

the **INVESTORS**voice

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HOW TO FIND A NEEDLE IN A HAYSTACK

DIVIDENDS BONDS NEW YEARS RESOLUTIONS



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How to find a needle in a haystack

The 'Top Down' approach to identifying momentum stocks

The stock market, just like our economy, travels in cycles. There are times of expansion and times of contraction. Who could forget the mining boom of recent years - and the equally memorable contraction when the GFC cut a swath through our savings? It is fair to say though, that even during a period of contraction there are some sectors of the economy that outperform others. In recent times, the property markets in Sydney and Melbourne have provided visible examples. Therefore, the challenge for investors is to identify momentum sectors of the market. Because of the liquidity offered by the equity market, changing from one sector to another is relatively simple, whereas it is almost impossible to find the same flexibility in the highly illiquid property market.

In the stock market there are basically three cycle conditions we need to consider - the boom cycle, the bust cycle and the equilibrium cycle. These market cycles are simply a reflection of the supply/demand relationship.

A boom cycle, or Bull Market, is defined as rapidly increasing prices over time. This condition is caused when demand for the stock outstrips supply. In this case, the buyers must offer higher and higher prices to get the stock they require and thus, the market goes up.

A bust cycle is the opposite of this. A rapid decrease in stock prices occurs because demand falls away. The result is that the sellers must offer their stock at lower and lower prices in order to entice the buyers back into the market which of course leads to a fall in the market.

The equilibrium cycle is where the supply and demand relationships are in balance and the share price simply travels sideways. Both buyers and sellers agree that the market offers fair value and neither is in the ascendency.

So the question is how do we, as small investors, profit during these cycles? Well the answer is not complicated. In fact, it sounds like an oversimplification. All we need to do is find stocks where demand is

greater than supply.

So how do you find this proverbial needle in the haystack?

There are many ways to find stocks in which to invest. Some people assiduously read newspaper articles. Some will use special software to scan the market. Some will rely on a tip from a friend or broker, whilst many will spend hours scrolling through the internet looking for stocks that match their specific investment needs. This is known as the 'Bottom Up' approach, where we try to find a sound investment on a stock by stock basis. At best, this process is very time consuming.

There is another very simple and very effective method which is often overlooked in these modern days of computer-based trading. It is called the 'Top Down' approach to selecting stocks.

Find the best performing stocks in the best performing sectors. We do this by first identifying the top performing sectors in the market, and then within those sectors, identifying the top performing stocks.

In the book *The Seven Rules of Wall Street: Crash-Tested Investment Strategies That Beat the Market* by Sam Stoval, published by McGraw Hill, the author suggests that for a balanced portfolio you should only invest in the top three sectors of a market.

To add to his thoughts there is also another well considered market truism.

"The worst performing stock in the best performing sector will outperform the best performing stock in the worst performing sector"

If you believe this to be true, then your first step will be to identify which individual sectors of the market are outperforming the market as a whole at any given time. Within these better performing sectors, there will be some stocks that perform better than others. You simply need to drill down to find a stock that is performing well relative to that sector. In these top perform-

David Barnes and Don Odgers
Chartwise Academy

“Think of it as panning for gold”

ing sectors we can consider that demand for most stocks is outperforming the supply of scrip, thus leading to a rise in price.

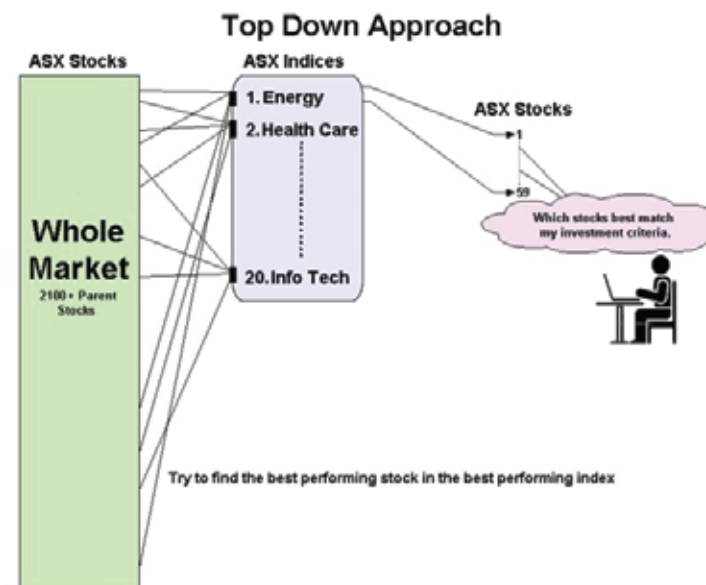
This approach also allows you to apply a filter to the whole market at one time, thus removing the need to follow every single instrument. Effectively you filter out all the underperforming stocks until you are left with the high performers. Think of it as panning for gold. It is impossible to follow every one of the 2100+ parent instruments in the market today – just understanding the top 20 indices (or sectors) is a good first step.

In the diagram you can see that the Energy Index (XJE) is the best performing index and, therefore, you may wish to consider investing in this sector of the market. Having made this decision, all you need to do is find a stock that best suits your investment criteria from within that sector of the market. In other words, a stock that performs well in the best performing sector.

“sector growth does not guarantee ongoing performance”

How to find a needle in a haystack

The 'Top Down' approach to identifying momentum stocks



As with all investments in the stock market, sector growth does not guarantee ongoing performance. We all remember the Dot Com boom from 1997 to 2000 and the mining boom more recently. During the Dot Com boom we could make money on almost any stock within the Technology sector, irrespective of the quality of the company. However, when the sector fell out of favour, stocks declined rapidly. So as well as managing your individual holdings you also need to watch sector performance. Sometimes the sector performance can fall away even though your stocks are continuing to rise. Therefore, watching the sector performance can give you an early indicator that 'it might be time to take profits.'

Word of Caution: when trading or investing using a sector approach to the market, be aware that some of the smaller sectors with only a few stocks, can be driven by the performance of just one or two stocks. For example, the Telecommunication sector is really driven by the performance of Telstra alone.

In Summary

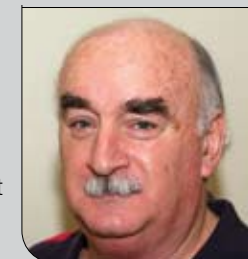
- Identify the best performing market sector (or sectors).
- Find a best performing stock in the best performing sector.
- If you find a stock meets your investment criteria you might decide to enter a position - or you might decide just to add it to your watch list.

Happy Trading.

David Barnes and Don Odgers are from Chartwise Academy

President's Message

By Bill Shirley



While sitting at my study desk sorting out the background data for this issue's message, it made me reflect about what the Association has achieved in many areas in recent times.

An example would be that during a recent twelve-month period a hundred and seventy meetings have been held by our entity. This outlined set of activities has allowed our members to be exposed to a wide range of investment information. I think this is a great achievement for all concerned, particularly as these events are all co-ordinated by our member volunteers.

Thus, I and the Board would like to offer our sincere thanks to all our volunteers around the country for their efforts in the above outlined areas, as well as the valuable private time that has been consumed – Thank You.

Now on to an investment matter, that may be of interest to you in relation to the on-going management of your current investment portfolio and future reasonable risk control.

As background, you may remember that in our last issue I gave a brief overview on a subject titled "Bumper Super Returns" outlining an average return of approximately 13.50% over the last five years. I mentioned that some planning should be considered in relation to a future downturn that may happen some time in the future; we know history will repeat itself.

Recently around the end of August to the middle of October, the market experienced about a 6.25% reduction in value. The ASX 200 has now recovered in the region of about 4.50% of this figure. A further 1.75% is yet to be achieved.

I hope the small market change overviewed above is a warning sign to us all that suitable strategies need to be considered in relation to a future downturn. It will happen.

We long-term investors must remember there will be a degree of volatility in the markets from time to time. The portfolio management challenge will be to achieve a correct balance between future earnings growth and valuation growth verses an acceptable risk profile that is suitable for your own investment model.

On other AIA matters, recently two of your Board members travelled to Perth to hold our AGM for the first time in that City. It was pleasing to talk and discuss investment matters with the members who attended this event. They all showed a keen interest in their investment activities and the questions discussed. I can only say you are a very lucky group to have such a flexible venue, as well as a local organisation that orchestrates all your range of events to enjoy.

Finally the Board and I would like to wish all our members a very Happy & Merry Xmas, including an enjoyable festive season with your family circle and long-term friends. In addition, I hope this Holiday period is a safe one for all.

Merry Xmas

Kind Regards ~ Bill Shirley

THE SMSF OWNERS' ALLIANCE

SMSFOA

Duncan Fairweather
Executive Director, SMSF Owners' Alliance

Self-managed superannuation funds are major investors in shares and other asset classes. That's why we think members of the Australian Investors Association may want to know about the SMSF Owners' Alliance (SMSFOA).

The SMSFOA created a voice for Australia's one million SMSF owners nearly two years ago because we could see the writing on the wall. Without being paranoid, we knew they were coming to get us!

