

# the INVESTORSvoice

Magazine of the Australian Investors Association - *Investors helping Investors*

March 2014

## 50 STOCK MARKET TIPS

## 2014 what to expect SMSF Borrowing Disability Trusts



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# 50 STOCK MARKET Tips

Brian Mc Erlean AIA Member WA

*This article is written by an amateur investor. It means you should consult a professional financial advisor who will know your personal circumstances before you get carried away with the tips. The guidance below comes from clippings, anecdotes and notes accumulated over 25 years. Some intelligence may even be out of date.*

Isaac Newton alluded to the fact we stand on the shoulders of the giants that went before us but in investing we stand on the mistakes of the investors that have gone before us. I am affiliated to the expression “Do as I say and not as I do”.

1. Martin Roth’s Book Top Stocks is my number one purchase each year. The 20th Edition of Top Stocks 2014 is now available.

2. As an AIA member you can access Robert Vagg’s charts. They will tell you where the All Ordinaries Index resides on an historical basis. Right now it is very much below the long term average.

3. Compare your results to an Index Fund or an All Ordinaries Accumulation Index. I have a small parcel of VAS shares which are listed on the ASX. I suspect VAS may well win over time!

4. Check out the management fees for an Index Fund such as VAS. Usually they are as low as 0.2%.

5. Ask yourself if the stock you are buying will be around in 10 years from now. Do you think BHP will be around in 2023?

6. Great fortunes have been made by compounding individual stocks over long periods of time. This achievement relies on their long term survival. Check out the records for Berkshire Hathaway (Warren Buffet) in the US. There will never be a fossil record for companies.

7. A high return on equity (ROE) stock with low debt in the right industry is often a good stock. If it has the ability to raise prices and it generates cash this helps too.

8. Companies with wide moats and who are close to monopolies like the four banks, Coles and Woolworths are hard to compete with. They still have to be bought at the right price and time. Nobody wanted them in 2008.

9. Benjamin Graham said before he died he reckoned he could double the return of the Dow Jones by buying A) Bullet Proof Businesses. B) Financially sound. C) Trading at a discount. D) P/E <10 E) In a diversified portfolio. F) 30 stocks. G) Only add stocks when opportunities present themselves. He has been dead a long time. He did die wealthy after going broke in 1929.

10. Understand the difference between gearing and debt/equity. Directors love to talk about their company’s low gearing. Gearing is debt/debt + equity. Investors like to look at the debt/equity ratio.

11. If you are entering the stock market for the first time at retirement be very careful. Professor Burton Malkiel in his book “A Random Walk down Wall Street” could only get a statistical compound return of 10 % per year by theoretically holding an Index fund for 25 years – any 25 year span in the Dow. You should have been reading this when you were 20, so should !!!!

12. If you do not trust the company you should not be a shareholder in it.

13. In a cockpit emergency great pilots know when the computer is talking bullsh\*t. The book QF32 is a great read. Great investors know when the prevailing wisdom is wrong. They only know this through experience. You need to read and educate yourself if you want to be a stock picker and not rely on someone at the coffee machine to tell you what to do.

14. Size is not everything in a company if it brings complacency.

15. People that have beaten betting systems have one thing in common. They bet infrequently. That is why Buffet has often talked about the average investor having a punch card with twenty opportunities in their whole life. They should invest infrequently and they should be as sure as they can be.

16. In the US from 1926 – 2012 the net result average return after inflation was Stocks 6.7% Bonds 2.3% and Cash 0.5%

17. Study the companies you own and their competitors. Most investors don’t even read the annual reports. That is why it is so difficult to follow more than 10 stocks. It requires effort.

18. In the US in 1960 the average holding period for a stock was 8 years now it is around 4 months. Most people do not allow companies to compound over time.

19. If property rises at 10% a year long term and it cost 1- 2% to manage it, how can property trusts outperform businesses unless they are developers? Good businesses should return at least 15% on equity.

20. Don’t say I will buy at \$10 and sell at \$20. It has no meaning.

21. Don’t buy stocks because you have a heap of cash e.g. sale of a family business.

22. Immortal Industries. Think about industries that will still be around 10 years from now. In Australia there will be more of us eating more food and on average we will be older requiring more healthcare. In contrast, what will communications or transport look like?

23. The time to sell a stock is when the competitive advantage is fading, your daughter is getting married or when debt to equity is blown out as often happens in a takeover using debt. If business sentiment pulls back or interest rise you could find yourself swimming rather rapidly outside the flags.

24. The All Ordinaries Index that we see every night on the TV news does not include dividends. Imagine if it did. It would then demonstrate compounding in grand style.

25. Women trade less than men and are more successful as traders.

26. The best traders sell their losers and ride their winners. Mums and Dads tend to hold losers in the hope they will return to glory. Come on admit you have done it – or are doing it.

## 50 Stock Market Tips

27. In the US 2/3rds of fund managers couldn’t beat the Index – hence the ascent of Index funds. An Index fund just passively mirrors the Index e.g. top 100, 200, 300. Mums and Dads perform worse than fund managers. Is there any hope? I am not in the business of selling hope.

28. If debt is under control, return on equity (ROE) is one of the most important factors to consider. So what is it? ROE is the Net Income after tax divided by Shareholder Equity. In theory a company with a consistent ROE of 20% should be worth twice as much as a company with a consistent ROE of 10%.

29. Investing too little at a time of opportunity says a lot about us and whether we should be investing at all. What did you do in 2008 and 2009? Be truthful please.

30. Patience and discipline are the most important virtues of great investors. Most investors follow the flock and what is written in the popular press. The vast majority buy at the same time and sell at the same time. You and I are the hugely self-disciplined exception, of course.

31. The stock market is the only market in the world where, when prices drop precipitously, we all clog the exits at the same time. This is the opposite behaviour to the Christmas sales.

32. Financing new technologies is very often a losing proposition. Remember the dot com fiasco in the US in which Buffet refused to participate?

33. Financial success often undermines ambition and frugality in succeeding generations. We have all heard the expression “shirtsleeves to shirtsleeves in three generations”. By the way, I am the first generation but running out of time.

34. Be very careful with new floats especially if the company has no track record of success. You don’t even know if management can handle growth. That requires a different skill set. Don’t tell me you bought CBA and CSL on the float. If they were the only companies you ever bought in a float, I take my hat off to you.

35. These are the industries I personally avoid:  
☐ Airlines (capital intensive and subject to international competition by owners with deep pockets),  
☐ Telecommunications (constant change – ask Nokia),  
☐ Single jockey companies (the jockey can die or move to a competitor),  
☐ Single product companies ( subject to competition or failure) and  
☐ Single commodity companies( subject to commodity cycles).

36. Look at the top 20 shareholders at the back of the annual report. Watch the company you keep.

37. Most analysts publish future earnings estimates on the high side.

38. Don’t believe everything you read or hear. Many commentators and fund managers mimic each other in case they are publicly ridiculed or lose their jobs.

39. Do not follow people who claim they can time the market. John Bogle the founder of the Vanguard Fund stated once that he never met anyone nor knew of anyone who knew anyone that could consistently time the market. They might have heard the bell ringing once and started writing a book but they all fail. How can anyone say “get in on 23/3/15 and get out on the 26/7/17” and keep doing it?

## President’s Message By Bill Shirley



As I write this message the year is almost two months gone. I hope that this year will be a good year in relation to your investment returns, whether they reside in various investment platforms or located in a SMSF structure.

My investment tip for year is based around some comments recently detailed in our local newspapers, centred on the growth prospects for this year and into the near future. For example, the OECD warns us that a global slowdown in productivity, as well the risk of higher unemployment, will usher in a new period of low growth. This should be a concern for all us, including those who are self-funded retirees. Maybe, we should be exploring investments in high yielding Australian stocks space that are also fully franked, thereby increasing the expected return that could be achieved. It’s a nice simple approach, I believe.

A further insight in this area is the growth in private self-managed super funds over the last few years. The recently quoted figures clearly make this a preferred pathway for many local investors. Self-managed funds now account for 16% of the Australian equity market, with a total estimated capital value of around \$520 billion. The number of funds is estimated to be around 510,000 plus and the growth in the number of funds has been around 440,000 over the last twenty years. It is also estimated that this sector will invest in the region of \$8 billion per year, over the next few years. These are interesting numbers. I think around 750,000 trustees have found the right investment platform, and should be on a winner for at least improved net yields versus other investment platforms.

National Conference – The planning for this 2014 Conference is progressing very well and you should see more details in March when we release the new style brochure. However, please don’t forget to pencil the event into your dairies for the first week of August.

AIA Matters – Media Releases – Recently, while reviewing the Associations strategic interim plan, a need for improvement in the Media release area was highlighted.

I would like to make a request for suitably qualified retired member to help us write one to three page press release statements from time to time (probably around six times per year). An example would be the current “Investor Sentiment Survey” we jointly issue quarterly during the year. I would welcome any volunteers. If you are interested, please give me a call, or email me, using my AIA listed contact information.

We also would wish a speedy recovery to some of our members who have unwell, or have been hospitalised lately, and hope all are on the path to good health.

In conclusion, we would like to wish all our members a successful investment year; as well as a safe and happy one for all members, and their families.

Kind Regards  
Bill Shirley



# 50 STOCK MARKET Tips

40. Even universities now admit the Warren Buffet has beaten the market long term through some ability that sets him apart from all other stock market investors other than luck. It is worth reading the books about his activities and to learn something from his style of investing.

41. Watch the "Warren Buffet MBA talk" in ten parts on youtube.com. Also search Warren Buffet and Charlie Munger on youtube and listen to what they say. Buffet has never written a book or disclosed his methodology but his interviews and shareholder letters are worth reading.

