

the INVESTORSvoice

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

June 2014

MARKET GETS A HEALTH CHECK

Understand
position sizing
SMSF Trustees
Share Portfolio



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Market gets a **HEALTH CHECK...**

Elio D'Amato

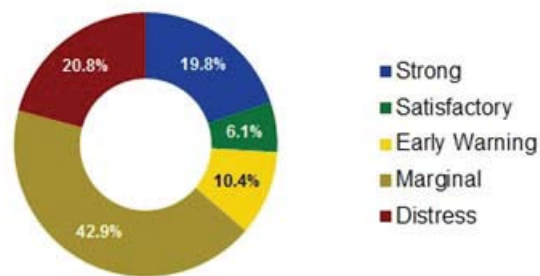


Finding stocks that offer real value in the current market can be difficult. While the share market has posted strong gains of late, building pressure from upward interest rates and challenging domestic business conditions mean investors need to ensure their portfolios consist of bulletproof stocks.

Lincoln Indicators recently released its biannual Health of the Market report, reviewing reported company information up to 31 December 2013. The findings highlighted that Australian stocks are looking a bit 'green', with only 26% of listed companies in a Strong or Satisfactory Financial Health position.

As a result, if you're pouring your money into the market using the 'dart board' method of choosing stocks, there is a high likelihood of picking a dud.

Health of the Market



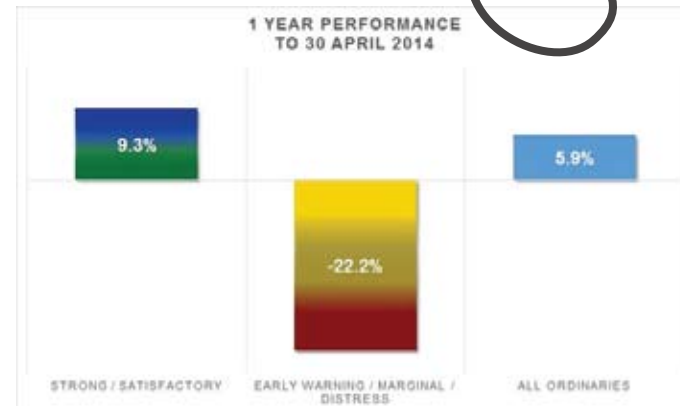
Financial health

No DIY investor has time to assess every single stock on the ASX. In order to avoid blindly picking stocks, the core of your decision making should revolve around identifying quality businesses with a great balance sheet, great operating cash flow and a strong level of profit.

We analyse companies firstly for Financial Health. We measure 12 accounting ratios to assess a company's level of insolvency risk. Every company on the ASX has its profitability, cash flow and balance sheet positions scrutinised and a holistic Financial Health score is determined. Companies with a Strong or Satisfactory rating are judged as being exposed to acceptable levels of risk and should make up the bulk of your investment portfolio. Companies with an Early Warning, Marginal or Distress rating carry escalating degrees of risk and should be avoided by risk-averse investors. We use this to assist DIY investors to properly assess a company's quality. In doing so, investors gain greater confidence and control over their portfolios. Financial Health is the number one check we do on any stock before we invest. If it is not financially healthy, it doesn't warrant your money.

We have identified solid companies that continue to perform. Over 12 months, companies with Strong or Satisfactory Financial Health went on to perform better as demonstrated by their median price performance below. Alternatively, unhealthy stocks (Early Warning, Marginal and Distress) considerably underperformed. This has been a trend observed by Lincoln over many years.

“**Cash flow** is one thing”
companies **can't lie about!**



However, it is worth emphasising that a bad Financial Health rating is not a death sentence - stocks can turn around and may end up being a consideration down the track. Since the last Health of the Market report was released in June 2013, 77 stocks transitioned from poor Financial Health to Strong or Satisfactory. These included Atlas Iron Limited (AGO), Magellan Flagship Fund Limited (MFF), Seek Limited (SEK) and Fairfax Media Limited (FXJ).

Some tips

Firstly, you should look at key data before deciding to invest, including:

- is the company highly profitable?
- is it carrying high levels of debt?
- is it generating positive net operating cash flow?

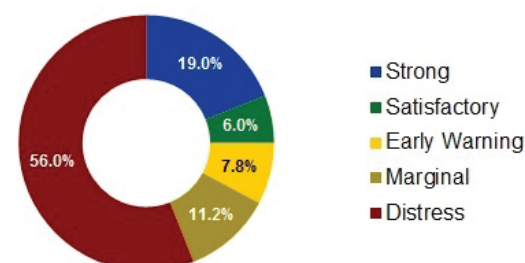
Cash flow is one thing companies can't lie about, particularly operating cash flow. Businesses need to be getting more cash in than cash out in order to be considered a quality company.

Health of the market

After assessing up to 2,000 companies in our latest Health of the Market report, we found that 64% of the market has a Financial Health rating of Marginal or Distress, with only 26% of companies Strong or Satisfactory and, therefore, exposed to acceptable levels of risk.

Consumers Services, Financials, Retail and Telecommunications remain the strongest sectors, driven by influences such as the dominance of large, stable blue chip companies. On the flipside, Healthcare, Materials, Utilities and Energy contain the highest amount of Distress companies, symptomatic of the low operating cash flow or high debt properties many of these entities exhibit.

Health Care



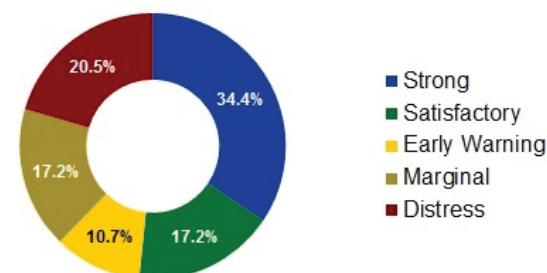
Market gets a health check

Logically it makes sense that sectors like Mining and Healthcare would have a higher proportion of companies with poor Financial Health, as they consist of many speculative, non-profitable companies. However, we would emphasise that just because a sector has a large percentage of companies with poor Financial Health, it doesn't mean it won't also contain a few gems.

An ageing population, an ever increasing demand on healthcare services and an affluent generation retiring that will spend money to stay fit and healthy, all bode well for the future. More to the point, the Healthcare sector currently has some exceptionally strong, financially healthy companies, including Lincoln favourites CSL Limited (CSL), Ramsay Health Care Limited (RHC), ResMed Inc. (RMD), Sirtex Medical Limited (SRX), Capitol Health Limited (CAJ) and Vita Life Sciences Limited (VSC). As such, the Healthcare sector remains one of Lincoln's preferred sectors.

Similarly, the Health of the Market report shows 84% of listed mining companies are in states of Marginal or Distress Financial Health. Investors need to look at the fundamental quality of the business and avoid risky companies that are going to run out of cash. Lincoln's picks from an income perspective in the mining sector include copper and gold miner Sandfire Resources NL (SFR), iron ore miner BC Iron Limited (BCI) and mining services firm Mineral Resources Limited (MIN).

Diversified Financials



On a positive note, the Diversified Financials sector reigned supreme and is a great performer for a number of reasons. Firstly, bank stocks are operating in a very favourable environment, so many are flush with cash and we've seen this result in high dividends for investors. In addition, increased regulation over the last couple of years is starting to flow through the balance sheets.

Summary

Australia is a pretty risky investment environment. Two thirds of our market is exposed to unacceptable levels of risk and this is a timely reminder that investors need to 'lift the hood' on stocks to find their true value. Our top tips include the following.

- Assess a company's Financial Health to identify its risk profile and look to invest in stocks that are Strong or Satisfactory.
- Look at the fundamentals (bottom-up investing) to assess its management and outlook. In particular look at earnings per share, return on equity, the return on assets and the price to earnings ratio.
- Don't worry too much about sector allocation as bottom-up investing will take care of this for you. Remember a company with good fundamentals will still perform in a struggling sector.
- Don't focus solely on valuations. Sometimes you will pay a bit more than the asking price, but a strong stock will reward you in the long run.

Download Lincoln's Health of the Market report at www.lincolnindicators.com.au/hotm

President's Message By Bill Shirley



We live in an environment that increasingly relies on the Internet to supply information from many sources. We at the AIA are trying to follow this growing trend by utilising this tool in the areas of our website and our publications, Investor Update, and Member Update. We would very much like to receive your feedback in relation to how we are travelling in this area and if the documents assist your investment objectives, including SMSF structures. We look forward to your feedback.

Foreign Exchange Trading Risk.

My investment comment for this issue is concentrated in the area of foreign exchange trading, (4X for short), and the possible inherent associated risks. Recently there has been some press coverage, and more importantly, I have received several phone calls outlying deplorable member experiences in relation to loss of savings therefore I would like to make a few comments in relation to general retail investment activities in this space. Some points you should consider are:

- Review your gearing limits.
- Consider the amount of funds you wish to allocate to this class of derivative investment in relation to your total holdings.
- Assess the skills you require. This field is dominated by speculators, investment banks and high-frequency trading groups. These entities have far greater access to the skill sets required to operate in this investment environment.

I believe care in these outlined areas may go a long way to minimising your risk component in this segment of the market.

Strategic Alliance for Investors.

Recently we formally agreed to a developing Strategic Alliance with the Association of Independent Retirees (A.I.R.) with the signing in Brisbane of a Memorandum of Understanding (MOU). As this future partnership develops over the coming months, the reciprocal arrangement will provide a wider range of services to members of both organisations.

The first steps have started with an AIR Deputy Director presenting a paper at our conference in August together with some AIR members taking up our offer of event attendance. I hope these are the initial steps towards a long and successful joint venture for both entities.

National Conference.

Most of the planning for this complex event are now based around the product delivery areas such as final arrangements in the accommodation area, travel, bookings, audio, refreshments & sponsor siting arrangements areas, as well the Marketing aspects of the event. Your committee, and our staff are working hard to achieve an informative and friendly event.

Bookings are flowing in by mail, phone and online. The program is packed with some of the most sought after speakers in Australia and we hope to see you at the Marriott in August. We enclose the brochure for your review. Additional details can also be found via our web site.

In conclusion, I hope we all survive Winter in good health and our investments weather this down period.

Kind Regards – Bill Shirley

Matching up the returns in LICs

Boyd Peters, Contango

There has been much publicity and discussion related to Listed Investment Companies (LICs). It has been said that LICs are at the start of a “golden decade”, with their values tipped to soar from \$23.9 billion at March 2014, to \$100 billion by 2020.