With the government at the time promising to return the budget to surplus in 2014, we sensed that this was totally unachievable under the government's budget settings and we knew the \$500+ billion sitting in self-managed funds would be a juicy revenue target. So it turned out to be. Remember the attempt by the previous government to put a new tax on super fund earnings over \$100k in retirement phase? That fizzled out because Treasury and the ATO told them, and in turn the present government when it came to power, that it was impractical and would cost too much to implement such a tax. The new government dumped the idea along with a raft of other taxes planned by the previous government.

The current government promised there'd be no unexpected adverse changes to superannuation in its first term, but we've seen governments change their policies once in office. SMSFs are not in the clear

In recent weeks, we've seen escalating attacks on them in the media and commentators who profess outrage at what they see as an unfair budget. They see SMSF's as islands of privilege in a sea of disadvantage.

If you believe this rhetoric, SMSFs are guilty of:

- Pushing up house prices
- Not paying their share of tax
- Burdening the budget
- Giving the rich an unfair tax break
- Pressuring companies to pay too much in dividends
- Endangering the stability of the financial system

Even the interim report of David Murray's Financial System Inquiry was alarmed that the top 20% of taxpayers get 57% of the super tax concessions. Expressed like that, it certainly looks unfair – until you find that the same 20% of taxpayers pay 64% of income tax revenue.

Ken Henry justified tax breaks for superannuation in his seminal report: "The essential reason for treating lifetime, long term savings more favourably is that income taxation creates a bias against savings, particularly long-term savings. Taxes on savings income, including the taxation of inflationary gains, can discriminate against taxpayers who choose to defer consumption and save. The longer the person saves and reinvests, the greater the implicit tax on future consumption ... These individuals pay a higher lifetime tax bill than people with similar earnings who choose to save less."

SMSFOA's view is that policy governing SMSFs and superannuation generally must be driven by what should be the fundamental objective of a retirement income savings system - to enable most people to save enough during their working lives to be able to live on a reasonable 'replacement rate' throughout their retirement and old age. Most authorities, e.g. the OECD, reckon a reasonable replacement rate is between 60-80% of pre-retirement income.

“ People need to be encouraged to put more of their money into superannuation ”

On that measure, Australia is actually way off the pace. It's estimated by the government that only 20% of people are financially independent of the Age Pension and that will still be the case in 2050!

People need to be encouraged to put more of their money into superannuation. To that end the SMSFOA have consistently argued that the previous limits on voluntary contributions – cut by 50% by the former government – need to be restored.

And the contributions rules need to be more flexible so that people can turbo-charge their superannuation savings when they can afford to do so, usually in the latter stage of our working lives when we've paid off our house and educated our children. A more flexible approach would benefit women, in particular, who take time off from their careers to raise a family as well as many others with irregular work patterns.

We'd contemplate change to the structure of superannuation to make it more effective as a national savings mechanism but only after carefully considered policy change that does not disadvantage Australians who have saved diligently under the rules to achieve financial independence in retirement. SMSFs make up the largest and fastest growing sector of Australia's \$1.8 trillion superannuation savings pool. They are successful because the people who set them up and run them – the 'owners' – value control over their investment strategy, flexibility of investment choice and lower costs. They achieve these outcomes while producing – on average – investment performance as least as good as the professionally managed, APRA regulated funds.

But success often breeds envy and SMSFs can be portrayed as if we do not loudly and proudly champion them and the values that create and sustain them.

If you, as an investor and perhaps also as an SMSF 'owner', think we are on the right track please consider joining up as a member of SMSFOA. You can find out more about SMSFOA and become a member online at www.smsfoa.org.au

Legally Minimising Your TAXES and Maximising Your Retirement SAVINGS

Shane Ellis, Ellis Law

In the investment world, it is generally accepted that there is no such thing as a free lunch – but for those in the know, there are some excellent lunchtime specials to be found. Tax is a part of life, and for high income earning people, the effect of paying unnecessary tax on the long term wealth of their families can be especially significant. Yet for those in the know it can be legally minimised or wiped out totally!

For individuals earning a significant income, the most common strategies to minimize tax include: contributing to superannuation, ensuring you have a high quality tax deductible income protection policy in place, borrowing for negative gearing and investment purposes, and properly considering the holding period and ownership structure for your investments (for example, Family Trusts, SMSFs, Joint Ventures).

Opportunities that are less commonly considered are the benefits of Franking Credits within an investment portfolio, and/or the value of capital allowances (Depreciation) within a property investment portfolio. Further, by using directly held listed investments, such as share portfolios and listed property trusts, investors can manage embedded capital gains tax liabilities through time with the prudent management of their portfolio. The ups and downs of the markets provide the opportunity to manage tax outcomes within your portfolio, if it is carefully monitored and actioned at the right time.

Unfortunately, many investors don't consider beforehand the ownership structure for their investment portfolio. Proper consideration of this before investing is crucially important not only from an asset protection perspective, but also from a tax planning perspective.

Superannuation is, generally speaking, not very well understood by most people, however, this is often the best structure for investing your own money. Your investments can grow in a low or no income tax environment and then you can enjoy the ability to build and dispose of significant assets without CGT implications. You get to enjoy the fruits of your labour tax free after the age of 60, simply by properly structuring your SMSF pensions.

Consider an AIA member earning \$300,000 annually with an investment portfolio worth \$500,000 and a further \$500,000 in their super fund. The opportunities to work with a client like this are significant, including an investment portfolio review, restructuring into trusts (taking care to understand the stamp duty and CGT implications), establishing a SMSF, ensuring they have the correct estate planning structures (including Wills with Testamentary Trust Capacity), protecting their equity in the family home, and minimising the tax payable by their estate.

The difference in financial outcomes through time can be staggering when you take a little bit of time to get the right structures and strategies in place now. What many people don't consider is the significant tax that may unnecessarily become payable by their family if they were to pass away. The Government has a 'hidden death tax' on the payment of benefits from your superannuation fund that can cost your loved ones 16.5%. This can amount, in some instances, to tens or hundreds of thousands of dollars. The prime example of people caught out here are your adult children, and it is particularly damaging to people who work long and hard to earn a good income, and in turn claim a tax deduction on their superannuation contributions.

Strategies to be considered by these clients include the use of a Self-Managed Superannuation Fund and building what is known as an 'Anti-Detriment Reserve' within this fund. This effectively allows that fund to pay a benefit to the estate on the member's death which 'reimburses' the clients' estate for the contributions tax which has been

paid by the clients through the years. Further to this, it provides that SMSF with a massive tax deduction, often greater than \$1M, which can be carried forward by that superfund to offset any future earnings or contributions to that fund. Effectively, the SMSF then becomes a massive, tax free, highly protected, intergenerational wealth structure.

Outside of this, the tax free pension that was mentioned previously can actually continue after a member's death to the surviving spouse, provided you have the right documentation in place. The superannuation pension laws say that to do so your pension documents must be built as auto-reversionary pensions.

This is a space that moves fast though, so unless you have reviewed your structures very recently, with a specialist in the field, you could be missing opportunities. The best advice would be to seek the advice of someone who genuinely understands the opportunities that are available. Shane Ellis is the Principal and Senior Consulting Lawyer at SMSF Law Equity-protect

If you wish to discuss your ability to legally minimise tax on your investments or estate and to maximise your retirement savings, Shane has special appointment rates for AIA members. E: sellis@ellislaw.com.au

“ Your investments can grow in a low or no income tax environment ”

10 NEW YEAR RESOLUTIONS FOR THE EVERYDAY INVESTOR

Tim Lincoln, Lincoln Indicators

Many ill-informed investors struggle with their short term view on investing and ultimately panic, which leads to failure in the share market.

The New Year is a great time for investors to enact resolutions for the coming twelve months and to avoid the mistakes of the past. This year, commit to being among the very few investors who actually do succeed in the market, through the adoption of a structured long term approach that allows you to block out the noisy nonsense.

1. Know the type of investor you are

Before you even start, understand intimately the type of investor you are and what it is you are trying to achieve. Build your investor profile by clearly articulating your investment objectives - growth, income or both - and understand your appetite for risk. This will form the basis of your well defined investment strategy. Only when you know your end destination will you find the path that you must take to get there.

2. Financial health and golden rules - the fundamentals

At Lincoln Indicators, we believe that focussing on financially healthy businesses with strong fundamentals is the key to successful long-term investing. Without understanding the fundamentals of a business, you are purely speculating and seriously risking loss. Financial health must form the foundation and is essential if you are looking to drag yourself out of the realm of mediocrity. Other key golden rules then need to be assessed to determine a stock's growth and income qualities. For growth investors, look at earnings per share growth, return on assets and return on equity. While for income investors, focus on dividend yield and the sustainability of the dividend going forward.

3. Accept the fact you won't get every pick right

The first step to investing success over the long run is accepting the fact that you will not get 100% of your investments right all the time. If we did, then the market would be predictable and returns would be commensurate to a low risk investment such as a term deposit. Therefore, accepting fallibility is important, and acknowledging that you may only ever get 7-8 out of 10 right is actually a good thing. Therefore, develop an investment strategy that makes the odds work in your favour.