42. A leveraged account allows an investor to buy against the current value of shares. Buying on margin is out of favour at the moment and will likely return when the market gets high again. My philosophy is that if you are going to do this in a modest way it is probably best done when the market is low. The risk is that you can get taken out by a margin call at the bottom if you pick the wrong stocks or the market heads south. A leveraged account increases debt and risk so you should take advice from a licensed financial advisor who understands your circumstances.

43. Remember the overall trend of the stock market graph is saw-toothed and upwards over a generation. Note I said a generation. You need time in this game.

44. Debt is the most dangerous dish on the menu for companies, investors and societies (ask the US Treasury). Debt limits growth, it is subject to inflation and interest rates. You can lose your capital without losing your debt!

45. The stock market tends to lead the general economy but the converse has a low correlation. In other words it rises before the economy does. I have seen lead figures of between 6 and 12 months.

46. Most firms don't manage to sustain their competitive advantage.

47. In an average stock market the buyers = sellers. In a crash there may only be sellers. If we are really good investors shouldn't we be patiently waiting until there is an abundance of sellers? Then we cleverly top up our portfolios with the cash we did not use when stocks were overpriced and P/Es were outrageous.

48. George Soros and Warren Buffet would say that you should always protect your capital because when you lose it there is no going back. You may not be going back home either. Both Soros and Buffet have seen experienced investor friends lose all their capital.

49. Extreme caution should be exercised when companies are raising capital through placements. It may mean the bank won't lend them money. Why should you? In a growing company that is well managed, why would directors do a placement when they have to pay a rising dividend on the new shares forever. Bank interest can be fixed. Loans should be paid back. So if they can't get the money from the bank there has got to be a reason they are coming to YOU. Find out.

50. Ask your non-investor friends if they are buying shares. If they are in the market it is probably overvalued. The contrary is probably true too. You can tell them they are normal. This is a game where you have to be abnormal to succeed.

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## UP in January UP FOR THE YEAR DOWN in January DOWN FOR THE YEAR

Jody Elliss, Investor Centre



Institutions are strategic in nature and follow set investment strategies that only change dramatically if there is a sudden and unexpected disaster that threatens growth potential, e.g. economies going bankrupt and natural disasters.

As Institutions begin to prepare for Christmas they become defensive. Going "defensive" means that institutions will sell stocks that are not performing well and take profit from stocks that have had exceptional performance leading into this period. Institutions will delay buying stocks in general till they recommence in the New Year. The result is that sellers overpower buyers and our market generally goes down in this period. The deadline for institutional repositioning is the last options Thursday in December which is the Thursday before Christmas week. We can measure this value on the Index as our first point of reference. The second point of reference is the Australia Day holiday on 26th January. This is the last significant public holiday of the Christmas period and it sees Institutions return at full strength to the market. Institutions that have remained defensive across the volatile January period, which sees a lot of US economic data come out affecting world markets in the short term but normally neutralising by the first week of February, will now look to restock their portfolios.

Here we are measuring the institutional confidence in the market. If they restock by aggressively BUYING more stock, they believe the market will rise and this constitutes a **BULLISH** outlook for the market. The very fact that Institutions have a **BULLISH** sentiment means that in general the market is likely to rise and continue rising. Only a sudden and unexpected change will alter this outlook and even then, the market generally recovers more than 80% of the time.

If the Institutions look at the market and then go defensive by SELLING more stock, this constitutes a **BEARISH** outlook for the market. This will leave the market relatively flat and likely to rise on low volume but fall on high volume. This means that the market will under-react to good news and over-react to bad news and the majority of years like this end down from January values for the Index.

### 2014

If we measure the value at close on the last Options Day in December 2013, we see the Index was at 5225. In January we see the market after 26th January was trading at 5190, slightly down on the December value. This is indicative of a flat down year – with low volume rises and high volume falls. 2014 does have growth opportunities but for long-term investors – it should be regarded as a defensive year with slow growth and a high possibility of volatile downturns.



If the **Institutions** look at the **market** and then go defensive by **SELLING** more stock, this constitutes a **BEARISH outlook** for the **market**



# SENTIMENT ANALYSIS

## *A Third Way?*



There are traditionally two forms of analysis in the financial markets - Fundamental Analysis (FA) and Technical Analysis (TA). As global financial markets become more complex and inter-connected, a third way is emerging, which we will call Sentiment Analysis (SA). Sentiment Analysis may include newer tools or parameters, subjective considerations, and in some cases, borrowed or fringe tools from FA and TA. In this article, we will sketch a foundation for this third way, and suggest a step-by-step approach for its application. Sentiment Analysis may then be seen as complementary form of analysis, bridging the needless dichotomy between Fundamental and Technical Analysis, which may be apt for the current highly volatile market conditions.

### What is Market 'Sentiment'?

'Sentiment' in the financial markets is a nebulous thing. Broadly, it refers to two ideas. First, the inherent underlying nature of current market dynamics and second, some thoughts on how the main players or institutions which move the particular market perceive and react to relevant market factors. Some people refer to it as the 'mood' of the market. Highly experienced traders and investors often talk about it in subjective terms - their 'feel' for the market, or being 'in sync with the market.' Such esoteric approaches do not help us in trying to find more objective, testable concepts. However, from significant research and experience in various markets, ranging from commodities, indices, Foreign Exchange (FX) and stocks, we are able to distil a set of six relevant factors, which can carve out Sentiment Analysis as a third, supplementary approach to traditional Fundamental and Technical Analysis.

Relevant Factors for Sentiment Analysis (SA)  
The relevant factors for a cohesive framework for Sentiment Analysis (SA) include;

#### 1. Volume or Open Interest.

Sentiment can be associated with the volume of buyers and sellers. For example, in stocks volume bars or derived indicators, such as On Balance Volume (OBV) can be useful, particularly because they are objective and testable. In other markets such as FX because there is no centralised exchange, measuring volume can be a problem. In these markets, some large international brokers can provide 'tick volume' and similar data, which can assist. But this only measures the volume of their clients trading.

Lee M. Spano, Creatness International CEO

Similarly, other data, such as the Commitments of Traders (COT) report can provide another objective tool. In all cases, the key is to test and find a tool which complements one's existing tools and provides a statistical edge.

#### 2. Macroeconomic News and Some Fundamentals.

Sentiment can be associated with the main macroeconomic news stories and their related fundamentals. These are often the 'big stories' impacting global markets. For example, will the US adequately deal with its budget and Debt Ceiling issues? What current announcements or events relate to this issue, and how? These big issues can often be uncertain and so act as a bearish factor, or at least act like a wet blanket, thereby suffocating the usual underlying market dynamics. Here, we must clearly distinguish unqualified rumour or opinion from solid, verifiable marketing-impacting news or events.

#### 3. Volatility

When the market mood is stormy, usually caused by some over-riding uncertain fundamental issue, we will often see measures of volatility become extreme. These tools exist at two levels. First, on the technical chart of the market itself, such as the Average True Range (ATR) tool. Second, through the use of accepted international measures of market volatility, such as the Chicago Board's VIX Index, which measures volatility for US stocks and options, but it is also watched by global market participants.

#### 4. Erratic Price Action

When the market mood is uncertain, we will see erratic price action emerge in the charts. For example, candlesticks will often have large wicks in both directions, there will be consecutive counter-coloured candles, and candles will usually be very large and contradictory, not forming their usual patterns, particularly at pivot or turning points. More broadly, the market may be flat, or tightly range trending. Elliott waves will usually not exist.

#### 5. Correlated Global Markets

For all markets, it is important to study correlated global markets. For example, for Australian resources stocks, we will study the charts of the relevant sector index, the SP200, SP500, relevant commodities, such as Gold, Copper and Oil, and key currency markets, such as AUD/USD and importantly the USD Index (USDIX). These markets are correlated, both positively and negatively. When the market mood is stormy, then these typical correlations will break down or there is a flight to safe-havens. For example, in the FX markets, there is a movement into traditional safe-havens, such as The Yen or Swiss Franc.

“ ‘Sentiment’ in the financial markets is a **nebulous thing** ”

#### 6. Specific Sentiment Tools

Specific analytical tools for sentiment do exist, but these also need to be examined carefully. For example, international brokers, FXCM have a Speculative Sentiment Index (SSI). The FXCM SSI gives an insight into open interest of their clients only in regards to key currency pairs at a particular point in time. Naturally, the larger the broker the more useful such tools become, but again they need to be specifically tested for one's strategy or system.

#### A Suggested Approach

These six relevant factors are a good starting point for developing a sound, robust approach using Sentiment Analysis (SA). We can employ SA in addition to traditional Fundamental and Technical Analysis. Precisely how we do this depends on the specific market, the strategy as well as significant research and testing. However, a suggested approach to begin to add SA, or elements of SA, to the traditional basket of tools are as follows:

- **Step 1:** Pick one or two of the above relevant factors for you to study or test.
- **Step 2:** See if these fit with the current technical and/or fundamental tools you are currently using.
- **Step 3:** Proceed to test the use of the particular SA tool. For example, back-test and forward-test the use of the ATR in your stock trading strategy.
- **Step 4:** Ensure there is a discretionary element in your strategy or system for macroeconomic news or data events. For instance, this might be a filter to stay out of a market when there is a major global uncertainty.
- **Step 5:** Develop consistency through the regular use and ongoing testing of your SA tools. For example, have a dedicated section in your written trading or investing plan outlining your precise, tested SA rules or guidelines.

Sentiment Analysis may indeed be a sound middle ground for modern financial markets. It overcomes the false dichotomy between traditional Fundamental and Technical Analysis. It blends existing tools, brings others to the fore, and strikes a balance between mechanical and discretionary approaches. All of which provide an important level of flexibility- quite suitable for current global, inter-connected markets, and related issues, such as sovereign debt concerns.