For those new to the sector, LICs have characteristics of both managed funds and stock exchange-listed companies. LICs invest in other companies, with the purpose of giving their shareholders exposure to a variety of shares via their investment portfolio.

Investors like to invest in LICs for a variety of reasons including:

- diversification, where the LIC offers exposure to a large number of different companies in a range of industries;
- risk management, where the risk to capital losses connected to one company may be offset by gains by others in the portfolio;
- access to skilled investment professionals whose goal is to maximise returns on the investment portfolio;
- transparent investment philosophy, where LICs disclose how they invest their funds (enabling investors to choose a LIC based on their specific investment goals and risk preferences);
- ease of investment, by buying and selling through the ASX as with any other stock;
- low operational costs and better taxation issues; and
- regular franked dividends, providing the shareholder with reliable income streams enabling them to maintain a “buy-and-hold” investment strategy.

In recent years LICs have improved the way they engage their shareholders, providing more information more often, via more access points such as web sites, phone apps, visible investment managers and people to speak to in the company. LICs are doing this because - beyond being good practice - it can provide more liquidity to the stock and narrow the spread between the Bid and the Ask prices. Within this, if the shareholder is aware of those stocks within the investment portfolio, they can measure the effect that market fluctuations have on the portfolio and to a lesser degree the Net Tangible Assets (NTA).

Contango MicroCap Limited (CTN) is widely recognised as a model LIC for the speed, quality and volume of information it provides to its shareholders. In addition to being one of the first LICs to release its monthly NTA value, it has recently committed to providing its shareholders with a mid-month update on how the investment portfolio has performed. This should help shareholders and investors make better informed decisions.

Whereas once a LIC investor might just have seen the company share price or NTA, now they are seeing a range of information being provided by LICs including portfolio performance, share price total returns, discounts and premiums, “Pre” and “Post” NTA values, yield and franking. For those with little understanding of LICs, all this information can be confusing.

LICs commonly reference the following metrics to enable investors to make informed decisions.

- Performance of the underlying investment portfolio.
- NTA value of the portfolio.
- Share price total return - which recognises dividends paid.

This information provides clues to the market sentiment for the company, the LIC structurally, and the skills of the portfolio managers themselves.

Essentially, information about the investment portfolio is provided to make apparent the quantitative performance of the investment manager, thus demonstrating their skill and ability to generate returns in the future.

From the portfolio performance a company can derive its NTA value. The difference reflects factors such as fees, charges, operating costs and taxes paid out in the ordinary course of the company’s operations. In addition, the NTA adjusts each month for the impact of any capital events the company may also have undertaken - such as dividend payments and dividend reinvestment plans, share purchase plans, placements, options exercised, buy backs and, of course, company tax paid to the ATO. This NTA would be referred to as “Pre-Tax NTA” which is an unusual reference because it is an after company tax already paid to the ATO valuation. “Post-Tax NTA” refers to the hypothetical value of the company if the entire investment portfolio were sold that day and all unrealised capital gains were paid to the ATO. This is basically a theoretical value, because no LIC plans to do that. Sometimes you will read about discounts to NTA, and see them on a Pre-Tax and Post-Tax basis. This is when the share price is compared against the NTA value(s) and identifies whether the share price is under or above the LICs per-share asset value. Many people believe the best discount measure is to the Post-Tax NTA value, because it is what the NTA would be if the portfolio were sold down and monies returned to investors. There is, however, no firm rule regarding which one to use, as long as consistency is applied in measuring and comparing.

Regardless of what your entry point is you are still going to receive the future capital growth of the company which is mostly derived from the growth in the investment portfolio. The movement in the premium/discount is an additional source of return. Buying a LIC at a discount means you can get a dollar’s worth of assets working for you in the market at a cost lower than \$1. Sometimes this is considered free money. LICs can move in cycles between premiums and discounts, and investors can try and time this, as well as their investment in the market itself.

There is plenty of information about discounts and premiums. How material are they? That is a moot point. I would personally rather invest in a LIC that gave me a 40% return and at a 5% discount to its NTA, than in an LIC that gave me a 10% return but was at a 20% premium to its NTA.

“ LICs have characteristics of both managed funds and stock exchange listed companies ”



Matching up the returns in LICs continued...

This takes us to the share price, which trades independently of the actual value of the investment portfolio and NTA value. Essentially, the difference between the company’s NTA and share price is market sentiment – the expectation of future earnings, the skills of the manager, structure of the company, dividend outlook, franking, anticipated capital actions and so on.

At the end of the day, share price growth, dividends and franking are what shareholders receive and are, therefore, the key measures of performance. They need to understand, however, that comparing share performance between LICs and also to Index benchmarks may be pointless. LICs pay different amounts of tax at different times. They attach different amounts of franking to their dividends, and many have substantially increased the number of shares on issue in the last few years, via dividend reinvestment plans and option issues. For these LICs, looking at their share performance in tables is almost meaningless, as these tables don’t adjust for the additional shares issued.

Which brings us back to why many LICs are now providing information about the performance of the actual investment portfolio.

Boyd Peters, National Distribution Manager, Contangio Microcap Limited



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Beware of the risks for Individual SMSF trustees

Russell Lees, Sornem Private Wealth

Reading through recent judgements on disputes in relation to self-managed superannuation funds (SMSFs), I found several examples which highlight the dangers for individual trustees. This is particularly the case when one of the trustees is more active in managing the fund, whilst the other trustee takes a more hands off or passive role.

Below are two interesting cases arising from the actions of one of the trustees without the knowledge of the other trustees. In both cases the matter of who incurs any resulting penalties highlights the significant liability shared by all trustees and members of the fund. Shail Superannuation Fund and the Australian Taxation Office (ATO)

The Shail Superannuation Fund was structured where Mr & Mrs Shail were both individual trustees and members of the fund. Over a period of two months in 2005, Mr Shail used his authority as signatory on the bank account to transfer cash of \$3.5 million from the SMSF's cash account to an offshore bank account held in his name in Turkey.

The Shail Superannuation Fund was in accumulation mode and neither of the members had access to the funds under the preservation rules. Mr & Mrs Shail later separated and Mr Shail moved overseas.

As a result of the actions of Mr Shail, the ATO declared the fund non-complying and imposed a penalty on the trustees of \$1.6 million plus additional penalties of \$1.5 million. Mrs Shail argued that she should not be held liable since she was not involved in the actions of her former husband. The Administrative Appeals Tribunal (AAT), while sympathetic towards Mrs Shail, upheld the penalties to highlight the role and responsibilities of trustees as well as the regulatory regime they operate in.

Triway Superannuation Fund and the ATO

The Triway Superannuation Fund operated with three individual trustees and members - a father, mother and their son. The son, unfortunately had a drug addiction and between 2002 and 2003 he withdrew the majority of the fund's cash leaving the super fund with virtually no assets.

Whilst the theft of the funds by the son was a major compliance issue, the matter was hidden on the advice of their tax agent who concealed the loss of the funds for a period of almost five years. On discovery via an audit, in 2008 the ATO declared the fund to be non-compliant. The trustees appealed to the AAT seeking to have the non-compliance status waived but were unsuccessful.

Considerations

Both cases highlight that individual trustees are responsible for the actions of all other trustees. Taking a passive approach to the management of a SMSF and relying on a dominant trustee comes with significant risks. As illustrated above, each individual trustee is jointly and severally liable, regardless of who commits the offence.

It is important to note that in both cases, ensuring all trustees are signatories on the super fund's bank account would have been a major preventative measure. This should be one of the minimum safety nets for all SMSFs. If you are unsure on this for your fund, contact your bank to ascertain the situation and amend it if required.

Concealment of issues from the ATO is a severe compliance breach and one that will be picked up over time. Trustees should never at any time play a game of hide and seek with the ATO. Always declare as soon as the issue is discovered and always seek professional advice on the appropriate course of action.

In the above examples, if the superannuation funds had used corporate trustees, a breach by one of the directors, where the other directors had no knowledge of the offence, could have been indemnified under section 197 of the Corporations Act 2001. Our recommendation is that you should always seriously consider adopting a corporate trustee over using individual trustees. The benefits are huge and cannot be overstated.

Using Twitter for investing: Tweet, Twitterer, #&@!

Russell Lees, Director AIA



Glossary:

Twitter – an online social network and microblogging service that transmits short messages in real time of up to 140 characters in length

Tweet - a posting made on the social networking service Twitter

Twitterer - People who send tweets on the Twitter service

I've always tried to get my news as fast as possible. My hunger for the fastest news source goes back to the time when I worked for a company called Reuters in the 90's. Reuters biggest operations is providing international news and as a result I had access to their electronic news feeds providing real time news updates from investment markets from around the world. It was a fantastic source of global news and opinions from economists, analysts and market players. I quickly learnt the benefit of getting access to news announcements almost instantaneously. Reuters is a very old company dating back to 1851. Its survival had been built around its ability to adopt the latest technology required to transmit news and information to investors. Initially this was using pigeons. The company would record the closing prices on European stock exchanges and tape the data to pigeons and fly them to major European cities for publication in local newspapers. This was superseded by the invention of the Telegraph and finally with the invention of computers and IT networks, Reuters operates one of the world's largest private secure computer networks connecting banks, brokerage houses and corporates to real time financial information and trading systems.

The rise of the internet continues to advance the speed with which information is transmitted. Consider Facebook, where over 1 billion people around the world share and discuss day to day social matters in real time. Never before in history has the global population been so interconnected. In my search to find the best way to consolidate and locate current up to the minute financial news and information I stumbled upon Twitter. In some ways I was a late convert to Twitter because it intimidated me. I thought I would have to learn a foreign language to use it, its use of symbols and formats was initially baffling, but I stayed the course and continued to use it. It certainly has been the right decision. These days I can't get off it!

The biggest issue with the internet is there is just so much information out there, that finding and filtering all the information that may be of interest is not only frustrating but very time consuming. I have a bookmark list of all my favourite financial news and information sites that has taken years to build up and takes up considerable time each day jumping from one site to the other in search of news, opinions, and research to help me get an edge over other investors.

For the last eighteen months Twitter has become the one internet source I will access several times each day. Why? Because it's by far the best single site to obtain a consolidated and centralised site for the access of financial information and updates on any topic you choose to view. It requires no jumping from website to website, no filtering of good information from bad, only news announcements from sources you have chosen to receive. Typically announcements are headlines only describing in brief detail the topic of the announcement. With most postings there will also be a link to enable you to access the full article or to obtain further information. It is like a continuous updating stream of financial headlines and announcements where you have the choice to click the link to read the article or just ignore and go on to read the next headline.