4. Actively manage to your portfolio's objectives

An investor must regularly review and actively manage their portfolio in line with their objectives. Utilizing portfolio monitoring tools and services provided either through your broker or through other sophisticated investment tools such as Stock Doctor, will ensure that you're in control at all times and reduce the risk of nasty surprises. The frequency of review will depend on the time you have to commit, however, it must occur and it should be done with discipline - be it every week, month, or quarter.

1. Know the type of investor you are

2. Financial health and golden rules - the fundamentals

3. Accept the fact you won't get every pick right

4. Actively manage to your portfolio's objectives

5. Ensure your portfolio is diversified

6. Exit with discipline

7. Do your own research and take control

8. Be a brave opportunist

9. Every day is a learning experience

10. Learn from your past BUT invest for your future

5. Ensure your portfolio is diversified

While there are a number of ways to go about this, our experience is that finding great companies as a priority will provide a natural spread as there are great businesses in every sector. The fundamentals will also help you avoid industries with headwinds as their companies' challenges will be reflected in their results. However, best practise would suggest that investors consider having no more than a 25% allocation to a single sector and another good rule of thumb is to ensure your portfolio holds at least 15 different stocks.

6. Exit with discipline

While it is relatively easy to enter a trade, the decision to sell can be tough, particularly on a losing position. This is where an investing plan is essential, because a structured approach will remove any emotion and should make a sell decision easy. Put simply, if the fundamentals don't stack up then sell. Make sure your investing plan is set, follow it with discipline and stick to it!

7. Do your own research and take control

Everyone is an armchair expert in the stock market and it is easy to get picks through friends, media, your broker and countless other resources. Ultimately it is your money that you are investing, so make sure that you do your own research and qualify those recommendations. Even if you are utilising a broker, financial advisor or another research provider, understand the company you are investing in and the associated risks. Take control of your decisions as you bear the consequences.

8. Be a brave opportunist

If you have the ability to block out the noisy nonsense then this step is easy. Pessimists will always find a reason not to invest, however, a knowledgeable investor knows that this simply creates opportunity. For example, the differential between interest rates and dividend yields is still quite large, therefore, moments of weakness for bank stocks represent a wonderful chance to pick up an extra 1% - 2% income in a quality company. Find strength in the research you have done and profit from others' mistakes.

9. Every day is a learning experience

There is no better educator than experience, so writing down your rationale for each investment is a good discipline to get into to as you can learn some very valuable lessons. Over time, investors should continue to ask themselves whether that rationale still holds true, and if not, they should review that position in further detail. So be passionate. Embrace the pursuit of knowledge. It is not that hard. But your track record must be analysed and often this means reviewing some awkward truths.

10. Learn from your past BUT invest for your future

Often investors say that they might as well hold on to a losing investment as it has already dropped substantially. Instead, investors should consider whether there are better alternatives moving forward, and whether a company's outlook still aligns with your objectives. Though it is difficult to try to separate the past from your future, ultimately looking forward will make you a better investor because there is an "opportunity cost" of holding onto fundamentally inferior businesses.

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Important Information

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This information is current as at 3 November 2014.

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10 NEW YEAR
RESOLUTIONS
FOR THE EVERYDAY
INVESTOR *continued...*

“
**Find
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mistakes.**

”

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INTELLIGENT
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MARGIN LENDING

Is it time to reconsider?

Julie McKay

Small upward tick

The latest statistics from the Reserve Bank of Australia (RBA) show an ever so slight pickup in margin loan amount. This comes after almost consistent declines in loan amount, number of accounts and loan to security value ratio (in other words, the level of gearing) since 2009. Despite this slight upward tick, there is continued speculation about the future of margin lending.

Reductions in discretionary spend, acceleration of home loan repayments and weak equity markets clearly explained initial margin lending declines after 2009. In today's low interest rate environment with domestic equity markets growing by close to 13% p.a. since June 2010 (based on S&P/ASX 200 Accumulation Index which includes reinvestment of pre-tax dividends) continued rejection of gearing through a margin loan appears counter intuitive.

Not part of broader trend

Following the global financial crisis (GFC) there was plenty of talk about deleveraging – households doing everything possible to reduce debt. But significant deleveraging doesn't appear to be an ongoing reality in Australia. Based on RBA statistics published in October 2014, household debt has not exhibited the meteoric rise of the past 20 years. But household debt is only a fraction below previous highs and certainly did not experience declines similar to margin lending.

Margin lending in Australia reached a peak of 3.5% just before the GFC and has since fallen to around 1% of market capitalisation – well below average. All of this points to a more fundamental shift in investors' use of margin loans.

Reasons given for decline

There are a few key reasons people give for not using a margin loan: the strategy is not required anymore; I can get similar returns without taking the risks of gearing; gearing is too risky in an uncertain market; or, I can draw down on my home loan.

Let's distinguish between 'gearing' as a strategy (in the sense of getting exposure to an asset with a smaller amount of capital than would be required to buy the asset outright) and a margin loan which is a financial product for implementing a gearing strategy. There are many ways to implement a gearing strategy.

Gearing Australian equities can be done through warrants, contracts for difference (CFD) or options. These financial products have their own risks and benefits, but are typically only used by sophisticated investors. Three of the four arguments mentioned above concern gearing as an investment strategy.

No longer required

For people without a steady, non-market related income (such as someone retiring from paid employment) reducing market

There are many ways to implement a gearing strategy...

exposure is absolutely a rational strategy. Many post-retirement portfolios need some proportion of growth assets to offset inflation, but gearing is unlikely to be prudent given the investor's significantly reduced ability to recover capital if there is a market correction. However, many people with 10 years or more until retirement may be underestimating the realities of saving for retirement.

Growing longevity means many Australians will need to fund a longer than expected retirement period, or retire later than expected. Generally, this means starting retirement with a larger capital base. There are other consequences of longevity; any expected inheritance is likely to be delayed and an inheritance may be eroded by the costs of caring for older family members.

Saving alone, even in the tax advantageous super environment, may not be sufficient to accumulate the necessary capital. For many people to reach their retirement dreams (as well as other essential life goals such as homeownership), savings may need to earn annual returns in the low teens. Over the long term, these returns may only be achievable with some higher level of investment risk, including prudent gearing.

Other ways to get returns

There almost certainly will be portfolios offering a similar return to a geared equity portfolio, but no return comes without risk and financial markets eventually equate the prices of assets that have similar risks.

Investors may be able to pick an under or over priced asset today, but few can consistently pick mispriced financial investments over the long term.

The third argument is that gearing is "too risky over the short term". This basically states an inherent facet of all gearing strategies. To achieve a positive geared outcome, total investment returns must overcome the costs of gearing (as well as tax and fees of course). Options, CFDs and some warrants are typically cheaper ways to implement a short term market view.

But most gearing strategies need time to generate sufficient returns and that means a medium to long term investment horizon. Further, an investment strategy, whether geared or un-geared, must be based on a view of the market relative to the financial goals driving the investment. If you don't think the markets will make sufficient returns over your investment time frame, then not gearing is a rational strategy.

Home Loan or Margin Loan

The final argument focuses on the best way to implement a gearing strategy. We will only focus on borrowing to invest, rather than other gearing products such as options. Using residential home equity to invest in shares post Storm Financial, or after the best interest and appropriate advice obligations imposed by FOFA, is startling.

MARGIN LENDING

Is it time to reconsider?

continued...

We won't cover the potential difficulties that might arise in maintaining the tax deductibility of interest on the proportion of a home loan used to acquire investments. Suffice to say that the Tax Office may take a dim view of reducing the non-deductible portion in preference to the deductible portion of a loan facility.

The 2009 Parliamentary Inquiry into financial products and services found that the risk of losing the family home was strongly underestimated. The collateral for a home loan is the home itself, not the shares acquired with excess home equity. This means the lender has rights to repossess the home if the borrower fails to meet their obligations. A margin loan is full recourse (meaning a borrower must eventually repay the loan in full), but the margin lender only has rights to sell the collateral.

A number of articles also mention the "risk" of a margin call and how using home equity "avoids" that risk. Successful investors have an investment plan including an exit strategy. An exit strategy is even more essential when gearing – small market moves (both up and down) are magnified by gearing.

On the basis that any sensible gearing strategy includes moderate gearing over a diversified portfolio, the risk really being considered is that of a significant market correction – everyone invested in the market is exposed to that risk. A margin call is a last resort exit strategy not a risk.

A margin loan is not more expensive than a home loan. The portfolio reporting tools and margin call services offered by margin lenders means a margin loan is often the most appropriate financial product for many investors who want to implement a long term geared equity portfolio strategy.

Conclusion

The decline in margin lending may be an indicator of investor sentiment; some remain unconvinced that expected returns will more than exceed the costs of gearing. In that case, not gearing is an appropriate response to a reasonable market view. If the decline, however, represents a shift into using other borrowing facilities to gear an equity portfolio, then we may have forgotten the lessons from the GFC.