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# The Rise of the Contributory Mortgage Scheme

Kasey Lee, In House Solicitor AMF

Australia has experienced debt market turbulence since the Global Financial Crisis (GFC) in 2007. This flows from the US sub-prime crisis, together with successive interest rate increases and a cyclical softening in property markets. Under these economic conditions, mortgage schemes have not been immune to the crisis with some schemes experiencing financial stress, evidenced by a decrease in fund inflows and extensions of withdrawal periods or suspensions of withdrawals.

With large constructions loans defaults combined with the Government guarantee for cash deposits at banks, credit unions and building societies, many mortgage scheme investors wanted their money back. Pooled Mortgage Schemes were the hardest hit as they offered daily or monthly liquidity despite the fact that the Schemes were lent to property developers with scheduled repayments over several years. Large Pooled Schemes such as MFS Limited, City Pacific Mortgage Fund and LM First Mortgage Income Fund did not survive the impact of the GFC and have since collapsed. In 2012, Banksia Securities went into liquidation while holding \$650 million on behalf of approximately 3000 investors. In fact, since 2007, one-third of all unlisted mortgage funds earmarked as "unrated" by a major agency, have collapsed. Similarly, mortgage funds holding billions of dollars of ordinary investor funds have collapsed in recent years.

## Contributory Mortgage Scheme v Pooled Mortgage Scheme

Since the collapse of the large pooled mortgage schemes, those that survived have come to realise the problems associated with pooling large amounts of investor's money into a single fund. The Australian Securities and Investment Commission (ASIC) describes the key difference between a pooled mortgage scheme and a contributory mortgage scheme as: In pooled mortgage schemes, all investors' investments and returns are linked collectively with a pool of mortgages, whereas for contributory mortgage schemes each investor's investment and return is linked with the performance of a particular mortgage.

## A closer look at Contributory Mortgage Schemes

Generally, a contributory mortgage scheme is comprised of multiple sub-schemes. Members of the scheme invest in individual sub-schemes rather than the scheme as a whole. The scheme Product Disclosure Statement discloses generic information about all sub-schemes. Specific information, relating to each individual sub-scheme, is disclosed in Sub-Scheme Product Disclosure Statements for each sub-scheme (SPDS).

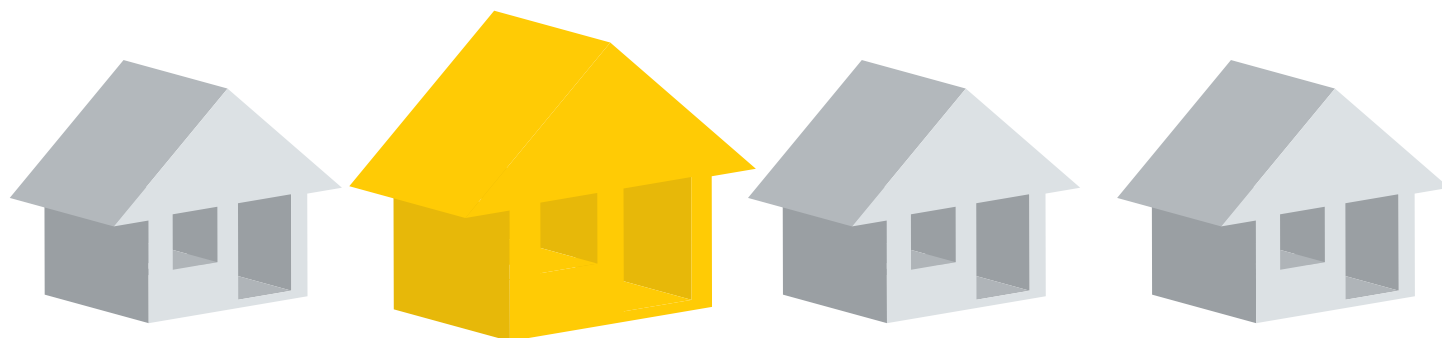
Each sub-scheme derives its income by investing in a particular mortgage investment. A particular mortgage investment involves a single loan to a specific borrower (or group of co-borrowers) secured over real property. Thus, when members invest in a sub-scheme, they are investing in a mortgage investment and the SPDS discloses information specific to that mortgage investment. The result is that Investor's contributions to a particular Mortgage Investment are quarantined within sub-schemes and investors in each Sub-Scheme do not have recourse to the property held in other sub-schemes.

Contributory mortgage schemes provide the opportunity for the investor to take control of their investments and invest only in those particular sub-schemes that appeal to them. They may decide to invest only in the Sydney market or perhaps South East Queensland. They may decide to invest in loans that have a Loan to Value Ratio of less than 60%. They may decide to stay away from construction loans. Whatever their investing strategy, the contributory mortgage scheme structure allows them to maintain control over their investments. As some schemes offer returns of up to 10% per annum, contributory mortgage schemes are attractive to savvy investors and those with self-managed super funds.

## Current Regulation of Mortgage Schemes

The offer of interests in mortgage schemes is regulated under the Corporations Act 2001. Schemes must be registered with ASIC as a Managed Investment Scheme and be operated by a responsible entity which has adopted a scheme constitution and compliance plan. The responsible entity also must satisfy the requirements of holding an Australian Financial Services Licence (AFSL) which includes having available adequate financial resources to provide the financial services covered by the AFSL.

Of particular importance is the mandatory Compliance Plan. The compliance plan for a scheme plays a key role in the range of measures designed to protect scheme members. Under the Corporations Act, a compliance plan must set out adequate measures that a responsible entity will apply to ensure that it complies with the Law and the scheme constitution: s601HA A Scheme's Compliance Plan should list the key processes, systems and structures that the responsible entity will apply including the processes, systems and structures by which a responsible entity will continuously review how it complies with its obligations under the Law and the scheme constitution.



A Compliance Committee with at least two external members oversees the Scheme's compliance with the Compliance Plan and any significant breaches must be reported to ASIC. There are serious consequences for breaching a scheme's Compliance Plan and ASIC will not register a founding compliance plan until it is satisfied that the Plan adequately covers all areas required by the legislation.

## What measures have ASIC place to avoid the losses suffered during the GFC?

As large pooled mortgage schemes starting collapsing, ASIC focused its attention on the mortgage scheme market in general and concluded that one of the major shortcomings was the number of funds failing to adequately disclose information to their investors.

Following consultation, ASIC released Regulatory Guide 45: Mortgage schemes: Improving Disclosure for Retail Investors ('RG 45'). RG 45 aimed at increasing the level of disclosure to retail investors, by requiring schemes to provide retail investors with the information they need to make an informed investment decision. At a minimum, disclosure against the benchmarks and the provision of the information in the disclosure principles is required.

Contributory mortgage funds have increased the level of disclosure to investors by providing a SPDS with all of the information necessary to enable the investor to make an informed decision regarding their investment.

“Contributory mortgage schemes provide investors with a new alternative to the old way of thinking.”

## The Future of Contributory Mortgage Funds

At an Independent Compliance Committee Members Forum meeting in 2013, ASIC Senior Manager, Paul Eastment, confirmed that whilst ASIC continues to monitor mortgage schemes in general, contributory mortgage schemes are usually not the ones causing the problems and it will continue to target the remaining pooled mortgage schemes.

In the wake of the collapse of the pooled mortgage scheme market, contributory mortgage schemes are rising in its place. Contributory mortgage schemes provide investors with a new alternative to the old way of thinking. Instead of handing over their life savings to a large scheme to lend as it pleases, these schemes are giving back the control to the investor and allowing them to make their own investment decisions and ultimately keep control of their money.

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# HOW TO INVEST FOR INCOME AND PRESERVE CAPITAL IN A VOLATILE WORLD

David Walker

Early in 2014 the questions at the top of mind for self-funded retirees are “how do I earn more income than term deposits and preserve my capital in a world of constant volatility? Equity as an asset class is riskier than fixed interest – how safe is it to turn to shares to earn more income?” Our answers are as follows:

- Equity, being ownership of a business, bears the risk of capital loss and will never be as safe as fixed interest. Investors still need to match their asset allocation to their risk tolerance.
- But some dividend yields are more secure than others. Retirees living off investment income need a process for identifying stocks trading on attractive dividend yields, and where the prospective total shareholder return is sufficient to justify bearing the equity risk for those securities.

**Our four-step process is:**

- Aim for a dividend yield reasonably higher than term deposits but not so high as to signal excessive risk like the omission of the dividend or financial distress.
- Shortlist stocks trading on this yield or greater which also have superior financial health based on a consistent and proven set of analytical measures.
- Apply a forward-looking, qualitative filter which screens out companies with poor governance and management, and where profitability is more likely to fall than rise.
- Only buy these stocks at a discount to value sufficient to preserve capital by reducing overpayment risk, and to generate an adequate total return.

The last point is very important. There is no point overpaying for any income stock, even a great one. Doing so eats into future returns and can invite negative returns.