It's just not news headlines you'll get access to. If you have a favourite economist, journalist, analyst or someone in the public space you enjoy reading their thoughts and opinions, it's highly likely they will have a Twitter profile you can connect up to. Setting up a Twitter account is easy. Jump across to their web site www.twitter.com and enter your full name, email address and the password you want to use for your account. Twitter will automatically suggest a username for you based on your first name and surname, but you can change this if you prefer an alternative. Click the 'Create my account' button.

The next step is to find people to 'follow'. The key here is building up a list of people whose posts you will find interesting. For investing purposes, a good place to start is people that are influential in the finance industry such as journalists, news sites, economist etc. Twitter will suggest some people for you to follow on the next screen. Don't worry if you follow the wrong people – you can easily 'unfollow' them later. You'll be able to search for Twitter users by name or topic using the search box. From here, you can look up thought leaders and prominent executives in the investment field, and also browse through categories to find people relevant to investing. There's no rush here, take your time, I've been building my "follow" list over eighteen months and it's still growing.

Once you've setup your account you can start viewing tweets. You can also start adding your own tweets but posts are limited to 140 characters, so you'll need to brief with your message. The key point here is the majority of users of Twitter don't post updates; instead, Twitter is mainly used to read and access news and information, not for making their own announcements. You don't have to Tweet to benefit from Twitter. Thanks to connectivity, these days you can access Twitter from your PC, mobile phone, iPad or any other internet connected device. It pays to stick with it; it takes a while until the format of posts start to make sense. It may take a week or two, but like riding a bike, you'll get it in no time. People who tweet will use @ before their user name, so Joe Blog will be @joeblog. For threads on particular topics the # is used, so if you want to view all headlines that are about LNG, search using #LNG. It's that simple.

As a starting point, some interesting sources on investing on Twitter are:

Business Spectator [@BusinessSpec](#)

Money Management [@moneymanage](#)

Stephen Koukoulas [@TheKouk](#)

The Australian [@australian](#)

The Age [@theage](#)

Financial Review [@FinancialReview](#)

Joe Hockey [@JoeHockey](#)

The Economist [@EconBizFin](#)

David Scutt [@David_Scutt](#)

Reuters Top News [@Reuters](#)

Alan Kohler [@AlanKohler](#)

Malcolm Turnbull [@TurnbullMalcolm](#)

Ross Gittins [@1RossGittins](#)

Craig James [@craigjamesOZ](#)

Drew Meredith [@DrewDWM](#)

Shane Oliver [@ShaneOliverAMP](#)

Rupert Murdoch [@rupertmurdoch](#)

Ok... for me, it's not always about investing or economics

Foxtel [@Foxtel](#)

Qantas Wallabies [@QantasWallabies](#)

My favourite - All Blacks [@allblacksrugby](#)

[@russell_lees](#) - contact me via Twitter if you have any questions.



DESIGN THINKING

In the financial markets...

Lee M. Spano

It might just be the case that this relatively new concept touches on understandings which can easily be overlooked in our preoccupation with analysis.

Design Thinking

What is Design Thinking (DT) and how might it be applied to trading and investing in the financial markets? The Harvard Business School defines DT as: "A process for practical, creative resolution of problems or issues that looks for an improved future result."

A concrete example from business might assist further. Consider a leading car manufacturing company. How does it best design a model that will sell, say for the next five to ten years? Here many factors or questions will be considered, such as consumer needs and wants, consumer and producer budgets, style and tastes for target demographics, geographic issues, brand fit, sustainability, and importantly the landscape - in what terrain will the vehicle mainly be used?

Notice how the designer starts with the end in mind. For, say a SUV, the designer needs to have a fair idea regarding the types of roads and the purposes the vehicle will be used for. In this way DT has a Top Down rather than a Bottom Up approach. It contrasts with mainstream science and mathematics, which are Bottom Up approaches. They are founded on the empirical method where evidence is gathered and tested to form general propositions or laws. The study of financial markets draws from economics and other social sciences such as behavioural finance, and so has its history in the scientific tradition.

The essential elements

The essential elements of DT can be distilled as:
Top Down - starting with the end or goal first, and understanding the landscape, field or knowledge domain first.
Creative and analytical thinking are combined, with no particular preference for either. Pragmatic and problem-solving, focusing on solution pathways and minimising the rigidity of theory.
Applied usually to complex and dynamic environments, so change, fluidity and adaptation are key parameters.

When we look at these elements, we immediately see a fit with modern financial markets. The markets are a complex, dynamic space. We need pragmatic problem-solving skills. We often require both creative and analytical mindsets. Yet it is the first element that is often over-looked or causes confusion. This might be due to the scientific tradition relying more on a Bottom Up approach and being more analytical.

Creative and analytical thinking are combined...

Fundamental and technical schools

Over recent decades approaches to the financial markets have been dominated by two main schools - fundamental analysis (FA) and more recently technical analysis (TA). Both these schools are inherently analytical in their approach. They have been drawn from scientific paradigms, where analysis is meant to exclude creative or intuitive thinking. They also embrace a Bottom Up approach, where evidence is sought and conclusions or rules are formed. The approach is often atomistic and not holistic. It struggles with complex, dynamic environments and usually produces tools or approaches that are cumbersome and blunt, often focusing on one or a few isolated variables.

For example, how many financial analysts will tell you to focus on a stock's price earnings (PE) ratio or its debt service ratio (DSR)?

Are these the main or only variables which will influence, say BHP's stock price in the next six to eighteen months? What about other variables, such as global commodity prices, the Australian dollar, sovereign debt concerns in China? Further, don't at least some simple technical factors also impact on price or at least price expectation, such as long term support/resistance lines drawn on a weekly or monthly chart of BHP? The traditional fundamental analyst struggles here, as does the traditional chartist. Why? It seems the foundations from which their tools are derived cannot cope. So can DT help?

Applying DT to the financial markets

When we examine the four DT elements we immediately see a better fit with modern, inter-connected financial markets. Particularly, a Top Down approach studying the landscape first and focusing on finding pragmatic solutions gives us a better framework to then develop robust, adaptive trading or investing plans.

Returning to our earlier example of BHP, the questions we asked above all impact the price and volumes of the BHP stock listed in Australia. The key is to understand the landscape of this particular financial market, ASX stocks and this particular stock first, and then ask some important DT questions.

First, what is our goal and what practical results do we want as a trader or an investor? For instance, what return on investment (ROI) are we seeking? How can we achieve this by leveraging the scarce resources of time and capital? Second, what fundamental, technical or other factors impact BHP's price? This might include those outlined above and also market sentiment. Third, how can we combine creative and analytical thinking to best devise and manage an edge in our trading or investing strategy? Fourth, how can we create a strategy that is pragmatic and adaptive-fluid enough to cope with complex inter-connected markets, yet still able to provide consistency in our results?

Notice that these are more open-ended questions. They do not assume any particular paradigm or school of thought, such as TA or FA. Crucially, they ensure we fit our strategy to the market, not the market to our strategy.

DESIGN THINKING

In the financial markets... continued...

To do this we must understand our particular market or landscape first.

Hybrid systems utilise DT

I have long designed and used hybrid systems in various financial markets, ranging from stocks to foreign exchange. Hybrid systems by their nature utilise DT. By hybrid systems I mean a blend between mechanical and discretionary systems or strategies designed to suit a particular financial market.

My hybrid systems use FA, TA and other tools, including sentiment analysis. The written trading or investing plans have both rules and guidelines. Rules are mandatory while guidelines are discretionary and usually have relevant factors alongside to guide the exercise of the discretion. The plan is focused on practical results, namely monthly or annual net ROI outcomes. It is Top Down, understanding the landscape of the particular market first and then matching the solution or strategy to it in order to achieve the desired results.

"When you're an investor, you can look at the quantitative and qualitative elements of an investment, but there's a third aspect: What you feel in your gut." - Kevin O'Leary.

Lee M. Spano, Private Investor & CEO, Creatness International



Contango
Mobile Investor App

Follow your CTN MicroCap shares on your phone

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CAUGHT SHORT

WHY MANY RETIREES' INCOMES WILL PROBABLY RUN OUT EARLY

Stephen Duchesne

If you are like the typical investor saving for retirement, particularly if you have a SMSF, you are not maximising the length of time your retirement investments will be able to provide your desired level of income post-retirement, and they may very well run out before you do. This is called "longevity risk" and arises from three sources.

1. Inadequate contributions

This is something we may not be able to control as our contribution rates are fixed and capped at a maximum. Unfortunately, many investors saving for retirement focus far too much on protecting themselves from day-to-day volatility while still in the accumulation phase when it actually doesn't really matter. While a poor investment choice of an individual share or fund can certainly inflict permanent damage at any time, a properly diversified equity portfolio (like the ASX 200) always recovers from a market down turn eventually. The trick is not to get panicked into selling at the market bottom, or having to sell because you need the income to live on and have no choice.

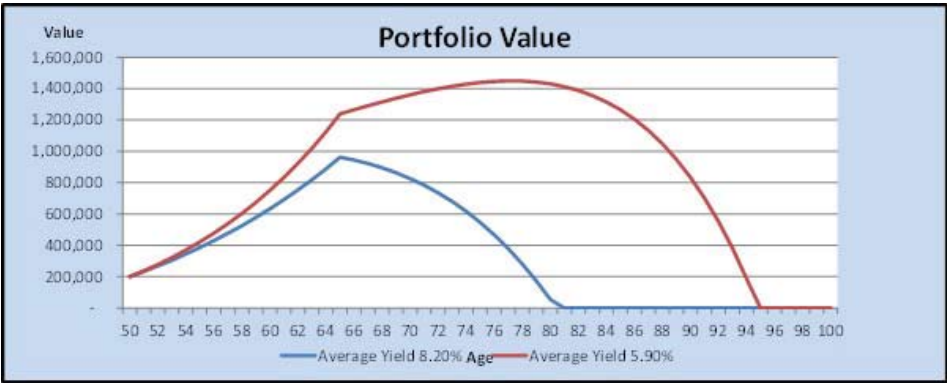
2. Sub-optimal asset allocation

Growth asset markets such as equities will bounce around significantly while you are still accumulating and not using your savings. This is the price one pays to get higher future returns, and as long as you don't need to sell investments at that time, it really doesn't matter. As a result of the emotional fear of volatility, many investors have too much invested in cash - up to 40% in many cases! While this might give them less anxiety while they are in accumulation phase, the after-tax yields on cash are not high enough to last the distance and maximise the longevity of the desired amount of post-retirement income.