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An Investor's Battle Plan for Winning the War Against Fear and Greed

By Angel Clark and Rob Markham, VectorVest

More than the high frequency traders, market makers, know-it-all analysts and hyped-up gurus, our biggest enemy as investors is ourselves. Navigating the emotional battleground of fear and greed is perhaps only surpassed by surviving puberty. But just as we managed to leave our high-strung teenage selves in the past, we can also mature into cool, calm and collected investors capable of crafting and executing high-probability trades in any circumstance.

First things first, you have to have a rock-solid plan before you start trading. Rarely does consistent success come unplanned. In fact, I would go so far to say that consistent success never happens without a plan. Think about your average tourist who visits a casino. The allure of the casinos is practically irresistible. Amid bells, whistles, dings and ka-chings, happy punters may get lucky and win a nice little pile of chips. Do they cash-in their chips and cheerfully walk away with bulging pockets?

Almost never.

The surge of excitement from winning speeds up the heart, short-circuits the brain, and leads directly to more gambling with bigger risk taking... until the cool, calm and collected casino gets it all back, and then some.

Of course, there's always the poor person that doesn't get to ride the high of that first magical win. They're in the hole from the start - and they just keep digging. They're afraid to walk away. That would make the loss real. They desperately try to play their way back to breakeven. If they just keep playing, then surely, their luck will turn around. After all, they can't lose every time, can they? Statistically speaking, probably not, but near enough that the occasional win won't even make a dent in the damage they've done.

Our recreational gamblers contrast perfectly with a professional gambler. The person with a plan. They've calculated their odds, they know precisely how much risk to take based on those odds and they don't let emotions get in their way. They don't win every time, but they know how to stay in the game until they do.

Now we are certainly not equating investing in the share market with going to the casino—but we can learn about how to deal with emotions from the professional punter.

And here's how you can be a successful investor or trader.

Never risk more than 1% of your portfolio value in a single trade. No, that doesn't mean using a 1% stop-loss. (Well, it would if you invested the entire amount of your capital in one stock, but let's assume that's something you would never, ever, ever do.)

Let's say you had a \$100,000 portfolio. What's 1% of 100k? \$1,000. That's the maximum loss allowed for a single stock in this portfolio. If you bought 10 stocks, investing \$10,000 into each, your stop-loss would be 10%. 10% of \$10,000 is \$1,000, the most you could risk. If you had purchased 20 stocks at \$5,000 each, you're maximum stop-loss would be 20%. 20% of \$5,000 is \$1,000. This should force you to pay attention to your entry

point, the volatility of your stock, and how much you invest. Make the trend your friend. Contrarian investors are an endangered species. Unless you've got the bankroll of Buffett and nothing but time on your hands to wait for profits, quit trying to nail a bottom (aka, catch a falling knife). Analyze the trend of the market before you even look twice at a stock. The market isn't a separate entity, it's composed of thousands of stocks – if it's moving in any direction, it's because there's essentially a stampede of stocks heading that same direction. Do you really want to be the person standing in the way of a stampede?

How do you objectively determine the direction? If you have VectorVest, use our market timing signals. If you don't have VectorVest, use a moving average on a major index like the ASX 200. You can get all kinds of fancy market analysis tools, but just try looking at a 40, 65 or 100-day moving average to get your best balance between too late and too soon.



Basically, you need a long enough moving average to signal a significant trend that has the probability of being sustainable, even if you're trading much shorter term. Once you're in that trend, you want it to follow price closely enough that your portfolio won't get killed before you get the signal the trend has broken down.

When the price of the index is above the moving average, it's okay to buy stocks. If the price of the index drops below the moving average, stop buying and protect your profits by tightening stops, using options, hedging with contra ETFs or plain old selling.

Don't buy stocks on speculation. Forget the hot 'tips' and do your homework. Speculation is a rich man's hobby. Instead, buy stocks that are making money and making it consistently. VectorVest has indicators that evaluate a stock's value based on earnings and earnings growth, as well as an indicator that assesses safety based on historical financial performance, but if you don't have VectorVest, you can still determine what your stocks is worth. Here's a quickie formula for determining a stock's current value; Value=100*EPS/Interest Yield (For interest yield, use the return of long-term AAA corporate bonds). Compare the stock and the value and decide whether any premium you're paying is fair.

Never risk more than 1% of your portfolio value in a single trade...



Next, look at the earnings growth for your stock (available at Financial Times, Yahoo! Finance and many other free sites). The stock's EY should be higher than the combination of interest rates and inflation. If you take just a few minutes to check these things out, you can ensure some minimum fundamental strength for a stock. Even if you consider yourself a short-term investor, I think you'll be impressed by how much easier it is to make money on 'good' stocks than bad.

Buy stocks that are already doing what you want them to do. Think back to that "catch a falling knife" reference. Does that sound like a fun activity? (Please say no.) Forget the bottoms; it's so much easier (and probable...and repeatable) to take a nice little chunk of profit out of the middle. The same techniques that we used to analyze the market's trend above can now be used to identify the stock's trend.



In addition to price trading above the moving average, look for the stock's price to be steadily rising from bottom-left to upper-right on a one year graph, the smoother the better. More often than not, predictable stock charts equal predictable profits.

Know when to hold them, know when to fold them—when to sell and let a stock go is the hardest question of all, especially for an emotional investor. You would think they were children you're afraid to kick out of the nest. They're not. They have no emotions, you won't hurt their feelings, if they aren't behaving and paying their way – Kick them out!

If they've been good, but start to go bad – Kick them out! They're costing you time and money. Again though, we have to have an objective way to determine when to let go, since Fear and Greed are more likely to wrestle control from you here than anywhere else.

An Investor's Battle Plan for Winning the War Against Fear and Greed *continued...*

Trailing stops and gain losses are popular exit strategies. The amount of either should not risk more than 1% of your portfolio value in a single position. They're also dependent on your goals and risk tolerance. Short quick gains tend to result in more winners, while more generous stops allow for bigger winners. Short quick gains may also lend more power to compounding profits; with each small gain, you're leveraging more money into the next position. Rinse and repeat.

To prevent whipsaws, particularly in shorter-term positions, pay attention to your entry point. Avoid buying at overbought levels by looking at the RSI or Stochastic. There's plenty of free, easy to understand information on both of these indicators (Google is your friend), but their purpose in life is to identify overbought and oversold positions. Don't buy when the indicator shows price is in overbought territory.

Also, pay attention to how far price has pulled away from the moving average you're using. Extremes tend to revert back to the norm. If you choose to ignore this (at your own peril), then keep yourself out of trouble using a trend line or a short-term moving average to follow the stock's parabolic rise very closely.

Look at the ATR (Average True Range) of a stock, another common and popular technical indicator. Multiply the ATR by 2 to 3. It's quite likely the stock could have a pullback to these levels. Can your stop loss accommodate that? If not, you should wait for a better entry or move on to the next stock.

Finally, when it comes to selling, never lose more than half your profit. While a trailing stop trails the stock's price, a profit trailing follows the profits and snaps in when they start to slip by your specified percentage. Some broker's offer this, others you'll need to track manually. Simply put, if you reach 10% profit and they slip to 5% because the stock is now retreating, sell. And never, ever let a profit turn into a loss, even if you have to sell at breakeven.

There's a lot more that could be said on this subject, but we'll save that for another article. Hopefully, these tips will help you fill some gaps in your current trading plan or maybe get you started in formulating one. Think of your trading plan as a battle plan, one that will help you win the war against your emotions and defeat fear and greed for good.

MARKET DIRECTION AND VOLATILITY

Lee M. Spano, Investor & Creatness International CEO

The equity markets have been extremely volatile in recent weeks, particularly in the banking and resources sectors, which dominate the ASX. In fact, there has been much conflicting, idle opinion about volatility. For the active investor or trader, it is important to understand volatility and its impact on market direction. This article will give you a greater insight into volatility, provide you with some practical tools, and touch on the threshold issue concerning the relationship between volatility and market direction.

What is Market Volatility?

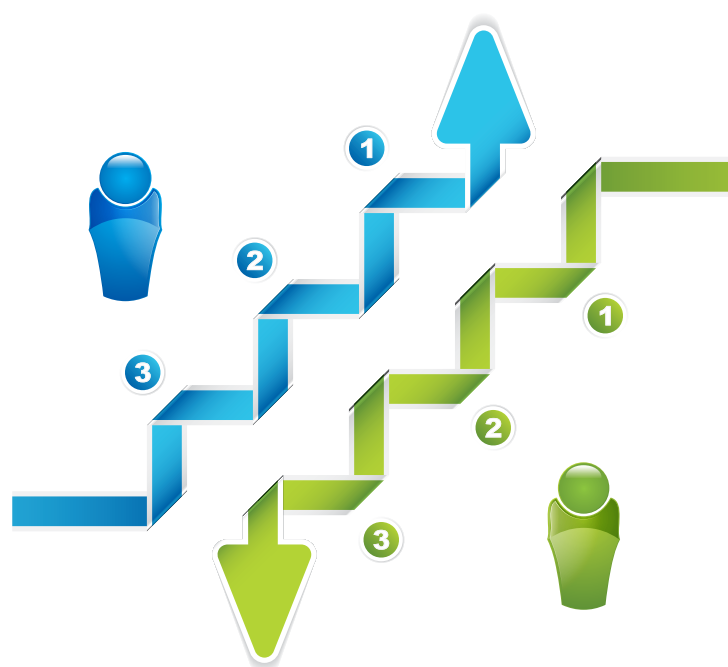
Volatility in the financial markets may simply be defined as the range of price movement over a specific period of time. There is no one accepted benchmark, just various tools or indicators used in different markets. One of the very live issues at the moment is whether measures of volatility can be a leading indicator of equity markets, or a lagging one. That is, whether volatility gives us an early, predictive signal of market direction, or it simply tells us what has already occurred.