Code	Company Name	Price	Value	V/P	DY	Fr	GUDY	CQR
ORL.AX	OrotonGroup Limited	\$4.06	\$4.96	22.2%	12.3%	100.0%	17.6%	95.5%
WTF.AX	Wotif.com Holdings Limited	\$2.55	\$2.65	3.9%	9.8%	100.0%	14.0%	83.6%
NHC.AX	New Hope Corporation Limited	\$3.40	\$3.04	-10.6%	9.1%	100.0%	13.0%	91.8%
MND.AX	Monadelphous Group Limited	\$15.45	\$17.61	14.0%	8.8%	100.0%	12.6%	82.7%
SMX.AX	SMS Management & Technology Limited	\$4.04	\$4.95	22.5%	7.5%	100.0%	10.7%	92.7%
FAN.AX	Fantastic Holdings Limited	\$1.90	\$1.96	3.2%	7.4%	100.0%	10.5%	87.3%
PBG.AX	Pacific Brands Limited	\$0.68	\$0.77	13.1%	7.3%	100.0%	10.5%	75.7%
WOR.AX	Worleyparsons Limited	\$15.66	\$14.85	-5.2%	5.9%	69.1%	7.4%	77.3%
CDD.AX	Cardno Limited	\$6.09	\$5.56	-8.7%	5.8%	89.2%	7.9%	71.2%
TLS.AX	Telstra Corporation Ltd	\$5.01	\$4.08	-18.5%	5.6%	100.0%	8.0%	79.6%
DJS.AX	David Jones Limited	\$3.06	\$2.21	-27.9%	5.5%	100.0%	7.9%	79.1%
ALQ.AX	ALS Ltd	\$7.80	\$5.70	-27.0%	5.5%	58.8%	6.6%	81.8%
SKE.AX	Skilled Group Ltd.	\$2.78	\$2.48	-10.7%	5.4%	100.0%	7.7%	81.8%
SVW.AX	Seven Group Holdings Ltd	\$7.91	\$7.39	-6.5%	5.1%	100.0%	7.2%	76.2%

Figure 1. Selected ASX companies trading on 5%+ dividend yields and with 70%+ quality ratings  
Source: StockslnValue

All prices as at market close on 7/02/14. V/P: ratio of value to price, DY: dividend yield, Fr: franking, GUDY: grossed-up dividend yield, CQR: Clime Quality Rating

**Steps 3 and 4. Apply a qualitative filter and buy only at a fair discount to value**

Screening well quantitatively does not make a stock suitable for investment, as the CQR filter is backward-looking. We have sufficient concerns about the profitability outlook for ORL, WTF, MND, WOR, CDD and DJS to avoid these companies while we would rather wait for FAN, PBG and SKE to report their profit results in coming weeks before confirming our qualitative thesis. We are positive on TLS but the stock is a little too expensive to justify a review in this article, which leaves only NHC, SMX and SVW as the stocks we would actually consider for income investors.

New Hope Corporation (NHC) faces a possibly structural downturn in thermal coal prices as China moves to improve air quality, so the high dividend yield signals minimal growth in intrinsic value ahead. However we forecast slowly rising dividends from a low FY14 base underpinned by a very strong balance sheet. We would buy at an 8% margin of safety discount to value for a 17% total return including the 9% dividend yield.

**Step 1: Choose the desired dividend yield**

With five-year term deposit rates around 5.0% at the time of writing, income investors will require dividend yields of more than 5.0%, with franking, to hold equity over the same period. A 5.0% fully franked yield is 7.1% grossed up.

**Step 2. Shortlist stocks with superior financial health**

Shares in companies with superior balance sheet strength, profitability and cashflow coverage of interest expense, liabilities and debt, tend to outperform. This is because such companies are less likely to cut or omit their dividends, require dilutive equity raisings to recapitalise, or go into liquidation. Financial health is rated highly by the market and is also associated with earnings and intrinsic value growth, which drive share prices higher over time.

StockslnValue aggregates 45 financial health ratios into a percentage score called the ‘Clime Quality Rating’ (CQR). This score, developed and tested by Clime Portfolio Manager George Whitehouse, is backward-looking but a powerful input to an investor’s quantitative screen for identifying stocks worth further investigation. It is also proven. Over the five years to 31 December 2013 an index of the top 50 quality stocks in our coverage universe of 400 stocks, weighted by each stock’s CQR, delivered a compound annual average growth rate (CAGR) of 24.7% compared with a -2.0% CAGR for the bottom 50 quality stocks and a 12.5% return for the All Ordinaries Accumulation Index.

The following table shows the results of a filter search in StockslnValue for stocks trading on a 5%+ dividend yield which also have a CQR of 70%+:

“There is no point overpaying for any income stock, even a great one”



Seven Group Holdings (SVW), a diversified operating and investment company, is 6.5% overvalued but could be purchased at a 10% margin of safety discount to our \$7.39 valuation, should a market correction give us an opportunity. Add the 5.1% dividend yield and the investor faces a forward return on 15%+ before intrinsic value growth. SVW’s WesTrac Caterpillar dealerships are experiencing a downturn in demand as mining investment cools but the balance sheet, cashflows and profitability are sufficiently strong we are more optimistic than the market on the dividend. SVW is strengthening its business by acquiring further dealerships in the downturn while reducing costs to sustain margins.

David Walker is Head of Equities Research at StockslnValue, a joint venture between Clime Investment Management, a value fund manager, and Eureka Report. StockslnValue provides valuations and quality ratings of 400 ASX-listed companies and equities research, insights and macro strategy. For an obligation free, FREE trial please visit [www.stockslnvalue.com.au](http://www.stockslnvalue.com.au) or call 1300 136 225.



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# HOW TO INVEST FOR INCOME AND PRESERVE CAPITAL IN A VOLATILE WORLD continued...

SMS Management & Technology (SMX), an IT services contractor and recruiter, is trading at an attractive 18% discount to our \$4.95 valuation. Further, over the next two years shareholders will likely receive 42 cents in fully franked dividends.

The market is extrapolating the current downturn in IT recruitment and contracting out to 2016 but we are confident an industry recovery will begin in late 2014. The rebound in business confidence should lead to greater capital investment in IT projects and recruitment of IT professionals to deliver them. Fixed cost leverage should amplify the boost to margins and earnings from the sales recovery. The CEO recently bought 100,000 shares.

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# What is Facebook & Why Should you use it?



Donna Meadows, AIA

In the ever changing world of technology, people are accessing information through different media including Facebook. Facebook is an online social networking service. As of January 2014, the company has about 1.15 billion monthly users.

The AIA is offering our members and followers choice and flexibility in the way they access information. By "liking" the AIA on Facebook, you can keep up to date with news and information we share as soon as it is posted on our page which is one of the main reasons that people "Like" a business Facebook page.

## What Happens When You Like the AIA Facebook Page?

When you first press the Like button, the AIA gets a notification that you have liked our page. You can choose to get notifications each time the page posts information. This is done by hovering over "liked", which is what the "Like" button changes to, and click on "Get Notifications". You will then get a notification when the AIA posts something new.



You will also now have access to our posts and you can "like", share, and comment. Our posts will begin showing up in your newsfeed, but the AIA have no access to your Facebook and cannot see your friends posts or other pages you've liked. We do not physically look at your Facebook account.

How do you "Like" the AIA on Facebook?

It is a really simple step. On the Investor Updates, Emails and Member Updates we send you, simply click on the Facebook icon on the top right hand side as per below. This will take you to our Facebook page where you can log in to your Facebook account and "Like" AIA.



Be our fan is also available on the bottom of all our website pages.

If you would like to keep up to date with the happenings of your association or, perhaps you would like to share the information with your friends, we invite you to "Like" us on Facebook.

## How do you get a Facebook account?

If you don't have a Facebook account, it is very simple to set one up. The only thing you'll need in addition to a birthday, a name and a gender is an e-mail address. First, go to [www.facebook.com](http://www.facebook.com) and look on the right side of your screen under the heading "sign up." Fill in the information and click the green "sign up" button.

After typing words to show you're human (as directed), Facebook will ask if you'd like to find your friends. It's a good idea to do this now, but don't worry -- you can always come back to this step later. Follow the prompts to allow Facebook to scour your e-mail service for people you've e-mailed who are also on Facebook. Click the boxes next to the ones you'd like to add. You do not have to add friends now or at any stage. You can simply use Facebook to get company notifications.

Next, it's time to create your profile. In general, the more detailed your profile, the easier it'll be for you to find people and for people to find you. It's worth taking your time when entering your high school, college and employer information (as prompted). Again, this is not necessary for you to use Facebook.

Then, again as prompted, include a photo of yourself, either by clicking the button to upload a photo that already exists on your computer, or by automatically taking a shot with your computer's built-in or connected webcam. In general, people tend to use informal pictures that do a good job of showing their face, but your profile picture can be anything under the sun - as long as it's rated PG-13 or below. Again, this is not necessary for you to use Facebook.

Now you can choose if you would like to go through your profile, adding whatever information you think is fun (click the pencil-shaped "edit profile" icon on the upper right). In this, and with everything on Facebook, most people enjoy letting their personalities show. As you explore the various slots where you can add profile information -- for example, "philosophy," "activities and interests" and "sports" -- consider taking the time to be honest and precise. Eventually, your Facebook profile will be as unique as you are.

The final step before Facebook allows you to start sharing content is confirming your registration through your e-mail account. Simply go to the e-mail you listed on the very first sign-up page, open the message from Facebook, and click "complete sign-up."

You're ready to start checking out all your favourite companies and looking for long lost friends.  
Happy "Facebooking!"  
Donna Meadows  
AIA - Events and Member Services Coordinator.

# The access you need

We provide investors with access to a wide range of ASX listed bluechip shares and exchange traded funds through an instalment warrant structure (which can be suitable for SMSFs).

## RBS Investor Products

Instalment warrants are one of the few products that allow investors who are SMSFs to obtain the benefits of gearing. This is due to the limited recourse nature of the borrowing associated with instalment warrants.

Apart from the benefits associated with gearing, interest deductions and enhanced franking credits generated by instalment warrants can be used to reduce earnings and contributions tax liabilities payable by SMSFs. SMSFs can also potentially enhance returns using instalment warrants due to the high level of franking credits generated by geared shares in a low tax vehicle\*.

## Multiple Solutions

RBS Investor Products Platform covers 2000 products/warrants listed on the ASX with different underlying assets giving access to Australian shares, international shares and managed funds.