Making an asset allocation change from a 40% cash, 30% income, 30% growth portfolio, to a 5% cash, 30% low risk fixed income, 65% growth portfolio, will increase the average post-tax yield by around 2.00% - 2.50% per year. This can extend the life of your post-retirement income by around 15 years from about 80 to 95 years , and help to mitigate risk.

Sequencing Risk

Figure 1



“As a result of the emotional fear of volatility, many investors have too much invested in cash”

This is the risk of getting the worst returns at the worst times from your portfolio, despite what the average return over your accumulation and decumulation phases turns out to be. For example, if you got high returns in the later years of saving when your investment balance is relatively high, and low or negative returns when the balances are low, the wealth outcome will be much higher than if it was the other way around, even though the average is the same.

For example, Figure 2 shows a simple 3 year portfolio where the returns in Order 1 are 50%, 20%, and 50%, giving an ending value of \$133, while the returns in Order 2 are the same but in reverse, giving an ending value of \$111 - or \$22 less. The average return for both portfolios, however, is the same.

In this way, the sequence of returns in accumulating and then decumulating portfolios is more important than the average return. Investors in retirement need to focus more on managing this, and less on just taking risks and trying to get the highest yield. In the post-retirement world where there are no second chances to accumulate, return of capital is more important than return on capital.

“The sequence of returns is more important than the average return”

“

The sequence of returns is more important than the average return”

CAUGHT SHORT

WHY MANY RETIREES' INCOMES WILL PROBABLY RUN OUT EARLY

continued...

	Annual Contributions	Return Order:1	Balance Order: 1	Return Order:2	Balance Order: 2
0			\$ 100.00		\$ 100.00
1	\$ 10.00	-50%	\$ 60.00	50%	\$ 160.00
2	\$ 10.00	20%	\$ 82.00	20%	\$ 202.00
3	\$ 10.00	50%	\$ 133.00	-50%	\$ 111.00
Average		6.67%		6.67%	
Difference			\$ 22.00		
% of Original			22.00%		

Figure 2:

Many investors are frightened by the increase in volatility that a higher allocation to growth assets, such as shares, can bring. While it doesn't matter too much in the accumulation phase, they fear that once in retirement they may be forced to sell in down markets for income to live on, thereby locking in permanent losses and suffering from sequencing risk. However, steadily allocating out of cash and income assets into equities and long dated secure fixed income in the 10-15 years before retirement, as illustrated in Figure 1, will help maximise the growth needed to last the retirement distance.

This will also provide protection on the downside for the inevitable share market downturns so that any share sales can be deferred until the markets recover. The investments in long dated low-risk fixed income bonds serve to lock-in the cash inflows as they mature, and provide the base level income for investors so they don't need to sell shares at the bottom of the market.

Accordingly, a balance between growth assets that help the portfolio last the distance, and long dated, low risk fixed income bonds that will mitigate the sequencing risk that comes with it, is a way to get the best of both worlds.

With this asset allocation, investors can avoid selling in down markets, thereby experiencing sequencing risk, and shortening the life of their portfolio.

Stephen Duchesne is a Non-Executive Director of Endowment Bond Exchange
<https://www.ebx.com.au>



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mFund to simplify how investors access unlisted managed funds

Ian Irvine, ASX Limited

Current Regulation of Mortgage Schemes

Many investors recognise the need to go beyond direct investment in Australian shares to diversify their portfolio, seeking to mitigate risk and to take advantage of market gains in other asset classes, such as international and emerging market equities, real estate investment trusts and corporate credit. Until now, some of these asset classes have been time consuming and costly to access, except through traditional unlisted managed funds. That's if you could get through all the paperwork. Now there's a solution. The mFund Settlement Service from the ASX is the new way to buy and sell unlisted managed funds, through a process that is similar to buying shares through a broker. In this article, we take a look at how mFund is changing the way investors diversify their portfolios.

If you've ever directly applied for (bought) or redeemed (sold) units in an unlisted managed fund, you may remember the onerous task of the paperwork. Once you have read through the product disclosure statement, you are required to complete the application form – which sometimes exceeds 16 pages in length – as well as completing all the mandatory identification checks required under Anti-Money Laundering and Counter-Terrorism laws. Once you've completed that paperwork, you attach a cheque, or make a payment via BPAY and post your documentation to the fund manager for processing. All this could take days to complete, by which time, the unit price of the fund may have changed. This manual, paper-based process seems antiquated in the world we live in today, yet this has been the only way to buy and sell unlisted managed funds, until now.

How is mFund different?

The ASX mFund Settlement Service allows you to buy and sell units in selected unlisted managed funds through an ASX broking service. It simplifies the process by replacing paper-based applications and redemptions with electronic versions, which are processed in real time. Being processed in real-time means that you have greater certainty about when your price will be set and when your units will be delivered.

The electronic application process means that investors can now tap into a new world of investment opportunities through a convenient, efficient way already familiar to share traders. So if you're one of the 34% of Australians who invest in shares and have considered diversifying your portfolio to include a range of asset classes, mFund could be the solution.

The key differences between buying and selling managed funds via mFund and through the traditional way are as follows.

- Convenience: while the mFund Settlement Service still requires investors to read and understand the product disclosure statement (PDS), the application form in the PDS is replaced with an electronic application – which results in less paperwork for the investor.

- Diversification: now investors can access a range of asset classes including international and emerging market shares, listed property, corporate bonds and infrastructure via the ASX.

- Transparency: by time-stamping the receipt of the electronic applications, mFund investors will have greater certainty about the price and the timing that units in the funds are issued or redeemed, compared to paper-based applications sent through the mail.

- Efficiency: through mFund, you will be required to complete an identity check once only if you use one broker for your mFund applications and redemptions. Using the traditional application process, you would be required to perform the identity check each time you apply for new units in a managed fund.

- Simplified reporting: for investors already trading shares on the ASX, any applications and redemptions of their mFund holdings will be shown on their CHESS statement, rather than potentially having multiple information sources if managed funds are bought through other means.

Break out: The simple way to buy unlisted managed funds

Step 1: Do your research

Learn about the mFund Settlement Service and research available funds

Step 2: Contact a broker or adviser

To discuss the funds you are interested in

Step 3: Review mFund information

Read the PDS, mFund Fact Sheet and fund profile documents

Step 4: Instruct broker or adviser

Your buy order and payment for new units in your chosen mFund are sent

Step 5: Your new mFund units are issued

New units in your mFund are transferred to your CHESS holding

Step 6: mFund confirmation and CHESS statement

Your mFund issuer sends a welcome pack and you receive an updated CHESS statement

Learn more

At launch, approximately 44 fund managers are participating in the mFund Settlement Service, representing over a third of Australia's retail funds management industry. Fund managers range from some of the largest in Australia, to a range of boutique investment managers, who aren't normally accessible to retail investors. Around 12 ASX brokers will participate in the service at launch, with others set to join, along with 10 unit registrars and administrators.

To learn more about the range of mFunds available and how they may be suitable for you, contact your broker or visit mfund.com.au

The ASX will provide a series of educational services, including seminars and courses around Australia for investors to learn more about mFund in the coming months. If you would like to keep informed about upcoming events, please visit asx.com.au/keepmeposted to register your details.

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Cochlear **versus** ResMed

Nathan Bell, Intelligent Investor

The healthcare sector has been the source of two of Australia's greatest success stories. Both stocks listed in 1995 and, since then, Cochlear's shares have increased twentyfold while ResMed is up a remarkable 54 times.

In recent times, however, the gloss has come off. Cochlear is now down about a third since it hit \$82.87 in January last year, while ResMed has fallen about 10% since peaking at \$5.94 in October. Before deciding which stock is the better bet, let's examine the recent problems.

Bionic ear manufacturer Cochlear is suffering from a product recall and reinvigorated competition. Sleep apnoea company ResMed on the other hand is dealing with hopefully a one-off dislocation in the US market, plus some added competition. Given the choice we'd take one-off market issues over product problems, so ResMed gets a win here – but much depends on Cochlear's recently launched products, particularly its Nucleus 6 processor. Success here would go a long way towards redressing the balance.

Let's assess each company using Porter's Five Forces: existing rivalry; threat of substitution; barriers to entry; and the bargaining power of customers and suppliers, plus our own assessment of valuation – to see which one prevails.

Force #1: Existing rivalry

While Cochlear firmly dominates its market, with a share of about 60%, ResMed runs neck and neck with Philips Respironics (each has about a 40% share). ResMed does, however, command a greater share of the premium variable and automatic pressure machines, which earn higher margins and stand to benefit more from the trend to home sleep testing.

Both markets face high fixed costs, long industry payback times and high barriers to exit, although they benefit from plenty of product differentiation, particularly Cochlear. For Cochlear, though, the rivalry is intensified by slowing industry sales growth. Result: Tie

Force #2: Threat of substitution

ResMed faces competition from various other treatment options like drugs and mandibular splints but Cochlear faces no such threat. Both companies do, however, need to maintain a constant cycle of product improvement, which results in huge



research and development spending. Result: Cochlear win

Force #3: Barriers to entry

The R&D spending does at least increase the barriers to entry, in terms of technical know-how and patents. Both companies are also protected by their brands and distribution networks – that is, the doctors (and, in ResMed's case, sleep clinics) that recommend their products.

For a new entrant to come into these markets and attack their positions is almost unthinkable, but we'll again give an edge to Cochlear due to the added technical complexity of its product. Result: Cochlear win

Force #4: Strength of suppliers and customers

Probably the only suppliers of note for both companies are the scientists that work on their products. It would no doubt be bad for business if the best ones went to work for a competitor, so they need to be looked after well enough to ensure this doesn't happen. As for customers, their strength is relatively weak, in that if they want to hear or have a good night's sleep, they'll need these products. Still, both companies depend on governments and health insurers to pay for all or part of their products.

This has been the major source of ResMed's recent problems, with US Medicare introducing competitive bidding on a range of 'durable medical equipment',

including ResMed's flow generators and masks. Cochlear isn't caught up in this and is a clear winner in terms of customer strength.

Result: Cochlear win

Force #5a: Financials

Here, Cochlear has the edge, enjoying an average operating margin over the past five years of 27% and an average return on capital of 44%, compared to figures of 22% and 28% for ResMed.