At the onset, it is important to draw a distinction between good and bad volatility. Good volatility is manageable volatility, where your investing or trading plan can still operate or is workable. Bad volatility, however, is extreme volatility which makes your investing or trading plan inoperable. Sudden price movements, gaps in price, an erratic market, will take out your stops, or make typical set ups impossible to identify. The threshold issue is how do we make this distinction between good and bad volatility at a very practical level? What tools can we use in this regard, and how can we embody them in our investing or trading plans?

Average True Range (ATR)

There are several tools from Technical Analysis (TA) which we can use to measure volatility. You will find them in most charting packages. The ATR is an excellent one. It measures the range between the highs, lows and closes over a certain period of time (p). P is typically 14, so on a daily chart it will be 14 days. When examined over a reasonable period of time, the ATR can give quite a clear indication when the market is too volatile to enter. Similarly, if the ATR is relatively low, it can give an indication that it might be safer to enter the market in anticipation of a major move, such as a breakout of a narrow trading range.

“It is important to draw a distinction between good and bad volatility...”



The US VIX Index

The US VIX Index is derived from the US Options Market. It is often called 'the fear index'. The VIX can be found on most charting packages. It is freely available at Stock Charts: [HYPER-LINK "http://www.stockcharts.com"](http://www.stockcharts.com) www.stockcharts.com – use the code \$VIX, preferably on a daily or weekly chart. You will often hear the media speak about the VIX, often loosely and imprecisely. Again, the key threshold issue is whether the VIX can impact market direction. Specifically, can we use it as a leading or lagging indicator of equity markets or indices, particularly the US SP500, or perhaps the ASX SP200? The best way to answer is to do a simple correlation study of the charts. Pull up a chart of say, the SP500 and overlay it with a chart of the VIX. Ask yourself these questions - do the pivot or turning points marry? Do the trends or overarching directions marry? Does one chart lead the other? This simple exercise might prove quite valuable to you. At the very least, regularly keep an eye on the VIX and your major index.

There are currently two schools of thought concerning the US VIX. The first is the contrarian school. It believes the VIX is inversely correlated with the major indices. That is, when the VIX is low, there is a probability markets will retrace or correct. This seems to be based on the idea that markets have been complacent for too long, and so a change is likely. The second school may be termed the normal school. They believe in a positive correlation between the VIX and major indices. That is, when the VIX is high, particularly over 20.0 or 30.0, there is a real danger of a retracement or market correction. The reasoning here is high volatility or heightened 'fear' is likely to make markets bearish. Either way, you can

undertake your own research here through a correlation study. However, please note the numbers 20.0 and 30.0. They are quite relevant. You can easily draw support/resistance lines around these numbers on the VIX chart.

It may also be the case both these schools are right. That is, the VIX is a leading indicator of market direction when used in a contrarian fashion, and it is a lagging indicator when used in the normal way. Again, your study of the charts can help you formulate your own independent opinion.

The Australian VIX

The Australian VIX analogous to the US VIX is the S&P/ASX 200 VIX Index. It is important to study this index over longer and medium time frames, such as a two year weekly chart, and also a two month daily chart. Similarly, study correlations with at least the ASX SP200. Notice whether pivot points or turning points marry, and notice any key levels. Also ask yourself whether there is a positive correlation with the US VIX and the Australian one. Again a careful, yet relatively simple study of the charts can give you some valuable insights.

Options traders and investors are very focused on volatility. They often use the measure of IV to make decisions about the underlying stock or its options contracts. Some clearly see IV as a leading indicator of price action. There is insufficient space to go into great detail here, suffice to say that volatility from IV or the options market, can indeed be a useful tool for determining market direction for stocks or options in both the US and Australia. So you may want to examine this tool further.

Volatility and Market Direction

This brings us squarely to the question of the possible link between volatility and overall market direction. From our research, we have found there are strong correlations between price action and volatility. However, whether volatility measures lead or lag the market is still a vexed issue. We have found volatility tools are better used to confirm other more primary tools.

Our primary tools remain key Technical Analysis (TA) from the charts, and specifically combined with Fundamental Analysis (FA). Volatility is subject to our analyses at these higher levels. For example, if we are investing in stocks, and the methodology used is a simple trend methodology, we might remain in a market, so long as there is still a valid trend. This is best determined technically and fundamentally. Volatility may alert us to possible changes, or might stop us from entering or adding to an existing position, but the primary level of analyses takes precedence in our decision-making. There is no one size fits all. Please undertake your own research. Things will vary with specific markets, differing time-frames and methodologies. Remember for long term success, the goal is to be able to think independently, and to create and manage your own investing or trading plans.

“There is no one size fits all...”

MARKET DIRECTION AND VOLATILITY continued...

Conclusion

I trust you now have a greater understanding of volatility. I have also touched on the threshold issue of the relationship between volatility and market direction. This issue is not straight forward. However, the tools we have sketched will assist. Importantly, they will help you to analyse the markets independently, and not simply rely on idle commentary in the broader media or elsewhere.

Lee M. Spano is CEO, Investor & Creatness International

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Trading the Dividend Seasons

Nick Radge

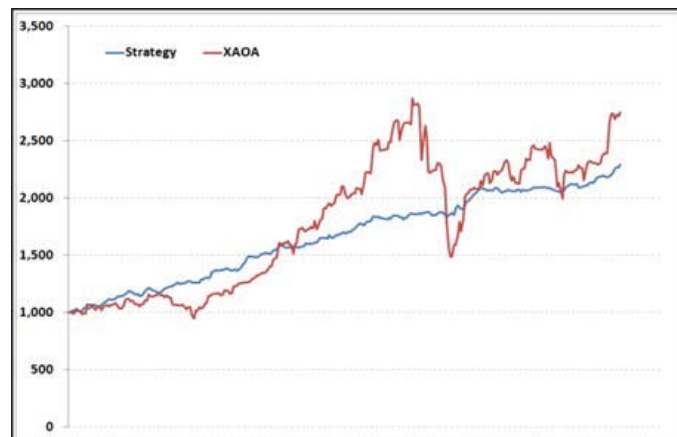
It's well known that share prices tend to move upward ahead of their respective dividend dates. Under the right circumstances this bias offers a great opportunity for earning some extra income.

As an example, take a look at the following Bank of Queensland (BOQ) chart. Each arrow denotes the ex-dividend date and as at writing we have another dividend coming up in late November. There are two points of interest here. Firstly, the share prices exhibits upside strength ahead of the ex-dividend dates. Secondly, after that time prices decline by some degree or move sideways.



Now it's important to understand that not every stock will travel this journey, and in certain market environments this is not a pattern worthy of trading. However, our research based on 15 years of price and dividend data across the ASX-20 universe shows a definite upside bias of around 63%. This may not sound like a lot, but a small edge like this, coupled with sound risk management, allows some nice profits to be generated.

The following chart shows a non-compounded view versus the growth of the All Ordinaries Accumulation Index (XAOA). On first glance this may not look overly appealing, but on closer inspection we can see some benefits. Firstly, the growth in equity is low in volatility providing a very palatable and low stress journey. That said, one can soup up the outcome by using leverage. Next, there is very minimal exposure to the market itself. We're only interested in the month or so ahead of the major dividends and when they're not in season we stay in cash and in comfort.



There is a time and place for leverage and whilst it can generate large profits, it can also lead to large losses. That said, because of the low volatility and exposure of this strategy, coupled with the relative safety of the ASX-20 universe, we thought it appropriate to investigate the use of leverage and dividend momentum. Below is the non-compounded equity growth versus the XAOA using a Loan to Valuation Ratio (LVR) of 20%.



An important element of the strategy is how it avoided the GFC. This was simply because there was no momentum leading into the dividend date, and is an important reminder that one shouldn't buy a stock simply because a dividend is coming up. A capital loss exceeding the size of the dividend will send an account spiralling backward - exactly what happened to many investors during 2008.

These charts show a variety of interest rate and equity market environments that provide a solid test of the strategy's robustness. However, in the current environment of extremely low interest rates, is there a greater influence from this dividend bias? Our real time research suggests there is.

Since July 2013 there have been 30 possible trades within the ASX-20 universe. These trades must meet a certain momentum criterion and the company must exhibit a minimum 4% dividend, therefore, the likes of BHP and RIO do not make the cut.

Of these 30 trades, the success rate of a rise into the ex-dividend date is 80% - well above the long term average of 63%. The average profit is over three times the average loss which is also well above the long term average of 1.25. If we look at it from a total return basis, since July 2013 through October 2014, excluding compounding, leverage and interest earned on cash, the return has been 17.6% versus the XAO of 15.5%.