**Speak to RBS about our Multi-Asset Investor Products.**  
Log on to [www.rbs.com.au/markets](http://www.rbs.com.au/markets) or call 1800 450 005





# SMSF Borrowing

## Is it right for you?

### Sequoia Superannuation

As the prices of Australian Real Estate and share markets continue to soar, so does the number of registered Self Managed Super Fund's (SMSF) in the nation taking advantage of the ability to borrow funds to purchase superannuation assets.

### Why has this come about?

Prior to 2007, the unique opportunity that SMSF's provided was that they allowed trustees to respond to the dynamic economic conditions they faced with their own personalized investment strategies – a 'hands on' control approach – a very different concept to the traditional managed fund style of superannuation that existed then, and still exists today.

This capability to engage in the outcome of your own retirement savings brought about many methods in SMSF investing strategies, however without the ability to borrow funds, many SMSF trustees found it difficult to find the capital to acquire large assets (such as real property). This eventually led the push to be able to borrow funds using your SMSF.

As a result of lobbying by superannuation groups, effective October 2007 legislation was passed to allow SMSF's to borrow money to purchase assets. Further legislative changes in 2010, and an important ATO ruling in 2012 (SMSFR 2012/1) clarified the legislative position and cleared the way for trustee's to 'gear up' their SMSFs, resulting in a boom in the number of SMSFs borrowing money to purchase assets such as real property and leveraged shares and investment products to secure their retirement futures.

According to the Australian Taxation Office, the SMSF sector accounts for about 35% of the total superannuation assets in the country. This makes SMSF's the largest sector of the Australian superannuation industry.

However, what you need to ask is whether borrowing is right for you? There are many positives, but there are also many restrictions and that need to be overcome to allow you to borrow using your superannuation fund.

### What are the negatives of borrowing funds in your SMSF?

Asset selection: Borrowing money inherently has risk. If the costs of borrowing and holding the asset exceed the capital growth and income produced by the asset you, will lose money. It is as simple as that. Whether you buy an asset using borrowed funds in your own name or via a SMSF, asset selection risk should be at the top of your thought process. As much as some people beg to differ, property does not always go up. Just because you are holding it in an SMSF does not change this fact.

**“When you combine ignorance and leverage, you get some pretty interesting results  
Warren Buffet**

“When you combine ignorance and leverage, you get some pretty interesting results.” Warren Buffet

### Contribution Risks:

When borrowing to buy an asset in a SMSF you need to find a way to fund the interest and capital repayments out of the bank account of the SMSF. Sounds pretty straight forward, however, the catch is that if you do not have enough cashflow in the SMSF to cover these monthly re-payments then you are going to have to make contributions into your SMSF which are subject to the mandated contribution limits. Breaching these contribution limits can potentially cause unwanted attention from the tax office. Be sure to check your contribution limits prior to embarking on an SMSF borrowing strategy.

### Establishment and Ongoing:

If deed establishment, regulatory bodies, investment strategies and rollovers are processes that you are not familiar with (or intimidated by), it is thoroughly recommended that you use a professional for their expertise. Too often investors run head first into setting up a SMSF only to hit the brick wall of administration.

The set-up and ongoing maintenance of a SMSF is a very time-consuming and complex procedure that will need attention on a regular basis. And if you're looking to borrow through your SMSF you better know what a bare trust or instalment warrant is, and how to set up a corporate trustee. The consequences of getting this wrong can be brutal; a non-complying SMSF for example will attract a penalty of all assets being taxed at the top marginal rate. There is also potential for double or even triple stamp duty to be payable due to incorrect structuring.

Other general restrictions on assets purchased using borrowed funds:

- The borrowed money must be used to acquire a 'Single Acquirable Asset' ('the asset'). This can be problematic when you have the intention of buying house and land packages off the plan, carrying out renovations or developments just to name a few scenarios;
- The money used to purchase the asset must be borrowed under a 'Limited Recourse Borrowing Arrangement' (LRBA) which is primarily designed to protect the consumer from the lender raiding other assets of the SMSF upon loan default, and this style of loan often attracts higher rates of interest.
- The asset must be held in a specially designed trust commonly called a 'bare trust' or a 'property trust'. To establish these and getting the proper advice, costs money;
- The borrowed money can be used to carry out 'repairs' and 'maintenance'; however it must not be used make 'improvements' to the asset. This is a fine line, and can cause headaches for SMSF trustees performing substantial renovations.
- An SMSF must not purchase a property from a 'related party' unless it is 'real business property' acquired at market value.



**SMSF Borrowing**  
Is it right for you?  
continued...

### What are the positives of borrowing funds in your SMSF?

Asset selection: As mentioned above, choosing the correct asset is of higher importance when using borrowed money. You may have heard the expression 'leverage is a double edged sword'. This saying still stands true in an SMSF. If you pick the right asset, and you are adequately geared, your return on equity should always be higher when using borrowed funds. It is possible to borrow money to purchase shares, property, managed funds, structured investments and any other investment class that you are able to obtain lending on a limited recourse basis.

It is no secret that the majority of Australians have accumulated wealth by borrowing funds to buy property and this property has increased in value over time. However it is the asset selection combined with borrowed funds (and time) that have provided the attractive return on equity that many Australians have enjoyed.

**“No matter how great the talent or efforts, some things just take time. You can't produce a baby in one month by getting nine women pregnant.” Warren Buffett**

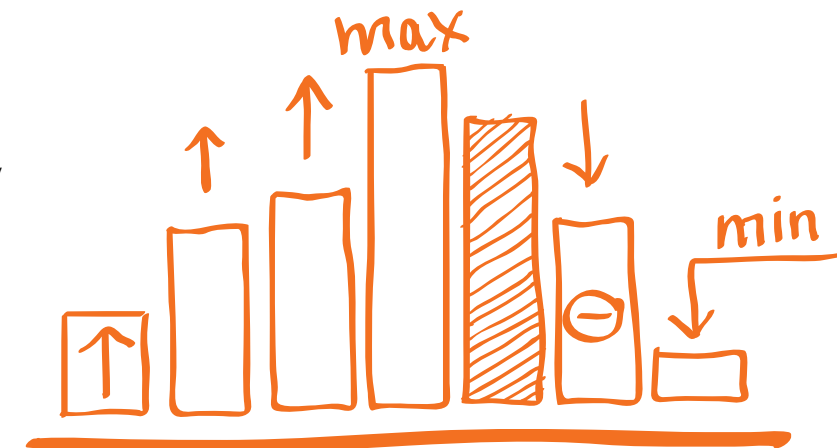
Taxation: When you borrow money in your own name to purchase an investment asset, in most situations where you pay interest on the loan, you should receive a tax deduction against your personal income, but you will not receive a tax deduction on principal repayments. Where a SMSF is responsible for making contributions into your fund via personal pre-tax contributions, and then using these funds to pay off the principal loan component. Put simply, by borrowing funds through your SMSF you can pay debt down faster due to the tax benefits available via super contributions.

**“Of course I am minimizing my tax. And if anybody in this country doesn't minimize their tax, they want their heads read...” Kerry Packer**

### What next?

Borrowing to purchase assets using your SMSF may not be for everyone, so make sure you get the right information and advice prior to making a decision to invest using borrowed funds. Yours in investing, Sequoia Superannuation.

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# Your Feelings are Killing your Profits

## The Fix is Easier Than You Think

Angel Clark, VectorVest

How much impact does the news, and the emotion-driven decisions it causes, have on the stock market's long-term growth, or more importantly, the growth of your own retirement portfolio? It seems that no matter what stumbling block the market may encounter, it always manages to bounce back (eventually), which is why many professional advisors would have their clients hold their shares even through the most problematic market periods.

I wonder if they would follow their own advice though. What if it was their portfolio that was down 40-60% and they were looking to retire next year?

"Staying the course" can deliver severe consequences, ones that most investors may not have the fortitude to withstand. The pain and exuberance encountered during these market swings often causes "trading common-sense" to fly out the window – sometimes permanently. Hope, Fear and Greed take turns jumping into the driver's seat, ready and willing to take your portfolio for one heck of a wild ride. Let's look at the possible impact of these ill-advised trips and what you can do to avoid them.

- Greed decides that the gravy-train is never going to end and convinces you to keep buying despite dangerous, overbought situations. Even when a correction comes, Greed cheers that this is a killer buying opportunity! So what if you're holding a 20% loss. If you buy more now you can lower your cost-basis and dollar-average your way to being a multi-millionaire in no time! But that's not what happens.

- Hope gently nudges Greed out of the way and admits while things could be better, they're not that bad. The market will turn around. It always does, just hang in there; everything will be ok before you know it. But it isn't.

- Fear shoves Hope out the driver's side door and plunks itself behind the wheel. Is there no end to the bad news?? Horrible headlines - plunging earnings, political debacles, global catastrophes! This crazy ride is over, Fear slams on the brakes.

Everything is liquidated to preserve as much of your nest egg as still possible, just in time for the market to take off and leave you in its dust.

The market doesn't have to have the last laugh though. There's a simple way you can take advantage of the high, long-term returns the stock market offers without the masochism of enduring 40%+ market corrections - and it'll help you put your emotions in the backseat!

Look at the first chart below, the ^AORD is up 67.5% from its close of 3204.50 on 17/6/02 to its close of 5366.90, 12 years later, on 10/2/14. Of course, it would be up much higher if it weren't for the bear market (8/10/07 to 2/3/09) which reduced gains by a whopping 53.97%. Subsequent corrections were considerably less severe, but took their toll as well.

Based on this chart, buy-and-hold investors that started their portfolios twelve years ago would only have a modest average annual return of 5.6% (67.5%/12 years), while investor's that started their portfolios post 2006 may still be struggling to get back to ground zero (despite eight years passing by). This should demonstrate that blindly holding stocks through corrections can lead to diminished returns and unnecessarily high risk profiles for investors, so let's apply the fix.