A return on capital of 28% is nothing to sneeze at, though, and an important advantage for ResMed is that it has greater scope to invest at this rate to increase earnings. Over the past five years, Cochlear has only been able to increase revenue and earnings per share by 5% and 2% per year respectively, while ResMed has managed 13% and 23%.

Result: Cochlear win

“The final piece of the jigsaw is valuation.”

Cochlear **versus** ResMed *continued...*

Force #5b: Growth potential

Cochlear's market is nearing maturity while ResMed estimates that the US market is only about 15% penetrated, with figures of about 10% for Europe and 5% for Asia. That's a lot of growth potential, and shareholders will do very well if it can be achieved with returns on capital of more than 20%.

Cash flow has been lumpy for both companies but both convert their net profit efficiently into cash, with an average of 35% of Cochlear's net profit being absorbed as capital expenditure over the past five years, compared to 38% for ResMed.

Result: ResMed win

Valuation

The final piece of the jigsaw is valuation. Cochlear's underlying earnings are hard to pin down because of its recent product launches, not to mention extensive currency hedging and lumpy Chinese government contracts. But if the company makes its guidance for the second half of 2014 and carries that performance into 2015, it could generate underlying earnings per share (before currency hedges) of around \$2.80.

That would put it on a 2015 price-earnings ratio of about 20 - not bad for a company of Cochlear's quality, despite its slowing growth (and the Nucleus 6 could go a long way to solving that problem). Although it's a stone's throw from our Buy price of \$55, Cochlear is a HOLD.

ResMed, though, looks a lot cheaper. The stock currently trades at about 18 times the consensus forecast for 2014 of US\$0.25 (A\$0.27) per ASX-listed CDI and about 16 times the US\$0.28 (A\$0.30) pencilled in for 2015.

Assuming that the problems caused by competitive bidding do indeed pass in a matter of months – as the company has said it expects – then this looks very cheap for a company of ResMed's quality and growth potential. It's a BUY.

Nathan Bell is Research Director of Intelligent Investor Share Advisor.

<http://shares.intelligentinvestor.com.au/iv/>



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Some implications for investors

Nick Griffin

One doesn't have to look far these days to see the profound impact that emerging Chinese consumers are having on everyday life, whether on a plane, at a tourist attraction, queuing outside a luxury goods store or enrolling in higher education. Emerging consumers generally, and Chinese consumers in particular, are some of the most voracious the world has ever seen.

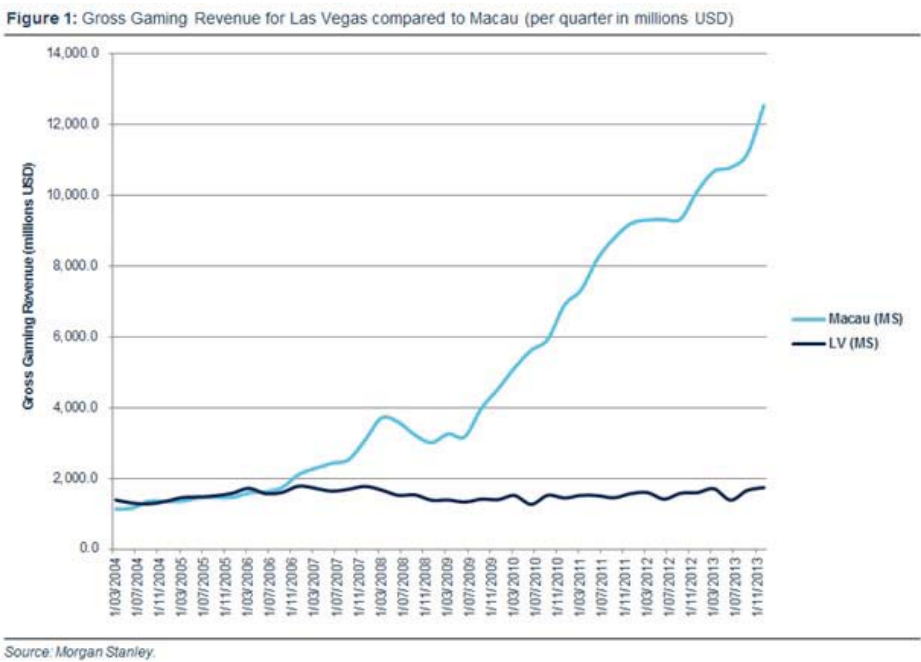
The beneficiaries of this range from high end luxury retailers and branded consumer goods companies to companies associated with international travel and integrated resort owners. Other less obvious and more mainstream industries set to benefit include whitegoods providers, auto manufacturers and consumer quality testing firms.

At K2 International, we are focused on the underlying economic drivers of a company and the industry in which it operates. We want to ensure that a company can grow its revenues with the assistance of a key structural growth tailwind, and that it can do this with some level of independence from the normal economic cycle. We have identified the emerging Chinese consumer in particular as a powerful structural force that is creating exciting investment opportunities. In this article we highlight three industries that are likely to be key beneficiaries: Macau integrated resorts (gaming), airline manufacturers and testing companies - particularly food testing companies.

Macau

Probably the most visible illustration of the emergence of the Chinese consumer has been the explosive rise of Macau as a gaming destination in Asia. There are no legal gambling areas in mainland China, and consequently Macau is the primary destination for wealthy Chinese consumers who seek to gamble. Since the opening of Sands Macau in 2003 visitor numbers and revenues have grown strongly, to the point where Macau is now six times the size of Las Vegas by gross gaming revenues (refer Figure 1).

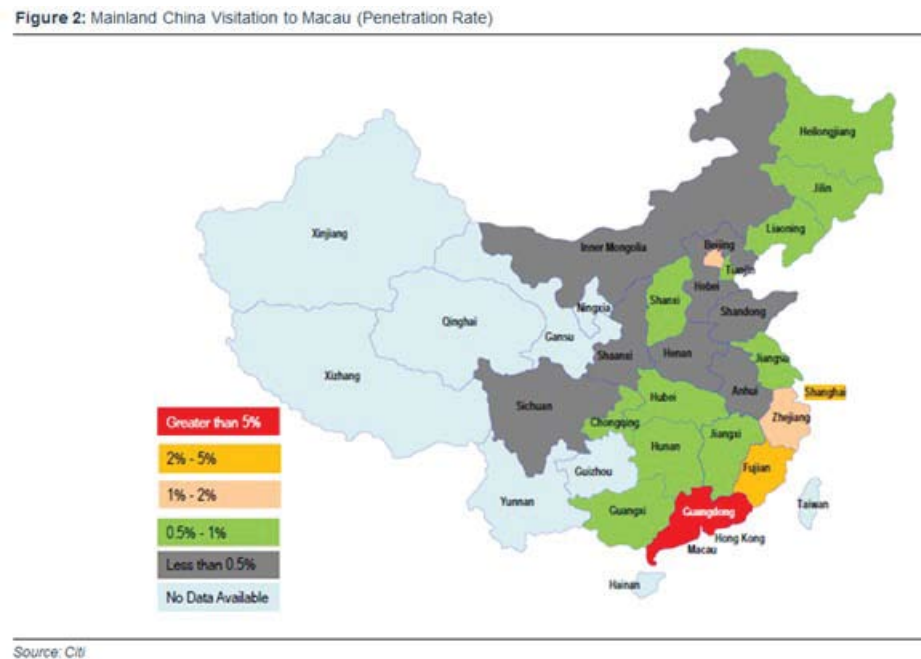
This statistic is staggering in itself, but what makes it more interesting is that Macau has only just scratched the surface of its potential. While Macau receives 20 million visits by mainland Chinese annually (30 million visits in total), some of the



Source: Morgan Stanley

companies based there estimate that this represents only 7 million actual individuals. That is, the average Chinese gambler visits 3 times each year. As such, the demand for gambling in Macau appears to be in its infancy and the primary constraint to growth is actually capacity through a lack of hotel rooms and congested transport infrastructure.

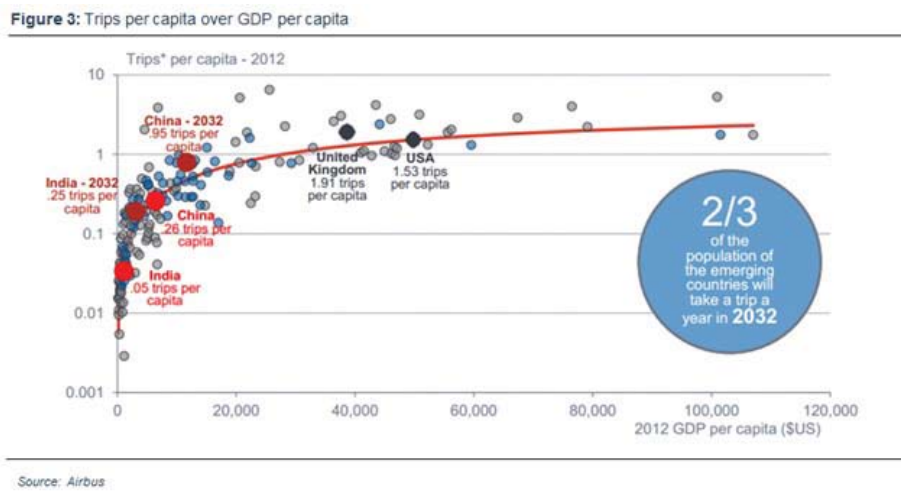
According to the gaming operators, and corroborated by industry analysis, there are approximately 100 million Chinese that fit the visitor demographic of Macau. This represents around 7.2% of the total Chinese population. If you consider that there are currently only 7 million unique visitors to Macau (i.e. 0.5% of the Chinese population), the potential upside is huge. Even if these 20 million visits are all unique entrants, this means that only 1.5% of the total Chinese population have actually visited Macau, yet it is already six times larger than Las Vegas! These include Wynn Macau, Galaxy Macau, Sands and MGM Resorts.