In summary, there is a definite and considerable edge to be found in the current low interest rate climate and I would suggest this bias will remain in place for some time yet. Even so, our research back to 2000 suggests this strategy offers a great vehicle for investors looking to add a little income to their existing portfolios.

Nick Radge is Head of Trading and Research at The Chartist - www.thechartist.com.au.

Bricks and Mortar

Harold Medd

well chosen properties do not often fall in value

Ask the real estate industry what's the best investment and you will not be surprised by the answer. Property is the world's greatest investment. Ask a stock broker the same question and he will have no doubt where you should put your hard earned cash.

The debate about whether property or shares generates the best return has been going on for years. The statistics for both are not accurate or unbiased enough to draw a finite conclusion. Both forms of investment have good years and bad years. It's a bit like the tortoise and the hare. A slow steady grind for property and a hop and a skip progression for stocks. Put another way it's the thrill of using your skill in the stock market against the set and forget of property. The choice is yours. Over the long term there is not much difference in the average return but averages are just that and skillful or lucky investments in either sector can very substantially distort the picture.

When we first set up our super fund I looked at property as a possible component. I rejected it for several reasons. The first was diversification. Our biggest asset is the house we live in. Adding investment property would only add to the weighting of our assets to the property sector. Secondly, the size and value of property I would want to buy as a secure investment would mean that we could not afford more than one or at most two properties without taking out a loan. That's a bit inflexible. According to the statistics that would be true of the majority of SMSFs. My third problem is cash flow in the pension phase of our SMSF. Rent from a property will provide a steady income which is appropriate but the real benefit from property investment comes from the increase in value and whilst that is significant it is not easily realized. If you need to take out more from your fund than the rents will provide you have only two options. Sell and accept the costs or take out a loan. If we had been looking at 20 years of the accumulation phase of our SMSF the decision might have been different.

The big advantage of property is that it is very much set and forget. It has to be because the entry and exit costs are high and you need a few years of growth to make the investment viable. Property is only set and forget so long as you get a good tenant. A property which cannot be let for a period of time for whatever reason,

becomes a drain on finances particularly if loans are involved. Residential property is unlikely to be vacant for long in the current market and you can insure against disasters. The big advantage is that well chosen properties do not often fall in value and when they do it is not by large amounts so there is a high level of security. The late Kerry Packer said "it doesn't matter what you pay for property so long as you keep it 10 years". That may be a bit of a generalization but it does largely sum up property investment.

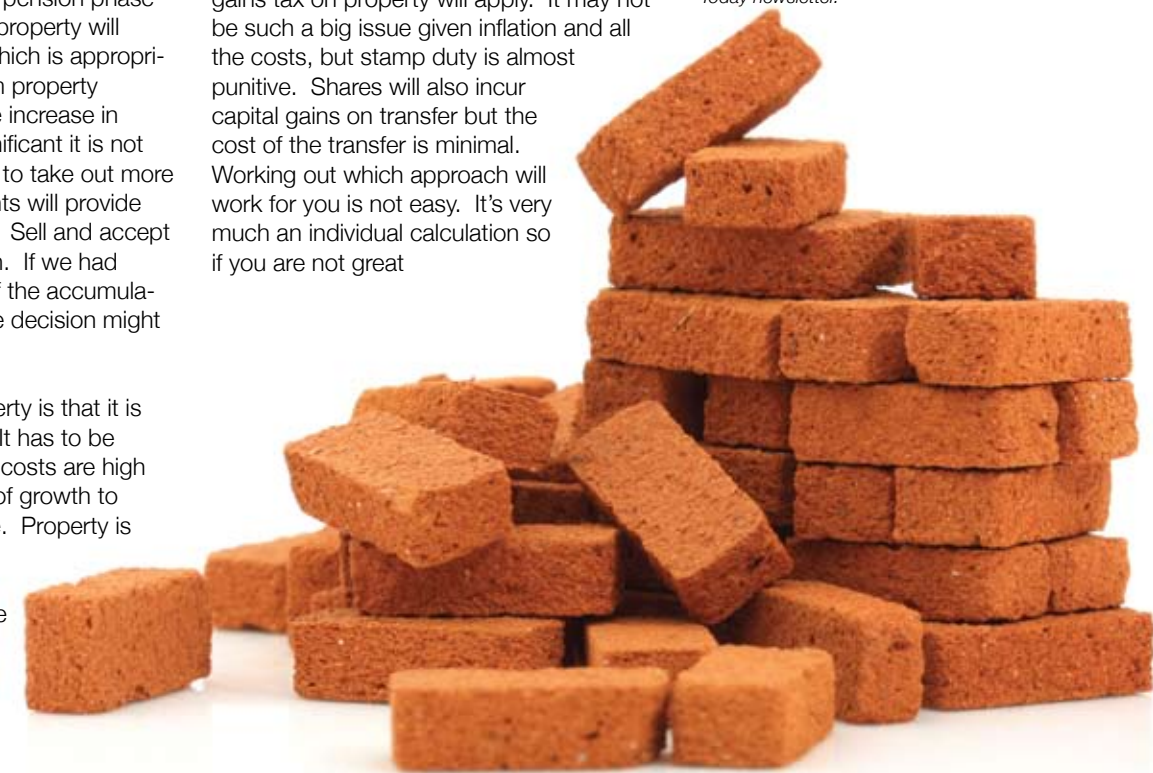
For high income earners negative gearing is an attractive proposition as it significantly cuts the cost of servicing any property loan but it doesn't work so well for your SMSF. Loans are permitted for SMSFs and that applies to shares as well as property. Gearing can be very effective so long as everything goes well but it's a bit risky for a SMSF. With the current level of interest rates, loans are very attractive and this has not been overlooked by the real estate industry. The recent heavy promotion of property loans targeting SMSFs I am sure will attract the attention of the regulators. SMSFs are about long term secure investment not a speculative vehicle.

Negative gearing an asset whilst working full time and then transferring the asset to a SMSF may be an option but there will be both capital gains tax and transfer costs. A SMSF is a separate entity from tax and regulatory points of view so any transfer of assets from an individual to a SMSF is seen as a transfer between entities. Capital gains tax on property will apply. It may not be such a big issue given inflation and all the costs, but stamp duty is almost punitive. Shares will also incur capital gains on transfer but the cost of the transfer is minimal. Working out which approach will work for you is not easy. It's very much an individual calculation so if you are not great

at maths and don't have a grasp of the regulations maybe you need help. You may also need a crystal ball as who knows what the regulators will do.

Working out whether property or shares is right for you is much more of a personal decision where the experts don't help. Property investment can involve a lot of maintenance issues but a good agent will look after that for you at a cost. Equities too can be managed entirely by your broker or adviser but being fully involved yourself is where the interest and enjoyment lies. You do need to have the temperament to cope with the sometimes big fluctuations.

Being involved in shares is a constant education in the commercial and industrial well-being of the world and its politics. I don't regret choosing to go with shares. Happy Investing - Harold Medd
This article was first printed in Marcus Padley's Marcus Today newsletter.



BEWARE the Dividend

Just as countries around the globe have different fashions, cuisines and languages, investors too seem to exude different traits and preferences depending on nationality. Compared with our global peers the likes of the USA, UK, Japan, Germany and Canada, Australian investors still appear to be fixated with income and dividend yields. Granted there are the frequently cited benefits for preferring dividend yielding companies, such as periodic income generation and the tax benefits stemming from franking credits and imputation credits, however, is that enough to justify such adoration? Should we be chasing dividend yields, or high quality businesses that invest in future growth?

Many investors and advisers believe the best way to approach investing in the stock market is to identify the ever-ambiguous 'blue chip' company that pays out a large portion of its earnings to shareholders as dividend yield. This tendency often causes the investor to neglect high quality prospects, and favour companies for little real reason other than being large organisations that pay high dividends. Such an approach, although simplistic and marketable, can be superfluous and counterproductive to investment performance.

In recent times a number of global factors have prompted the thirst for yield. The general decoupling of the interest rate cycle globally has been one key driver, however, there are numerous other factors at play. Unconventional monetary policy in places like the US, UK, Japan and Europe has left the Australian dollar the only AAA rated currency inside the world's top five most traded currencies, simultaneously sustaining a healthy foreign ownership of ASX listed high yielding shares. Recent price performance of the major banks and the likes of IAG, SUN, WES, WOW and Telstra demonstrates this trend, but over the longer term is the habitual preference for 'dividends for dividends sake' the way we should be constructing our investment portfolios?

Management teams basically have three options when it comes to company earnings. They can either reinvest the earnings for future business growth, pay out all or a portion of earnings as a dividend



Michael Kodari

to shareholders, or they can conduct a company share buyback. As a general rule the most benefit to shareholder equity is achieved when management choose to reinvest earnings back into the business, which then go on to earn the high return on equity rate, effectively compounding growth year after year. Investors need to remain conscious of the fact that dividend payments are in essence sacrificing future company growth for immediate gains in the form of income.