The FIX: Now, let's take a look at an easy solution to drastically reduce the worst of the market's severe downturns without changing our status as long-term investors.

The next graph shows two exponential moving averages of the ^AORD- a 75-day and a 100-day. The crossover of these moving averages gives a clear signal of when to protect profits (i.e. time to sell) and when it's time to resume buying shares. This should keep you on the road to buying low and selling before it's too late.



Now let's gauge the effectiveness of our fix. Since we know the AORD is up 67%, we can add the losses that were encountered during each correction to find the highest possible, shoot-for-moon, gain. This would be approximately 390% (Add the points from every peak to trough and every trough to peak: 12,554.20, which is 391.77% increase from our starting value of 3204.50)

Date	Peak	Date	Trough
17/6/02	3204.50	3/3/03	2715.00
8/10/07	6760.10	2/3/09	3111.70
4/4/11	5036.50	19/9/11	3978.50
10/2/14	5366.90		

Using the graph above, the first date that we can conclusively determine the 75-day moving average is below the 100-day moving average is 17/6/02, where the AORD closes at 3204.50. Using this as our exit, we would have avoided a 15% pullback before the market took off in 2003. Our moving averages then caught the major up move, crossing to the bullish side and signaling a re-entry on 4/6/03 at 2996.60.

Following this same method, the AORD would have received five 'sell' signals in the 12 year period shown by the chart above. Acting on these signals resulted in a total AORD gain of 120.8% vs. the 67.5% cited above. There were two periods that ended in losses, the biggest loss being less than 5% vs the 53% loss encountered during the bear market. That represents higher returns, less risk – a considerable improvement.

Signal	Date	AORD Close	Signal	Date	AORD Close	G/L
Sell Signal	17/6/02	3204.50				NA
Buy Signal	4/6/03	2996.60	Sell Signal	18/1/08	5799.40	93.53%
Buy Signal	11/6/09	4047.30	Sell Signal	17/5/10	4500.70	11.20%
Buy Signal	4/10/10	4678.40	Sell Signal	6/6/11	4648.70	-63%
Buy Signal	6/2/12	4364.60	Sell Signal	30/5/12	4148.70	-4.95%
Buy Signal	23/8/12	4411.80	Current	10/2/14	5366.90	21.65%
					Total Gain	120.8%

Your Feelings are Killing your Profits

The Fix is Easier Than You Think *continued...*

This objective approach provides "Road Signs" for the market's direction and can continue to deliver a significant improvement with minimal effort. Stop-losses and smart money management techniques should also be used to enhance the results even further. Adding a few more timing conditions for a slightly more sophisticated market-timing system may also prove to be very beneficial.

Don't expect your timing system to be perfect though, it's simply not necessary or realistic. The real winners are systems that adapt fast enough to reverse a false signal, getting you out of bad situations quickly with minimal damage. Accuracy and adaptability must balance if you want a good system. And if it all sounds too complicated and you just don't want to bother, you can always take a look at the VectorVest timing systems.

Please feel welcome to come and talk to us at the AIA 2014 National Conference and let us show you some of the techniques we can use to protect your portfolio.

“Don't expect your timing system to be perfect... it's simply not necessary or realistic!”



# 2014: What should we expect?

Roger Montgomery

There is no reward in calling markets, nor is it our style to do so. Occasionally however, it makes sense to piece together a few observations to see if a picture emerges that might be of some assistance to those who are looking for such insights. So here I go, putting my neck on the chopping block and making a tentative call on the returns equity investors might expect in 2014.

There's a fundamental scan I like to run on the market at the beginning of each year, which often gives me an insight into how the year is going to go. Since 2011, that scan has produced a sufficient number of high-quality candidates that were also good value. This meant we would have been able to construct an equity portfolio with some diversification. But is that the case in 2014?

This year has not begun how the last one ended. Exuberance for new floats, rising stock prices and a casual disregard for the US Federal Reserve's tapering of quantitative easing (QE) that was experienced towards the end of 2013 has, this year, given way to an understanding of the negative consequences of tapering. As US interest rates rise, money will flow out of emerging countries – including China – and back into the US. As a result, emerging markets and their currencies have collapsed, sending a chill through the spine of equities globally.

The impact for Australia of course is that emerging markets, including China – whose own growth is now slowing – are large users of commodities. Falling commodity prices cast Australian investments in a bearish light for foreigners, just as commodity sensitivity and trade proximity to China create economic headwinds.

In China, debt has expanded much faster than income and this is, quite obviously, unsustainable. While a crisis can be avoided with carefully managed credit tightening, the outcome is that the economic growth rate must slow with ramifications for neighbouring Asian countries, including Australia.

So there you have it: the outlook for the Australian economy is less rosy than it once was. But the really interesting point is that the rate of economic growth in Australia has very little, if anything, to do with the returns you will get from your shares.

## Who Cares About the Economy?

You see, stock markets are not correlated with economic growth rates, so it's easy to be led astray and invest on the basis of the strength of the economy.

A recent study conducted by my friend Ashley Owen, a director of Philo Capital Advisors, revealed only rarely does above average world economic growth coincide with above average stock market returns. In fact, it only occurred twice in the 34 years since 1980 – in '88 and again in '06. Similarly, there were only six years where below average economic growth coincided with below average stock market returns – '81, '90, '92, '01, '02 and '08.

In fact, at least half of the time when economic growth was above average, stock market returns were below average, and at least half of the time when economic growth was below average – including in recessions – stock market returns were above average.

And so, for us at The Montgomery Fund, awareness of both how the Australian economy is going, and where it's going next, is of limited value. Indeed, you might ask why we need economists at all!

To the extent that specific microeconomic influences impact individual sectors, industries and companies, we are interested in the state of the economy. Beyond that, however, we believe that it is interest rates and the proportion of the economy represented by corporate profits that impact long-term stock market returns. If the profit piece of the economic pie is expanding (usually at the expense of other economic slices such as salaries and social welfare), and if interest rates are low and/or declining, we should see good returns in the stock market over the decade or two that those conditions occur.

If however interest rates are low, but the trend is for them to rise, and corporate profits decline as a percentage of the economy (as measured by GDP), then we should expect more modest returns from the stock market.

This pattern was first observed by Warren Buffett. He noted that in the 17 years between 31 December 1964 and 31 December 1981, the Dow rose from 874.12 to 875.00. That's right! The US stock market rose by one-tenth of one per cent, over 17 years, despite the economy growing by 373 per cent over the same period.

Conversely, in the next 17-year period (between 31 December 1981 and 31 December 1998), the Dow Jones rose more than ten-fold, from 875.00 to 9181.43. And yet, during this period, the economy grew by a more modest 177 per cent.

**As US interest rates rise, money will flow out of emerging countries including China and back into the US.**

## 2014: What should we expect? continued...

**What was the difference?** It was interest rates and profits. Interest rates rose from 4.5 to 13.65 per cent in the first period, and fell back to 5.09 per cent in the second. Similarly, corporate profits didn't rise as a percentage of the economy (although the economy did grow) through the first period, but they did in the second.

### Worry Less

To a certain degree, you can now worry less about feeling as though you need to be up to speed with the vicissitudes of the economy, instead opting to cast your eye over that which is important: the prospects for individual businesses.

On that front, there's a great deal to say, but importantly, it needs to be put into the context of the market. You see, in the latter half of calendar 2013, investors (I apply that definition loosely) rewarded those companies that were of lower quality by bidding their prices up.

### Sell Quality! Seriously?

Yes, you heard it right. Believe it or not, some investors were actually advised by several large international investment banks to "sell out of quality" and move into more cyclical stocks exposed to an expanding economy. The impact was immediate. Healthcare stocks that we rate investment-grade rose 28 per cent from July 1 2013 to January 22 2014, but those we rate sub-investment grade rallied 51 per cent. Similarly, in the consumer staples sector, those stocks that Montgomery

rates investment-grade rose just 0.8 per cent, while those that we rate sub investment-grade rallied 53.9 per cent in aggregate. Finally, in the consumer discretionary sector, investment-grade stocks rallied 17.1 per cent, but sub investment-grade rallied 43.1 per cent. You may think something might be wrong with our quality rating system, but we know that in the long run, quality wins out. Essentially, we believed the "rally in rubbish" was unsustainable. And given that stock market returns are only correlated with economic growth half of the time, we have at least a 50 per cent chance of being correct anyway.

In the long run, it's far more rewarding to focus on businesses rather than stocks, and intrinsic values rather than prices – and that's where we return to the scan I mentioned at the beginning of this column.

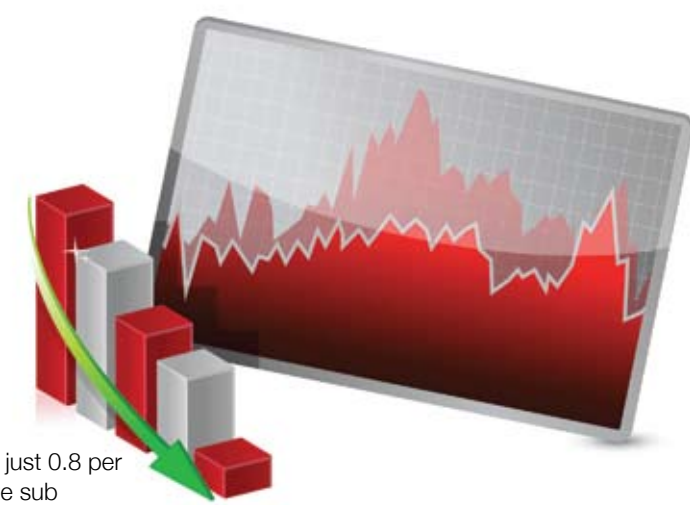
### Scanning for Opportunities

By looking at the entire market and allowing only companies with quality ratings to enter the universe of suitable companies, we immediately remove the issues surrounding sub-investment grade stocks. If we then rule out companies with net debt, returns on equity below 12 per cent and companies with no growth forecast for their earnings, we reduce the

number of companies to consider from almost 2000 to less than a hundred. If we then select those companies whose intrinsic values are forecast to grow, and whose shares are trading at a discount to intrinsic value of any amount, we discover that there is one company that one might consider investing in.