Source: Citi

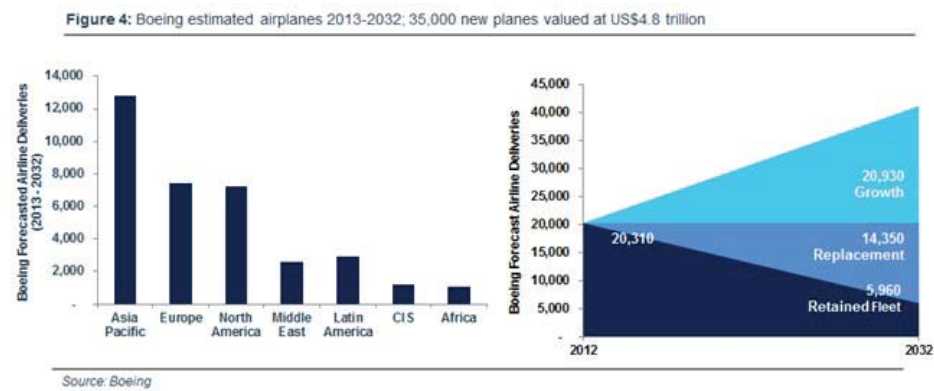
Airline Manufacturers

Despite the recent global financial crisis and a number of air-travel disruptions such as the SARS epidemic, the Iraq War and the September 11 terrorist attacks, commercial airline traffic has grown steadily at a rate of 5% annually, from 1980 to 2012. This has been made possible by greater affordability for the average consumer, specifically through the introduction of budget carriers and reduced price airfares. New destinations, enhanced safety and improved passenger comfort, have also all contributed to this growth. Industry research suggests that air travel growth accelerates in countries where GDP has reached an average level of US \$8,000 per person, a level which China and a number of other emerging markets have recently passed. Put simply, growing air travel equates to a growing demand for aeroplanes.



Source: Airbus.

Boeing itself has forecast a significant increase in airplane deliveries over the next two decades, with growth driven by Asia as well as the normal upgrade cycle. Such a prediction is particularly relevant in the airline industry, where manufacturers have high visibility based on their order backlogs. Order backlogs at both Boeing and Airbus currently stand at near record highs of 5,095 and 5,513 airplanes respectively, representing combined 8.5 years of production at current rates.



Source: Boeing.

Aerospace, by virtue of its strong need for safety, remains largely an oligopolistic business and we remain encouraged by how few new entrants there are in this industry. A number of companies are strongly leveraged to this structural growth opportunity. These include Boeing, Airbus, Lockheed Martin, GE, Textron and Bombardier.

Testing Services

We expect the Chinese middle class to demand stronger consumer protection via testing services. This will in part be driven by China's own set of controversies, ranging from Walmart's donkey meat incident in 2014, where a supplier had substituted donkey meat with cheaper fox meat, through to the tragic milk powder scandal in 2008, which resulted in the hospitalisation of over 50,000 children and caused four infant deaths. Such events have highlighted the growing complexity of food supply chains and consequently we anticipate that demand for food testing services will continue to grow strongly. Our largest position in this area is Eurofinsw which is the world's largest private food testing company. The food testing industry is estimated to have a turnover of US\$15 billion annually and will likely grow to \$19.7bn by 2018, approximately 6% growth per annum. Eurofins is the largest private participant, with an estimated 22% market share and is in our view currently the best investment in the food testing market.

THE EMERGING CHINESE CONSUMER

Some implications
for investors *continued...*

The testing industry is set to benefit from what we would consider a classic secular trend. Regular crises and increasing regulation, particularly in emerging markets such as China, will drive the total market for food testing services higher for many years to come. Barriers to entry will increase as testing methods become more complicated, and economies of scale will benefit larger participants. Several companies are strongly leveraged to growth within the testing industry. These include QIAGEN, Bureau Veritas, SGS and eurofins.

Conclusion

Our current macro thinking suggests it is still too early to re-enter emerging markets as an asset class, however, there are many exciting opportunities resulting from a rising middle class across emerging markets generally, but especially in China. This is likely to be a powerful secular tailwind for many industries across the world and our process at K2 International is focused on identifying attractive investments in companies that are set to benefit from trends such as these, regardless of their country of domicile. In our view these trends will endure for many years to come and at the right price, investments leveraged to these trends seem an obvious place for us to invest to generate absolute returns going forward.

Nick Griffin is the Head of Global Equities at K2 Asset Management Ltd. He will be presenting National AIA Conference on the Gold Coast on 5 August 2014.

We have *identified the emerging Chinese consumer in particular as a powerful structural force that is creating exciting investment opportunities*

UNDERSTAND POSITION SIZING

Colin Nicholson

Position sizing is a concept used extensively in trading to control risk. It is very important for trading in highly leveraged instruments like futures, but has a role in risk management in any form of trading.

Position sizing is much less used or even understood by investors, yet it can have a very important role to play in the control of risk in any form of investing. When investing in stocks, position size means the number of shares we should buy. To understand why it is important to control risk, consider table from chapter 2 of my book Building Wealth in the Stock Market:

% Loss of Capital	% Gain on Remaining Capital Needed to Recover
10	11
20	25
30	43
40	67
50	100
60	150
70	233
80	400
90	900

What this shows is that once we lose more than about 20% of our capital, it becomes very difficult to recover and may certainly take a long time. This is, of course, what happens when investors sell out in despair near the bottom of a bear market. However, on a smaller scale it applies to any stock on which we make a big loss: we must make a far larger gain on another stock or stocks just to get back to where we started.

This is where position sizing comes in; its aim is to never make a large loss on any investment that fails to perform for us. It is the mechanism by which we implement one of the oldest adages in investing: let profits run, but cut losses quickly. Of course, if we are great investors who never make poor investments and we never encounter another bear market, it may be academic. If you find such an investor or a market without cycles, please let me know.

The idea behind position sizing is to calculate the number of shares we can buy, such that we control the maximum risk we take on the investment. To do this, we first need to know four things:

1. Our total capital. This is simply the amount of capital we have for investing in stocks. It is the total value of all our stock holdings (number of shares multiplied by the last price they traded on the market – NOT the price we paid for the shares) plus our cash reserve.
 2. The price at which we hope to be able to buy the stock.
 3. Our stop-loss price. This is the price that we determine is where we would be wrong. There are many ways to do this. The principle is this: When we buy a stock we must have a clear idea of what we expect to happen that will make the investment
- 18

profitable for us. If we can define this clearly, then we can also define when it is not happening. This is the price at which we are wrong about what we expect to happen and is our stop-loss i.e. where we cut and run.

4. What percentage of our capital we are prepared to risk on the investment.

There is one caveat here. Position sizing only works effectively if we have a sufficient amount of capital to invest. If we only have \$10,000 to \$30,000 total investment capital, the percentage risked will need to be unrealistically high. Effectively, the minimum capital for position sizing to work well is possibly \$50,000, but \$100,000 would be better. Let us assume that:

1. Our total investment capital is \$400,000.
2. We hope to buy a stock at \$6.15.
3. Our stop loss is at \$5.10.
4. The maximum we are prepared to risk on the investment is 1% of capital.

From this information we make the following calculation: The maximum amount we are prepared to risk is $\$400,000 \times 1\% = \$4,000$. The maximum amount we are risking on each share is our buying price less the stop-loss price, which is $\$6.15 - \$5.10 = \$1.05$.

If we then divide the maximum risk we are prepared to take by the risk back to our stop-loss on each share, we can calculate the maximum number of shares we may buy, which in this case is $\$4,000 \div \$1.05 = 3,810$ shares.

To understand this calculation, assume that after we buy 3,810 shares at \$6.15, the price falls to \$5.10, when our stop-loss is hit and we sell. We will have lost $\$6.15 - \$5.10 = \$1.05$ on each share, or a total of $3,810 \times \$1.05 = \$4,000$, which is 1% of our capital.

There are some obvious caveats about this calculation of position size:

1. We have ignored brokerage to keep the explanation of the idea simple. In practice, if brokerage is a small percentage of the price and we do not make a great number of transactions, as a trader would do, it can be ignored.

2. We have assumed that we can actually buy at the price we estimated and that we can sell exactly at our stop-loss price. This is rarely the case. Sometimes it is in our favour when buying and or selling, but more often it is not, especially if a stop-loss is hit. Make an allowance for this when selecting the maximum percentage of capital to be risked on any investment.

Now, change one of the assumptions: Our stop loss is at \$5.90, instead of \$5.10

This means that we are now risking only $\$6.15 - \$5.90 = \$0.25$ per share if the price falls to our stop-loss.

On this changed assumption, our position size, the maximum number of shares that we may buy without risking more than 1% of our investment capital = $\$4,000 \div \$0.25 = 16,000$ shares.

Here I used a very close stop-loss price to show that if our stop-loss is relatively near to our buying price, we may buy a

UNDERSTANDING POSITION SIZING continued...

large parcel of shares (16,000 in the second calculation) without risking more than 1% of capital. However, if our stop-loss is much further below our buying price, we may only buy a much smaller parcel of shares (3,810 in the first calculation) without risking more than 1% of capital.

This is the key thing to understand about position sizing. No matter where our stop-loss is relative to the buying price, the position size changes accordingly: the wider the stop-loss, the smaller the number of shares and the closer the stop-loss, the larger the number of shares.

However, it is not quite that simple. If we consider out two examples: 3,810 shares costing \$16.15 each amount to an all-up investment of \$61,532. This is $\$61,532 \div \$400,000 = 15.4\%$ of our investment capital. That is a very aggressive allocation of capital and if we invested all our capital in a similar way, we would only be holding $\$400,000 \div \$61,532 = 6.5$ stocks (or $100 \div 15.4 = 6.5$). We would not have a well-diversified portfolio.

Now consider the other example: 16,000 shares costing \$16.15 each amount to an all-up investment of \$258,400. This is $\$258,400 \div \$400,000 = 64.6\%$ of our investment capital. This is aggressive in the extreme and means we would only hold two stocks if the balance of our capital was invested the same way. We have no diversification.

What these two examples reveal is that position sizing is one thing but it must be considered in the overall context of our investment risk management. While in both cases the amount at risk is the same 1% of our capital, in neither case will we be well-diversified. Diversification is a major risk mitigation strategy and theory suggests that we should have between at least 15 and not more than 30 stocks in our portfolio. This gives a range of between $100 \div 30 = 3.3\%$ and $100 \div 15 = 6.7\%$ of capital invested in each stock.

This means that a complete position sizing strategy must be seen as part of an overall risk strategy that also considers diversification.

Our position size calculation gives us the maximum number of shares we can buy. However, where this exceeds the percentage of capital that our diversification strategy allow us to invest in a stock, that would determine the position size and our risk in the investment, if the price falls back to our stop-loss, would be less than the maximum we are prepared to accept.

If our diversification strategy is that any one investment should not exceed 5% of our investment capital, then we should not invest more than $\$400,000 \times 5\% = \$20,000$ in any one stock. The stock we are intending to buy has an estimated cost of \$16.15 per share, which means we should not buy more than $\$20,000 \div \$16.15 = 1,238$ shares. In both the examples used earlier, we would only buy this number of shares.