At the end of the day, investors always have the option to raise cash by selling down shares, in effect creating a dividend, leaving the company free to reinvest profits into new ventures that will increase the value of the business into the future. Let's take a look at a real word example to determine whether a pure dividend focus is justified compared with a focus on top quality businesses that are reinvesting in growth. In the tables we have a snapshot of Australia's two largest telecommunications providers, Telstra Corporation and TPG telecom, from 30th June 2005 to 30th Jun 2014. The tables include the company share price and dividend yield, as well as the \$1000 value of a hypothetical investment and the dividend income received by a shareholder on that investment.

The most important sections of the tables are highlighted in yellow. The capital gain illustrates the change in the underlying share price over the period. The dividend growth indicates the change in dividend income received by the investor, while the 'effective yield' indicates the income return the investor receives on their initial investment of \$1000.

*Should we
be chasing
dividend yields,
or quality
businesses?*

BEWARE the Dividend

Telstra Corporation		
	Jun-05	Jun-14
Current Share Price	5.06	5.55
Dividend Yield	8.10%	5.40%
Initial Investment	1,000.00	1,096.83
Dividend Per Share	81.00	59.23
Capital Gain		9.68%
Dividend Growth		-26.88%
Effective Div. Yield		5.92%

TPG Telecom		
	Jun-05	Jun-14
Current Share Price	1.49	7.17
Dividend Yield	1.20%	1.70%
Initial Investment	1,000.00	4,812.08
Dividend Per Share	12.00	81.81
Capital Gain		381.21%
Dividend Growth		581.71%
Effective Div. Yield		8.18%

By comparing the two tables it is clear that over the time period TPG has achieved a capital gain of 381%, while TLS has seen a relatively minimal gain of 9.68%; or 19.15% compared with 1.02% on an annualised basis respectively. In monetary terms it means that a hypothetical \$1000 investment in TPG would be worth \$4812 today, while the same investment in TLS would be worth only \$1097.

In terms of capital gains there is no doubt about which of these two investments has produced the superior return but that's not the premise of this article. What I'd like to do now is focus attention towards the dividend characteristics of both companies. It is clear from the table that TLS has always maintained a higher 'headline' dividend yield than TPG, but beware of the dividend income per share over the timeline. What we can see is that the dividend income for a TLS shareholder has in fact fallen from \$81.00 down to \$59.23 on the original \$1000 investment. In essence what that implies is that the yield on the initial investment of \$1000, or the 'effective yield', has fallen from 8.10% to 5.92%. Let's now compare these figures with those of TPG. TPG's dividend income on the same \$1000 investment has risen substantially over the same period from only \$12.00 in 2005 to \$81.81 today. What is most noteworthy is that the \$81.81 income an investor receives today on a TPG investment made in June 2005, would be significantly greater than the \$59.23 income that the same investor would be receiving on the equivalent investment made in TLS. That's an 'effective yield' on TPG of 8.18% compared with a 5.92% on TLS.

What this highlights is despite the TLS superior dividend yield or 'headline yield', 5.40% versus 1.70% respectively, a sound investment decision a number of years ago means that an investor can reap both superior income and capital gains in spite of markedly different dividend yields. In effect this enables the investor to enjoy the best of both worlds by receiving superior capital growth and growing income over the medium to long term.

Earlier I asked the question, "Should we be chasing dividend yields, or quality businesses?" Based on the above example there is an argument for a focus towards investing in quality businesses. Following the simple structure of identifying sectors of the economy that are booming, then going a step further and selecting established businesses within those sectors that are financially sound. From that point forward both capital growth and dividend income tend to look after themselves.

Michael Kodari is Managing Director of KOSEC

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TOP 10 TIPS FOR ASSESSING BONDS

Elizabeth Moran, FIIG

Recently Glencore, a diversified multinational commodity trading and mining company, issued a bond in the domestic market for the first time. The company has a market capitalisation of around \$50 billion and is the nation's largest coal producer through its Australian subsidiary Glencore Xstrata.

The bond is a senior unsecured fixed rate bond that has a five year term and matures in September 2019. The fixed rate of interest at first issue was 4.75%.

This article will concentrate on how to assess a bond, using the Glencore bond as an example;

1 Assess the "survivability" of the company.
Do you think the company will be able to survive for the term of the bond and thus pay you interest and return face value at maturity? A company the size of Glencore with its significant assets would likely mean survivability for the five year bond term is high.

2 Understand where the bond sits in the capital structure.
This bond is senior unsecured, which means it sits at the senior debt level and in the case of a wind up means that subordinated debt, hybrids (if there are any) and shares that rank below must be wiped out completely before you would incur a loss. This gives investors some comfort and Glencore's large market capitalisation provides an excellent equity buffer against loss should the company default on one of its payments.

3 Check if the bond is fixed, floating or inflation linked.
The Glencore bond is a fixed rate bond and the interest payments to you will not change over the life of the bond. Interest payments are half yearly. Are you looking to add to the fixed rate component of your portfolio or is your allocation high enough? If your allocation is full you'll need to consider selling other fixed rate assets or perhaps waiting until a term deposit matures before you invest.

Floating rate bonds pay variable interest linked to a benchmark such as the bank bill swap rate (BBSW). Most inflation linked bonds also pay a fixed rate of interest but on an increasing capital value that rises with inflation.

4 Check the term to maturity.
There is a large secondary market where bonds are traded, but if you are a hold to maturity investor, you'll need to make sure the maturity date suits your portfolio.

5 Decide if you can buy the bond.
The vast majority of bonds are traded in the over the counter market and you need to find a bond broker to trade on your behalf. Over the counter bonds are available to retail and wholesale investors. But wholesale investors have a greater range of bonds to choose.

The Glencore bond was issued in the wholesale over the counter market and was only available to wholesale investors through a bond broker.



Source: FIIG Securities Limited

TOP 10 TIPS FOR ASSESSING BONDS continued...

6 Assess the return given the risks.
Every bond and company has risks. Do you know what they are and do the returns on offer adequately compensate you for the risks involved?

7 Check the size of the issue.
The larger the issue the likely greater the liquidity, as there will be a larger number of investors that hold the bond and it will be included in bond indices. The Glencore bond raised \$500 million and given the size we would expect it to have good liquidity.

8 Confirm the bond has a credit rating.
This will give you an indication of the risk involved. The higher the credit rating the lower the risk. The highest investment grade credit rating is "AAA", others include "AA" "A" and "BBB". The last three categories can also have a "+" or a "-" attached to them. The lower the risk, the lower the expected return. Non investment grade is anything rated "BB+" or lower.

Glencore has an investment grade credit rating, and it is considered low risk. It's important to note that in Australia only wholesale investors can be told the credit rating.

9 Assess the relative value compared to other company investments.
What returns are available on other investments in Glencore's capital structure? Does the company issue senior secured or subordinated debt and what are the returns on offer? Is the return on the senior bond what you would expect given returns on these other investments?

10 Assess the relative value compared to other bonds from similar companies.

What rates of return are available from companies in the same sector and/or similarly rated companies? One possible comparator is Adani Abbott Point, which owns the Abbot Point Coal Terminal located 25 kilometres north of Bowen, Queensland. The terminal is one of the largest coal terminals in Australia. Although this company's credit rating is lower than Glencore, its May 2020 bond pays a premium of over 1% more than the Glencore bond.

The Glencore bond was attractive to wholesale investors as it met the above criteria. A good bond broker should be able to provide you with research on the bonds they trade. This list will help you determine if the bond suits your portfolio and can be used to ask your broker questions.

Elizabeth Moran is the Director, Client Education and Research, FIIG Securities Limited

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YIELDING MORE INCOME

Roger Montgomery

The conventional attraction to dividends has stood Australian investors in good stead over the years. But the increasingly amorous interest in franked dividends, and in some cases, just the franking credits, may be about to produce an outcome that many investors vowed they would never repeat following the Global Financial Crisis.

The panjandrum at global fund manager Henderson Group reckon Australian firms have increased their dividends by an astonishing 89 per cent since 2009 to \$44.5 billion. Henderson also noted the Australian increase was the greatest among the ten largest developed stock markets in the world. They further noted that the increase was more than double the 43% increase worldwide over the same period.

The driver

Australia's population is on the cusp of a boom in retirees – whose top will not so much resemble a peak as it will a 45-year plateau. Everything that is now demanded by those aged in their 60s, 70s, 80s and 90s will be demanded in vastly higher quantities.

There are now three million people, or 14% of the population, aged over 65. It is expected this number will triple over the next 35 years.

Figure 1 illustrates the change in the population pyramid over the twenty years between 1987 and 2007. As you can see, the most dramatic increases in age cohorts has occurred, as baby boomers who were aged between 25 to 40 years old in 1987 have moved into the 45 to 60 year-old category 2 years later.