Should you rush out to buy it? No. The fact that there is only one quality company whose shares are at a discount to its value (the company, for those who want to conduct their own research, or seek advice on, is Flight Centre) suggests that there are a whole bunch more that aren't either cheap or of sufficient quality. In the past, when such a lack of opportunities has prevailed, the market has not subsequently produced a return that rewarded the risk.

Having said that, we need to remember that markets can remain irrational for much longer than we can remain liquid. This means we could be wrong, but given all of the factors illustrated above, I would suggest the returns enjoyed by investors in poorer-quality issued in the second half of 2013 are unlikely to be repeated in the immediate future.



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# SPECIAL DISABILITY TRUSTS

Jon Kalkman, AIA Member

Parents of a child with a disability need to face their greatest fear, that there may be no provision for their disabled child when they die. Most legal professionals do not specialize in this area as each case is both infrequent and unique.

The most common advice is to establish a testamentary trust for the disabled child. A testamentary trust is a trust created by your Will and does not come into effect until after your death. There are various types of testamentary trusts but it is usually a trust where the trustee has full discretion about distributions to the beneficiaries.

Many disabled adults qualify for the Disability Support Pension (DSP) which is subject to Centrelink's Assets and Income Tests. A single pensioner who is not a homeowner will have their pension reduced if their assets exceed \$339,250 and/or their income exceeds \$156 per fortnight. These thresholds are indexed bi-annually in March and September.

Any disabled adult who is also a beneficiary of a testamentary trust may thus find their DSP reduced or eliminated by the benevolence of their benefactor and loss of the Disability Support Pension may have significant implications for a range of other benefits such as medical, housing and transport assistance.

### Special Disability Trusts

One solution to this dilemma may be a Special Disability Trust which is established primarily for succession planning by parents and immediate family members for the current and future care and accommodation needs of a person with a severe disability or medical condition.

The general approach is that the trust can pay for any care, accommodation, medical costs and other needs of the beneficiary during their lifetime. A Special Disability Trust is entitled to a number of government concessions to help families make this provision for their disabled child.

The trust is established by a trust deed that must meet a number of stringent conditions in order to qualify for a range of government concessions set out below.

### A Special Disability Trust must meet the following requirements:

- have only one beneficiary (that is the person for whom the trust is established),
- the beneficiary must meet all eligibility criteria. This includes someone who qualifies for the disability support pension,
- the primary purpose must be to provide only for the accommodation and care needs of the beneficiary,
- have a trust deed that contains the clauses as set out in the model trust deed,
- have an independent trustee, or alternatively have more than one trustee,
- comply with the investment restrictions,
- provide annual financial statements, and
- conduct independent audits when required.

### General Features

When Special Disability Trusts were first legislated in 2006, they were limited to providing funds to pay accommodation and care of the disabled person. Recent changes have broadened the scope of these trusts:

A beneficiary of a Special Disability Trust can work up to seven hours a week at or above the relevant minimum wage, A trust can pay for the beneficiary's medical expenses, including private health fund membership costs and maintenance of trust property, and

A trust can spend up to \$10,750 in a financial year (indexed annually), on discretionary items not related to the care and accommodation needs of the beneficiary of the trust as long as the expense complies with legislative requirements. Other members of the immediate family of the principal beneficiary cannot benefit from the trust either through employment or by loans

A Special Disability Trust ends when the beneficiary dies or all the funds in the trust are exhausted. If the beneficiary dies with funds remaining in the trust, these funds are distributed to the secondary beneficiaries as outlined in the Trust Deed. A Special Disability Trust can be established at any time or it can be established as a testamentary trust as part of a will.

## SPECIAL DISABILITY TRUSTS continued...

### Implications

The income from the special disability trust can pay for all of the expenses that arise as a result of a disability including, medical, dental, therapy, communication and equipment costs as well as accommodation costs such as rent. In addition, the trust can provide up to \$10,750 per year or \$200 per week for discretionary items such as toiletries, fares as well as recreation and leisure activities.

### Centrelink Concessions

Anyone can donate to a Special Disability Trust and there is no limit to the size of the funds in the trust and the Special Disability Trust provides: An Assets Test assessment exemption of up to \$609,500 (as at 1 July 2013) is available to the beneficiary. All trust income is excluded from the income test assessment for the beneficiary. A gifting concession is available of up to \$500,000 combined (total amount in trust that has received gifting concession) by one or more eligible immediate family members of the beneficiary.

### Implications

The assets test exemption is in addition to the normal assets test and so the beneficiary could have assets of \$948,750 (\$609,500 + \$339,250) before their disability support pension is reduced and these limits are indexed annually. With respect to the donor's eligibility for the age pension, a Special Disability Trust allows them to reduce their own assets by \$500,000, without being affected by the normal gifting rules. Note: Recipients of the age pension are subject to the gifting rules which limit the amount that can be given away to reduce their assets. If more than \$30,000 is given away over 5 years those gifts are still counted as assets in determining the age pension. The gifting concession only has a life of 5 years. Gifts to the Special Disability Trust that are made more than 5 years ago, no longer qualify for the gifting concession.

### Tax

A Special Disability Trust has a number of tax concessions. Capital gains tax exemption for any asset donated into a Special Disability Trust, Capital gains tax main residence exemption for Special Disability Trusts, Capital gains tax exemption for the recipient of the beneficiary's main residence, if disposed of within two years of the beneficiary's death, and Income from the Special Disability Trust is taxable in the hands of the beneficiary at their marginal rate. Undistributed income of a Special Disability Trust is taxed at the beneficiary's personal income tax rate, rather than the highest marginal tax rate

### Implication

As the Disability Support Pension is a tax-exempt Government payment, income received from the trust would benefit from the low income tax threshold. A Special Disability Trust allows undistributed income to accumulate within the trust without a penalty tax. This provides the trustee greater flexibility to pay for large items such as a modified motor vehicle.

Note: In other discretionary trusts, all income must be distributed to beneficiaries where it is taxed at their marginal rates. Any trust income that is not so distributed is taxed at the highest marginal rate.

### Compliance

Failure to meet the conditions of the trust deed would make the trust non-compliant and would mean the loss of these generous concessions.

### Trustee(s)

The trustee's responsibility is to act in the best interests of the beneficiary in accordance with the terms of the trust, through provisions in the trust deed or Will. In brief, the duties of the trustee are: to implement the trust in accordance with its terms, to consider whether to spend trust



money or otherwise use the trust property for the benefit of the beneficiary, with reasonable regularity, to invest trust property prudently and in accordance with the directions contained in the trust, to avoid unnecessary expense or waste of trust property, to take professional advice (legal, financial, accounting, medical or other advice) if required (at the expense of the trust), to keep accounts of assets and liabilities and income and expenditure and be ready to account to the beneficiary if required, and if the trust is relevant to the income support entitlements of the beneficiary, to provide information to Centrelink or Department of Veterans' Affairs as required.

Trustees have the right to have their reasonable trust-related expenses paid from the trust. There is a legal obligation on the trustee to look after the trust property, and invest it and use it wisely and carefully for the benefit of the beneficiary.

The Trustee must: keep or cause to be kept proper accounts in respect of all receipts and payments on account of the Trust Fund and all dealings connected with the Trust Fund, and prepare or cause to be prepared written financial statements showing the financial position of the trust at the end of that Accounting Period. The trustee must provide the financial statements of the trust and action audits when/if requested. Implications Careful consideration needs to be given to the appointment of the trustee(s)

### Conclusion

This is not an issue that affects everyone. Those that are affected often find great difficulty in getting quality information. The information provided here may prove useful for those families when discussing this estate planning dilemma with their legal adviser.



A trust can pay for the **BENEFICIARY'S MEDICAL EXPENSES**, including private **HEALTH FUND** membership **COSTS**



# Size & Diversity

## of the market makes for robust portfolio...

Elizabeth Moran, FIIG Director

Investors know that size counts. Bigger companies with higher net asset values and diversified income streams are lower risk than smaller companies concentrated in just one product and geographical segment. Just as investors favour diversified companies like Wesfarmers because of its range of investments (retail, coal, insurance, chemicals and energy) it's important to diversify your portfolio across asset classes to protect it from shocks. Diversification aids stability.

While I've been writing about fixed income and in particular, bonds for some months, few investors appreciate the size of the market. The fixed income asset class covers a broad range of investments that mostly have known returns although many investments do not have "fixed returns" (for example floating rate and inflation linked bonds) so the name "fixed income" can be a little misleading. Fix income encompasses: deposits, bonds, hybrids and various types of asset-backed securities. So bonds are actually a sub-class within the broader fixed income definition. Generally cash or deposits are listed on a stand-alone basis, which given its importance and size (\$1,668.52bn as at 31 December 2013) is understandable.

Discounting cash, the remainder of the Australian fixed income asset class is estimated at \$988bn as at 31 December 2013. To put the number in context, the ASX top 100 companies by market capitalisation were worth \$1,531bn at the same date.

By far, the largest single bond issuer is the Commonwealth government, which had \$265.88bn in outstanding fixed rate bonds and \$21.67bn in index linked or inflation linked bonds as at 31 December 2013 (see Figure 1). Combined, the state governments and territories had \$199.90bn in outstanding bonds. Corporations were another large segment with \$247.36bn in fixed and floating rate bonds as well as an additional \$4.91bn issued in inflation linked bonds.