In that case, the percentage of our capital that we would be risking if the price fell back to our stop-loss would be: First example = $1,238 \times \$1.05 = \$1,296$, which is $\$1,296 \div \$400,000 = 0.32\%$ of our total investment capital instead of the 1% of our total investment capital that is the maximum we are prepared to risk. Second example = $1,238 \times \$0.25 = \310 , which is $\$310 \div \$400,000 = 0.08\%$ of our total investment capital instead of 1% of our total investment capital that is the maximum we are prepared to risk. A significant insight from this discussion should be an increased understanding that many parts of our investment plan are interconnected in some way and our investment decision-making is inevitably a balancing of strategies.

I have distilled the logic of the position sizing and diversification calculations in a spreadsheet that is available on my free website www.bwts.com.au on the Data and Other Files page that is on the Free Resources drop-down menu. It uses the risk parameters that I use in my investment plan, outlined in my book Building Wealth in the Stock Market, but can easily be adapted for different investment plans.

See Colin speak at the AIA Annual Conference, 3-6 August 2014. Full details on the AIA Website www.investors.asn.au

Timing²

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THE SLEEP AT NIGHT FACTOR for your share portfolio

Jeremy Gard, Sequoia Asset Management

Have you ever bought a stock right at the top of the market on the advice of your broker, or worse, a tip from a friend?

Many market players will use a “Stop Loss” order to minimise the risk by taking losses quickly when the market falls by a certain percentage. This seems like a prudent strategy, but in practice, it can sometimes be fraught with danger. If the market falls fast you risk price slippage and having to crystallise a capital loss. This may not always be the best solution. I want to give you an alternative strategy that many investors overlook. In times of falling markets and high volatility, as we saw in the GFC, this little known tactic will give you the ability to come out the other side with your capital intact or even better.

To illustrate this, if we use the ASX 200 index as a benchmark from the November 2007 top to the March 2009 bottom, the market wiped off 3,778 points, a fall of 55% in 16 months. If you held a portfolio of “blue chips” during this period, you would not be happy.



When a fall of this magnitude occurs, and it will happen again if the past is any indication, then we need to remember the following statistic:

- a 50% loss requires a 100% gain just to break even.

If you have \$10.00 and you lose 50% you now have \$5.00. To make your remaining \$5.00 back into \$10.00 requires a 100% return. While not saying it can't be done, you do lose the power of momentum and investing power.

“A 50% loss requires a 100% gain just to break even”

The following table shows the various reductions and corresponding gains required to break even.

Loss	Gain Required
10%	11.1%
20%	25.0%
30%	42.9%
40%	60.0%
50%	100.0%
60%	250.0%
70%	333.3%

How do I “insure” my shares?

To avoid this scenario, use insurance!

As simple and logical as this seems, many investors do not employ this basic risk management strategy. Would you drive your car if it were not insured? Hardly anyone ever talks about the importance of insuring investment portfolios. Sometimes called the “Married Put” strategy, this is how it works.

When you buy shares, you can also buy a “Put Option”. A put option gives you the right to sell your shares at a pre-determined price but not the obligation. Much like insurance, you know the “agreed value” at which you can sell your shares. The best part is you are not obligated to do so, therefore, you can still enjoy all the upside. Furthermore, if the share price falls you will not be forced to sell out of your position, as you would with a stop loss strategy, thereby giving you more time for the share price to recover.

Doesn't this cost more, and won't it reduce the returns from my investment? Yes, and yes! Like any insurance policy there is a cost involved. Generally you look to insure your share assets for a period of 12 months. During this period you will also get a return, or dividends, from your share investment which can be used to offset the cost of insurance. This sounds simple doesn't it? The simplest strategies are often the most effective. Let me show you how it works.

Scenario

We have bought some shares and at the same time we have bought a 12 month insurance policy giving us the right to sell these shares at the insured level any time during the 12 month period. Prior to the trade, we did some simple homework and worked out that the cost of the insurance should be subsidised by the dividends and franking credits.

What happens next? There are two scenarios to consider:

- the stock value rises; or
- the stock value falls.

Stock value rises: the roll up

Obviously, we buy shares in the hope of a price rise so we can generate capital growth. So if the price rises, we gain.

Here's an example from 12 December 2012

Buy ANZ shares:

Buy ANZ December 2013 \$24.50 Put options:

Dividends and franking credits paid during the option period:

Total risk#

\$24.50

\$1.90

\$2.34

\$0.44 profit

Assuming dividends and franking credits were paid, as they were in this example. At the expiry of the option in December 2013, ANZ was trading at around \$31.00.

Assuming we held for the period, the downside was a \$0.44 profit, but we ended up with a paper gain of just under \$7 per share (share price movements, plus dividends and franking, less option costs).

The roll up

One strategy you might consider in times of big gains in the share price, depending on how much time is left to run on your put options, is to roll up your insurance to the current market level and effectively lock in profits at this higher level.

For example, let's say you bought the ANZ shares for \$24.50 in December 2012, and you bought a December 2013 put option. In December 2013, less than 12 months later, the price was \$31.00 – a 26% gain. You are nervous that the share might fall, but you do like the outlook and don't want to sell.

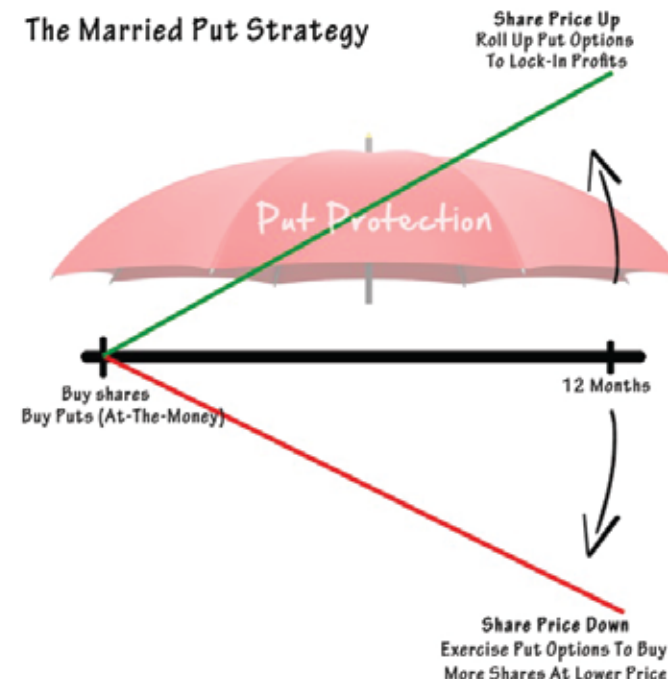
At this point it is possible to buy a new put option with an exercise price of \$31.00. Hence, you have effectively locked in the \$6.50 gain. The beauty is that if the share price keeps going up, you still enjoy all of the gains. Similarly if the value of your home has increased and you increase the agreed value on your policy, buying a new higher exercise price put option gives you a new “agreed value” on your shares.

Share price falls: accumulating free shares

The part that I really like about this strategy is when the share price falls in value. Let's say the price of the ANZ shares purchased in the scenario above fell to \$15.00 over the same period resulting in a 38% fall in the value of your shares.

Normally, without the put option, a share holder would then be left with the prospect of having to generate a 63% gain from the current price of the shares, just to get back to the original purchase price.

The Married Put Strategy



THE SLEEP AT NIGHT FACTOR
for your share portfolio continued...

However, as we have protected the shares at \$24.50, the simple solution is now to exercise the put options, get back our original investment capital, and re-invest back into ANZ shares at \$15.00, thereby gaining 63% more shares in our portfolio than we originally had, for no extra cost. We would also buy another 12 month insurance policy to protect ourselves at \$15.00.

What we've effectively done here is positioned ourselves potentially to get greater returns from our portfolio in the future, should the price rise in value, which it invariably does in time.

Jeremy Gard is an Investment Manager at Sequoia Asset Management.

Sequoia has been successfully implementing this strategy for their clients for many years.

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McIntosh v McIntosh

QSC 99 has important implications for SMSF succession planning

Bryce Figot, DBA Lawyers

On Friday the Supreme Court of Queensland handed down what we believe is a 'first of its kind' judgement. McIntosh v McIntosh [2014] QSC 99 was the first time that the following specific question was expressly considered by a court: If a person is eligible to receive a deceased's super both as the deceased's legal personal representative and also in his or her personal capacity, and the person receives the super personally, must he or she transfer it to the estate?

The answer will surprise many!

The facts

Elizabeth McIntosh (the mother) and John McIntosh (the father) were married in 1968. In 1972 the mother gave birth to James. The mother and the father divorced in 1979 and had and continue to have an acrimonious relationship. The mother stated that she and James lived together for the bulk of his life. James was killed on 14 July 2013. At that time he lived with the mother. James died without a surviving spouse or children. He also died intestate (ie, without a valid will). Under the rules of intestacy, James' estate is to be distributed between his two parents in equal shares. The mother had previously applied (12 September 2013) to be the administrator of James' estate. She stated in an affidavit that she understood that, if she were so appointed, she was required to collect her son's assets and distribute his estate by dividing them equally between herself and the father. She said 'I propose faithfully to do this.'

She was granted 'Letters of Administration' (ie, appointed as the administrator). The net assets of James' estate were about \$80,000. However, he had significantly more in various super funds, totalling approximately \$454,000.

On 30 September 2013 the mother then applied to James' super funds to have his super death benefits paid to her personally, describing the interdependency relationship that existed between her and her son. Each super fund agreed to do so. This meant that it appeared that all of the super (ie, about \$454,000) would be paid directly to the mother and none of it to the father. The father would receive only half of the estate (ie, half of about \$80,000).

The father's lawyers wrote to the mother stating:

As administrator, I note that your client will make her best endeavours to maximise the size of the estate. Bearing this in mind, please advise whether your client intends to seek any or all of the deceased's superannuation entitlements to be paid entirely to her in her personal capacity.

The mother's lawyers wrote back stating:

... we do not hold any instructions in relation to the superannuation as it does not form part of the estate ... If you are able to direct us to the law that requires our client as personal representative to make such an application to the super funds then we will take instructions in this regard

The father's lawyer replied that:

... as personal representative, your client has a fiduciary obligation to maximise the return for the estate. Clearly your client is in breach of her obligation if she has actively sought payment to herself direct in lieu of the estate. The mother then filed this application.

