (shares, debentures or loan) I believe it is a good idea to understand their business plan and market. If the business plan of Banksia Securities was to lend moneys in direct competition to the banks, then it seems to me that there would indubitably be a problem as the banks have a lower cost of funds and a greater distribution network. This then results in either the margins of Banksia Securities being lower than that of the banks, or that the quality of their lending would be of a lower standard.

By contrast, many mortgage funds (disclosure note – such as the ones operated by GPS) lend into niche markets where there is limited competition from the banks. As an example GPS has developed a niche market in the sub $5 million construction market in South East Queensland. We stick to our turf, know our product and it is not a big volume market for the banks.

Stick to the plan and be prudent with the analysis

My business, GPS, operates two mortgage funds. One of the funds will achieve its current optimal level of funds under management by the end of 2012, and the other is on a limited growth strategy. The priority for my business in 2013 is in delivering prudential product for my investor base.

When analysing a loan for a project we treat it as an investment in the business. The business plan is to build and sell (manufacture) product. We get a specialist analyst (a valuer) to check the raw material cost and the end production sale prices. A specialist analyst (quantity surveyor) is engaged to check the production cost. An assessment is conducted of the workforce, namely the developer, builder and marketers. We understand where we rank in the end payment scheme (first cab off the rank). We analyse discount factors (loan to value ratios). If it is a sound business investment backed by quality independent analysis from people who hold professional indemnity insurance, then an investment is made into the business. If the niche nature of the investment can provide a premium return then, all the better.

The underlying theory should be the same for any investment decision, namely to understand the business plan and the quality of the analysis.

A final word for 2012 and a look ahead

As this article is for the beginning of the year, it is usual to provide some comments about the year ahead.

I do not have a crystal ball and so cannot tell you such things as how much lower interest rates will fall, what will occur in Europe, who will win the Federal Election and what impact it will have on the economy, whether the mining boom is really over and the like. I will leave that for the economists and the media.

What I do know is that investors are currently cashed up and with current interest rates they will have to start making investment decisions through either necessity (interest rates lower than inflation?) or greed. History shows that when there are moneys flowing from investments there will be plenty of people who will gladly step up to take on the challenge. Please be careful and understand the business plan and structure of any investments.

The challenge before the GPS business in 2013 will be in delivering prudential product. I know this is the major issue for other fund managers who hold mortgages as part of their portfolio. I have already signed one agreement to provide product for a much larger institution (and they now want to increase the amount). I am well advanced with several others. Why GPS does not simply increase its investor base to service such product is a business decision of GPS, which you can read more about at our website or discuss with me personally on 0427 574 246.

To all investors, may you enjoy much prosperity and happiness throughout 2013.

2013 Annual Conference

Where to from here?

Sunday July 28th to Wednesday July 31st

At The Marriott Resort Gold Coast

Planning and preparations for this year's conference are nearing completion and we will be issuing full details really soon now.

We are receiving many mixed messages regarding the investment climate. Interest rates are trending lower, and we all have stories of businesses struggling to survive. And yet…… the stock-market continues its upward journey.

Writing in FNArena this week – Andrew Nelson says *"Unfortunately the turmoil of the last few years has left investors feeling a bit sceptical , not trusting the run and becoming increasingly concerned the recent re-rating of the market has happened despite continuing global challenges and a near stagnant domestic economy and little in the way of earnings growth in Australia".*

What are we to make of this??

In fact – **Where to from here?**

The 2013 conference will attempt to answer these questions. Mark the dates in your diary now!

We have been able to negotiate an extremely attractive room rate this year of $175 per night at the Marriott Resort. Of course, other accommodation options are available also.

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