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Asset backed securities, where there are specific assets that provide security to bondholders, is once again a growing segment, as investor confidence and demand has recovered after the global financial crisis. Approximately 80 per cent of the total \$128.3bn on issue was residential and commercial mortgage backed securities.

Banks and finance companies pool mortgages and then split them into different classes, much the same way as a capital structure diagram, where those in the

So bonds are actually a sub-class within the broader fixed income definition

highest ranked class sit at the top of the structure and principal is returned to them first; then when they are repaid in full, the second class begins to be repaid, and so on. Investors receive regular interest throughout the life of the security. Those in the lowest class take on equity like risk but are paid higher returns to compensate. New bond issuance in the wholesale, over-the-counter domestic market in 2013 was \$79.5bn, a little less than the A\$87.4bn issued in 2012. However, the availability of very cheap funding in the US meant that Australian companies preferred that market and issued US\$101.59bn (US\$116.82bn in 2012) in public and private placement deals.

Issuance in the smaller ASX market (total value of bonds issued \$40.54bn excluding Commonwealth government securities at year end 2013) was \$8.4bn, consisting of seven financial institution issues and one corporate issue.

A robust investment portfolio will be diversified across asset classes, industrial sectors, issuers and over different geographical segments. The size to the Australian bond market and the certainty and additional returns bonds provide over cash make it worth investigating.

## The Lament of Last Minute Will-He

Shane Ellis, SMSF Law

I received a call from a family friend whose son had played rugby with my son on a school tour in France and England during the 2007 Rugby World Cup. We had enjoyed their company as we travelled around watching the boys and the Wallabies do their best.

Will-He's wife was calling me because Will-He was home in his bed and was close to death. I had known that he had been unwell with cancer problems on and off for years but I was not aware that he was so unwell. Will-He's wife asked me to call over to their home to ensure his affairs were in order. I advised that I would be happy to do so, and asked permission to bring my clerk along as a second witness. My clerk had also gone to school with the boys.

I arrived at Will-He's home and was welcomed at the door by his wife and only son. Will-He was propped up in bed and was a shadow of the large boisterous character that I had enjoyed a few beers with overseas. He acknowledged me, and I went to check that his documents were in order. There were a number of things that needed to be done including the signing off on the life insurance nominations, and of his final Last will & Testament & Enduring Powers of Attorney.

My sixth sense kicked in, and I was loathe taking the time to travel back to my office to do these documents, so I connected in via the laptop belonging to Will-He's wife and adjusted the documents in the dining room and printed them off on their home printer. My clerk and I assisted Will-He to sign the papers. He smiled at me and I took him by the arm and re-assured him that all was now in order and that he could rest peacefully when he chose to do so. That was 2.30pm. I left to have a bit of private time after the emotional ordeal of assisting Will-He in this way. I then received a phone call at 4pm that day. Just 1½ hours later. It was from Will-He's son thanking me for my assistance and advising me that Will-He had passed away peacefully shortly after I had left their home.

I expressed my best wishes for the boy and his mum. I noted what a grand fellow his dad had been and asked that they call me if they need any assistance at all with any of Will-He's affairs. I was rocked to my core. It was just so surreal that this fellow had turned out to be the scariest "Last Minute Will-He" that I had dealt with in my legal career. If the affairs were not corrected there may have been a challenge to the estate; many thousands in unnecessary legal fees for Probate that was not needed with the structuring of the estate and life insurance; or his wife might have been forced to share the estate with others that Will-He did not intend to benefit.

How many times do we put off important tasks telling ourselves that "we will get around to it", with a false sense of security that there will always be enough time in our future to do it?

Time is the most valuable item in our lives. It is irreplaceable. It is finite.

And we never know how much of our time is left in our life at any given moment.

This true story, "The Lament of Last Minute Will-He", highlights the importance of getting your affairs in order now, and not



waiting until the last minute – because you never know when your last minute may be.

Proper estate protection planning is paramount to ensuring that you will be able to rest in peace, and that in a time of grief your loved ones aren't left with the financial and emotional turmoil of tidying up your estate.

We all know that it is often unnecessary fights over money that tears families apart. Getting your affairs in order now may very well prevent that happening to your loved ones.

Now it is obvious that his name is not Will-He, but in view of what took place he will always be remembered as "Last Minute Will-He" to me.

**"Prevention IS better than cure in the real world, AND PREVENTION IS OFTEN VERY MUCH CHEAPER IN THE LEGAL WORLD".**



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Nathan Bell,  
Research Director

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# Calendar of Events

Date	Event	Time	Venue
MARCH			
03-Mar-14	Canberra Discussion Group	7.30pm	Southern Cross Club, 92-96 Corina Street, Woden ACT
04-Mar-14	Geelong Discussion Group	7.00pm	St George Workers Club, 212 Pakington Street, Geelong West VIC
04-Mar-14	Perth Information Meeting	7.00pm	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs
04-Mar-14	Sydney South Discussion Group	7.30pm	Miranda Community Centre, Wattle Room, 93 Karimbla Road, Miranda NSW
05-Mar-14	Frankston South Discussion Group	1.00pm	Private address. Contact event coordinator: Bill Shirley email: aiavic@investors.asn.au
05-Mar-14	Brisbane Information Meeting	1.00pm	Broncos Leagues Club, Fulcher Rd, Red Hill
12-Mar-14	Sydney North Shore Information Meeting	7.00pm	The Chatswood Club, 11 Help St, Chatswood
17-Mar-14	Chermside Equities Discussion Group	7.00pm	Chermside Library, Hamilton Road, Chermside QLD
18-Mar-14	Brisbane Investment Management Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
18-Mar-14	Adelaide Discussion Group	7.00pm	German Club, 223 Flinders St, Adelaide (Wolf Blass Weinkeller Room)
18-Mar-14	Perth Equities Discussion Group	7.30pm	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs
19-Mar-14	Brisbane Share Investments Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
26-Mar-14	Kew Discussion Group	7.00pm	Phyllis Hore Room, Kew Library, Corner Cotham & Civic Dr, Kew VIC
27-Mar-14	Bayside Discussion Group	4.00pm	Contact coordinator Kevin Macdonald ph: 0417 328 748 email: km.macdonald@bigpond.com
31-Mar-14	Brisbane SMSF Discussion Group	7.00pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
APRIL			
01-Apr-14	Perth Information Meeting	6.00pm	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs
01-Apr-14	Sydney South Discussion Group	7.30pm	Miranda Community Centre, Wattle Room, 93 Karimbla Road, Miranda NSW
01-Apr-14	Adelaide Information Group	7.00pm	German Club, 223 Flinders St, Adelaide (Wolf Blass Weinkeller Room)
02-Apr-14	Sydney Hills District Discussion Group	7.00pm	B Davis & Associates, Suite 17, 35 Old Northern Road, Baulkham Hills NSW
02-Apr-14	Blackburn Discussion Group	7.15pm	Naturalist Club of Victoria, 1 Gardenia St, Blackburn VIC
02-Apr-14	Brisbane Information Meeting	1.00pm	Broncos Leagues Club, Fulcher Rd, Red Hill
05-Apr-14	Perth Seminar - Masterclass in Stock Selection	8.30am	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs
07-Apr-14	Canberra Discussion Group	7.30pm	Southern Cross Club, 92-96 Corina Street, Woden ACT
08-Apr-14	Melbourne Information Meeting	6.30pm	Telstra Conference Centre, Room 1, Level 1, 242 Exhibition St, Melbourne VIC
09-Apr-14	Sydney North Shore Information Meeting	7.30pm	The Chatswood Club, 11 Help St, Chatswood
15-Apr-14	Brisbane Investment Management Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
15-Apr-14	Gold Coast Information Meeting	9.30am	Robina Community Centre, Robina Town Centre Drive, Robina QLD
15-Apr-14	Perth Equities Discussion Group	7.30pm	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs
16-Apr-14	Brisbane Share Investments Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
28-Apr-14	Chermside Equities Discussion Group	7.00pm	Chermside Library, Hamilton Road, Chermside QLD
28-Apr-14	Brisbane SMSF Discussion Group	7.00pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
MAY			
05-May-14	Canberra Discussion Group	7.30pm	Southern Cross Club, 92-96 Corina Street, Woden ACT
06-May-14	Perth Information Group	7.00pm	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs
06-May-14	Adelaide Information Group	7.00pm	German Club, 223 Flinders St, Adelaide (Wolf Blass Weinkeller Room)
06-May-14	Sydney South Discussion Group	7.30pm	Miranda Community Centre, Wattle Room, 93 Karimbla Road, Miranda NSW
06-May-14	Sydney Hills District Discussion Group	7.00pm	B Davis & Associates, Suite 17, 35 Old Northern Road, Baulkham Hills NSW
07-May-14	Brisbane Information Meeting	1.00pm	Broncos Leagues Club, Fulcher Rd, Red Hill
14-May-14	Sydney North Shore Information Meeting	7.00pm	The Chatswood Club, 11 Help St, Chatswood
19-May-14	Chermside Equities Discussion Group	7.00pm	Chermside Library, Hamilton Road, Chermside QLD
20-May-14	Perth Equities Discussion Group	7.30pm	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs
20-May-14	Brisbane Investment Management Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
21-May-14	Brisbane Share Investments Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
22-May-14	Bayside Discussion Group	4.00pm	Hampton Community Centre, Willis Street, Hampton VIC
26-May-14	Brisbane SMSF Discussion Group	7.00pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
28-May-14	Kew Discussion Group	7.00pm	Contact coordinator Kevin Macdonald ph: 0417 328 748 email: km.macdonald@bigpond.com

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