The court's finding

Atkinson J held:

... there was a clear conflict of duty ... contrary to her fiduciary duties as administrator. When the mother made application to each of the superannuation funds for the

moneys to be paid to her personally rather than to the estate, she was preferring her own interests to her duty as legal personal representative to make an application for the funds to be paid to her as legal personal representative. She was in a situation of conflict which she resolved in favour of her own interests. As such she acted ... in breach of her fiduciary duty as administrator of the estate ...

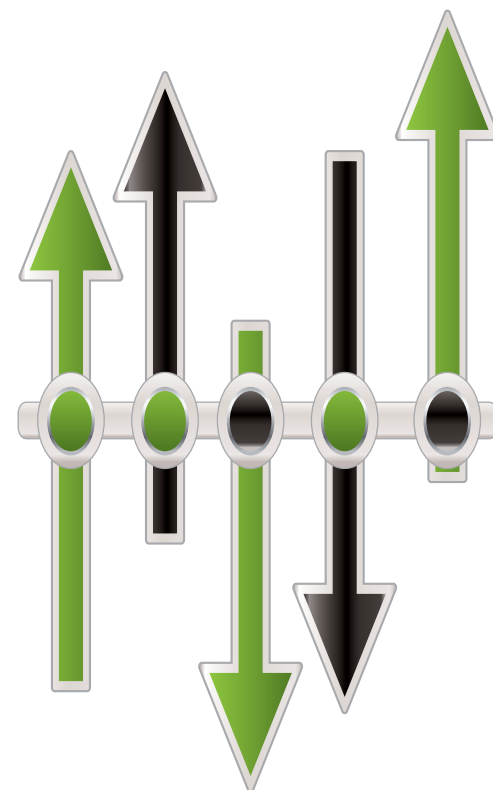
Accordingly, Atkinson J held that the mother was required to account to the estate for the super death benefits (ie, 'hand over' the benefits).

What would have changed this outcome?

The above outcome might surprise many. The trustees of three large super funds (Host Plus, Intrust Super and Hesta) determined to pay super death benefits to a deceased's interdependent mother, yet the mother was ordered to then pay that money to the estate so that a significant portion could be paid to the father.

This outcome is more surprising as the mother appears to have been the nominated beneficiary in respect of each of the super funds (albeit it via non-binding nominations in each case).

This begs the question: What would have changed this outcome? There are two different additional facts that probably would have done so.



McIntosh v McIntosh

QSC 99 has important implications for SMSF succession planning *continued...*

Firstly, if a binding death benefit nomination had existed in favour of the mother personally, then this matter almost certainly would not have arisen.

Secondly, if James had made a will naming the mother as the executrix then there is strong indication the outcome would have been different. Atkinson J stated that the method of 'appointment is an important distinction between them as the appointment of an executor is the act of the testator exercising a testamentary choice'. She went on to state that although generally the legal personal representative can not 'enter into engagements in which [he or she] has or may have a personal interest conflicting with the interests of those whom [he or she] is bound to protect' there is an exception to this. Namely, where the willmaker — with knowledge of the facts — imposes a duty which is inconsistent with a pre-existing interest which he or she has in another capacity, then the legal personal representative might still be able to validly pursue their personal interests.

Implications for SMSF advisers?

Although this was not an SMSF-related decision, it has several critical implications for SMSF advisers.

Firstly, this case serves as an important reminder of how strict the fiduciary duties are that apply to legal personal representatives and others (eg, trustees of super funds).

Secondly, it illustrates that even if the personal estate is relatively small, a will is still important. Again, if James had made a will and appointed the mother as his executrix, it appears that there is a fair chance that the court would have decided differently. More particularly, the court may have taken the view that James appointed the mother in the informed knowledge of her consent, thereby authorising her to apply to all of the super funds to have the death benefits paid to herself.

Thirdly, it raises important questions about binding death benefit nominations. Had a valid binding death benefit nomination been in place in favour of the mother, this case probably would not have arisen. Naturally, this suggests that binding death benefit nominations are the solution. However, the draw backs of binding death benefit nominations must be remembered. Even a valid binding death benefit nomination does not necessarily mean that the money will be paid in an efficient manner. Recall Wooster v Morris [2013] VSC 594 where the deceased had made a binding death benefit nomination in favour of his two daughters from a previous marriage, his second spouse was controlling the SMSF and the second spouse decided not to honour the binding death benefit nomination and instead decided to pay everything to herself personally. Accordingly, the identity of who will be 'holding the purse' upon death is vital. This segues into the final point.

It is critical that the right people are controlling the SMSF upon death

It is critical that the right people are controlling the SMSF upon death. Even if there was no binding death benefit nomination and no will, if the right people were controlling the SMSF upon death, things may well have been different. Although McIntosh v McIntosh illustrates that the mother was under a duty to vigorously apply for the benefits in her capacity as legal personal representative of the deceased, the trustee of the SMSF might nevertheless have decided to pay the super death benefits to her regardless. For more information on SMSF succession planning — including a step-by-step guide to ensure that the right people control the SMSF at the right time — see The Complete Guide to SMSFs and Planning for Loss of Capacity and Death.

* * *

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Nathan Bell,
Research Director

Calendar of Events

Date	Event	Time	Venue
JUNE			
3/06/2014	Perth Information Meeting	7.00pm	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs WA
3/06/2014	Sydney South Discussion Group	7.30pm	Miranda Community Centre, Wattle Room, 93 Karimbla Road, Miranda NSW
4/06/2014	Brisbane Information Meeting	1.00pm	Broncos Leagues Club, Fulcher Rd, Red Hill QLD
4/06/2014	Sydney Hills District Discussion Group	7.00pm	B Davis & Associates, Suite 17, 35 Old Northern Road, Baulkham Hills NSW
4/06/2014	Blackburn Discussion Group	7.15pm	Naturalist Club of Victoria, 1 Gardenia Street, Blackburn VIC
9/06/2014	Canberra Discussion Group	7.30pm	Canberra Labor Club, Chandler Street, Belconnen ACT
10/06/2014	Adelaide Information Group	7.00pm	German Club, 223 Flinders St, Adelaide (Senatorium Room) SA
10/06/2014	Melbourne Information Meeting	6.30pm	Telstra Conference Centre, Room 1, Level 1, 242 Exhibition St, Melbourne
11/06/2014	Sydney North Shore Information Meeting	7.00pm	The Chatswood Club, 11 Help St, Chatswood NSW
16/06/2014	Chermside Equities Discussion Group	7.00pm	Chermside Library, Hamilton Road, Chermside QLD
17/06/2014	Perth Equities Discussion Group	7.30pm	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs WA
17/06/2014	Brisbane Investment Management Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
17/06/2014	Gold Coast Information Meeting	9.30am	Robina Community Centre, Robina Town Centre Drive, Robina QLD
18/06/2014	Brisbane Share Investments Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
30/06/2014	Brisbane SMSF Discussion Group	7.00pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
JULY			
1/07/2014	Perth Information Meeting	7.00pm	Wembley Downs Tennis Club, Cnr Morden & Ednah Streets, Wembley Downs WA
1/07/2014	Sydney South Discussion Group	7.30pm	Miranda Community Centre, Wattle Room, 93 Karimbla Road, Miranda NSW
1/07/2014	Adelaide Information Group	7.00pm	German Club, 223 Flinders St, Adelaide (Senatorium Room) SA
1/07/2014	Geelong Discussion Group	7.00pm	St George Workers Club, 212 Pakington Street, Geelong West VIC
2/07/2014	Brisbane Information Meeting	1.00pm	Broncos Leagues Club, Fulcher Rd, Red Hill QLD
4/07/2014	Sydney Seminar	8.30am	SMC Conference & Function Centre, 66 Goulburn Street, Sydney NSW
9/07/2014	Sydney North Shore Information Meeting	7.00pm	The Chatswood Club, 11 Help St, Chatswood NSW
9/07/2014	Frankston Discussion Group	1.00pm	Private address, please contact event coordinator Bill Shirley, E: aiavic@investors.asn.au
12/07/2014	Brisbane Lunch with Brian McElean	11.30am	Broncos Leagues Club, Fulcher Rd, Red Hill QLD
14/07/2014	Canberra Discussion Group	7.30pm	Canberra Labor Club, Chandler Street, Belconnen ACT
15/07/2014	Perth Equities Discussion Group	7.30pm	Wembley Downs Tennis Club, Cnr Morden & Ednah St, Wembley Downs WA
15/07/2014	Brisbane Investment Management Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
16/07/2014	Brisbane Share Investments Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
21/07/2014	Chermside Equities Discussion Group	7.00pm	Chermside Library, Hamilton Road, Chermside QLD
23/07/2014	Kew Discussion Group	7.00pm	Phyllis Hore Room, Kew Library, Corner Cotham & Civic Drive, Kew VIC
24/07/2014	Bayside Discussion Group	4.00pm	Contact Coordinator Kevin Macdonald for details Tel: 0417 328 748 Email: km.macdonald@bigpond.com Hampton VIC
28/07/2014	Brisbane SMSF Discussion Group	7.00pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
30/07/2014	Sydney Hills District Discussion Group	7.00pm	B Davis & Associates, Suite 17, 35 Old Northern Road, Baulkham Hills NSW
AUGUST			
3/08/2014	ANNUAL CONFERENCE	5.00pm	Marriott Resort & Spa Ferny Ave Surfers Paradise
3/08/2014	Half Day Workshop	1.00pm	Marriott Resort & Spa Ferny Ave Surfers Paradise
5/08/2014	Sydney South Discussion Group	7.30pm	Miranda Community Centre, Wattle Room, 93 Karimbla Road, Miranda NSW
12/08/2014	Perth Information Meeting	7.00pm	Wembley Downs Tennis Club, Cnr Morden & Ednah Streets, Wembley Downs WA
12/08/2014	Adelaide Information Group	7.00pm	German Club, 223 Flinders St, Adelaide (Senatorium Room) SA
12/08/2014	Melbourne Information Meeting	1.00pm	Telstra Conference Centre, Room 1, Level 1, 242 Exhibition St, Melbourne
13/08/2014	Sydney North Shore Information Meeting	7.00pm	The Chatswood Club, 11 Help St, Chatswood NSW
18/08/2014	Chermside Equities Discussion Group	7.00pm	Chermside Library, Hamilton Road, Chermside QLD
19/08/2014	Brisbane Investment Management Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
19/08/2014	Gold Coast Information Meeting	9.30am	Robina Community Centre, Robina Town Centre Drive, Robina QLD
20/08/2014	Brisbane Share Investments Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
25/08/2014	Brisbane SMSF Discussion Group	7.00pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD

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