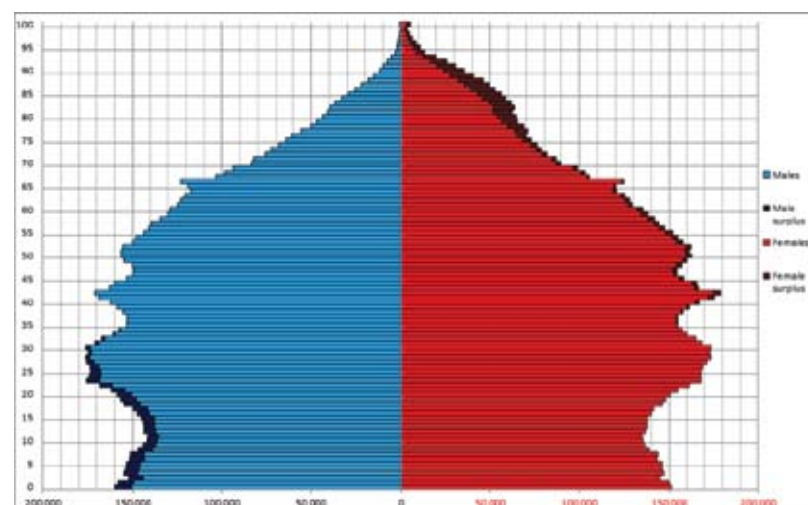


Figure 1. Baby boomers ageing 1987 – 2007

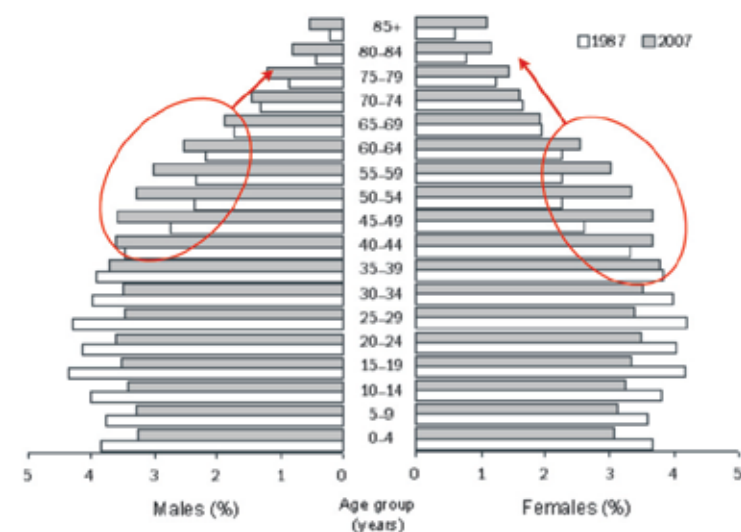


Figure 2.

Of course, another seven years has since passed and in 2014 the vanguard of the tidal wave are now aged between 52 and 67. Think of the things that this age group demand and you can be sure more of it will be needed in the next ten years. As today's 52 to 67 year olds head toward and into the 62 to 77 year-old cohort by 2014, the wave of change will be most obviously felt in the demand for services and products needed by those currently aged 67 to 77. Demand for these items will boom for twenty years or more.

The one item that will most surely be in high demand through this period will be income itself. As baby boomers approach retirement, their interest in dividends increases. This is especially so just prior to retirement, as well as in the early years of retirement itself. These are the years that boomers celebrate their newfound freedom by spending more than they will in later years.

Of course, the fact that this is all occurring at a time when global interest rates are at record lows, is serving only to accentuate the demand for a higher income return than that currently available on cash deposits and bank bills.

And finally of course, baby boomers have a disproportionately large amount of their wealth sitting in cash thanks to the Global Financial Crisis and fears of another.

One cannot help but expect asset prices to rise when the returns on overweight cash positions are so low and those with the cash are in a stage of life requiring income.

The Current Context

It's unsurprising then, that dividends and capital returns have dominated the stock market narrative in 2014. Companies including BHP Billiton, the Commonwealth Bank of Australia, Suncorp, Rio Tinto, CSL and Boral have all delivered double-digit rises in dividends. In the case of Suncorp and Boral, the dividend increases were greater than 35%. Wesfarmers increased its regular dividend by 10 cents or 5.6%, whilst also paying a special fully-franked "centenary dividend" of 10 cents and an extra dollar per share of "special distribution" associated with an equity consolidation. Not to be outdone, Suncorp offered a 30 cents per share special dividend, while Telstra raised its final dividend for the first time in seven years at the same time it announced a \$1 billion share buyback.

YIELDING MORE INCOME

With Australia's taxation framework favourably disposed to dividends, especially for all those baby boomers (with Self-Managed Super Funds) referred to earlier, it's no surprise that dividends are expected by many to continue to increase, offering relatively attractive yields.

Yielding future dangers

Much like yo-yos and hula hoops, however, when everyone's doing 'it', it seems right and it also seems that the trend will never end. But end it always does, and while we cannot be sure of the timing, we can be certain that the pendulum will indeed swing the other way.

Interest rates – those miserly returns paid on term deposits – will eventually rise and when they do they will act like gravity does on Earth. Just as gravity pulls everything down to ground level, so rising interest rates will force the market prices of shares, property, farms, business and bonds lower.

Ask yourself this; if interest rates on term deposits were at 10%, or even 8%, would you have as much invested in the stock market? Or would you allocate more to the safety of a bank account? And if everyone thinks alike, what do you think will happen to share prices? Correct. They will fall.

For investors paying almost any price for that extra basis point of yield, and especially for those with leverage in the stock market or elsewhere, the reckoning may be painful.

Make no mistake, while interest rates remain low and the prospect for higher rates is "down the track somewhere", then the music will keep playing and asset prices can rise surprisingly high. If, however, interest rates start going up because the economy improves, then after an initial bout of optimism reflecting an expectation of a strengthening economy, asset prices will start to fall.

You should, therefore, be dancing close to the door. The one caveat is lower rates necessitated by declining levels of economic growth, deflation or stagnation. If fears of such a scenario gain mainstream mindshare, that too could cause a reappraisal of share ownership – a polite way of saying the market could sell off.

Roger Montgomery is the Chief Investment Officer at The Montgomery Fund

Investors can download a Product Disclosure Statement at www.montinvest.com/tmf

WILL ROBO ADVICE IMPACT

the financial planning industry in Australia?

Josh Garratt

Computer software that automatically generates financial advice and investment portfolio tips are quickly becoming a reality and could fundamentally change the way some people manage their investments.

The algorithm driven 'robo' systems automate the advice component of portfolio management and are attracting increasing interest in the investment world.

Investors simply log into a robo advice website and answer an online survey to determine their risk level, time frame and investment objectives. The robo adviser will then build a portfolio for the client.

This approach to financial advice is aimed at technology savvy investors seeking lower fees as well as those who can't afford the cost of a 'human' adviser. For people who don't use an adviser, particularly in the self-managed super fund sector, the opportunity to source new investment ideas or check their current portfolio against a computer generated 'ideal' portfolio will be very tempting.

Although they aren't yet available to the Australian market, robo advisers have become very successful overseas in the last few years.

Wealthfront, the largest robo advice provider in the United States, raised more than \$US1 billion in two and a half years, and Nutmeg in the UK recently raised \$US32 million. Vanguard, the third largest electronic funds transfer provider in the US, announced earlier this year that it was also joining the robo advisory industry. Other major competitors include Wealthsimple, Nest Wealth, Smart Money Capital Management and Shareowner.

Will robo advisers replace financial advisers? Probably not. It is unlikely an algorithm will ever be able to quantify the needs and motivation of an individual investor. Also a good adviser does more than create a financial plan. They offer advice around insurance, debt, taxation, investment structures and estate planning.

However, they will make advice scalable and affordable for the many people who don't have the means to afford a human adviser.

Although they're not for everyone, robo advisers definitely look like they'll be part of our future.

Robo adviser benefits:

- Lower fees - fees range from 0.25-1% a year;
- Robo advisers will take on clients with small portfolios;
- Ideal for investors with time pressures.

Josh Garratt is Head of Marketing at Cromwell Property Group (ASX: CMW) www.cromwell.com.au

“they will make advice scalable and affordable for the many people”

PLAN B

“It is always wise to ensure that there is a backup plan”

In the last edition, we had a look at Strategy Number 1, "LOAN SOME", that wise families teach their young'uns at an early stage of their financial development, so they better understand the major benefits of SMSFs.

This article noted that Wise Gen X and Gen Ys make measured contributions to their SMSFs other than their Superannuation Guarantee Contributions (SGC). They take more notice of their contributions as they get nearer to retirement age and then ramp them up considerably the closer they get. They make loans to their SMSF to acquire single assets regularly!

Now, let's look at how Strategy Number 1 can be linked to another strategy to maximise investment returns even further.

STRATEGY No 2 "DOING YOUR BLOCK"

Okay, you have been employing the first strategy for some time and you have locked some good money away into your SMSF, so what now? No snoozing and losing remember!

Well, why not use the money you have built up as a deposit on a renovator (you know, the worst house in the best street)? All Gen Xers and Gen Ys love "THE BLOCK". After all it just won a Logie again. So why not spend some time Doing Your Block? The Tax Office very kindly released a ruling in 2012 confirming that it was acceptable for a SMSF to use its own resources to renovate a property that has been bought with a SMSF borrowing. Prior to that ruling a SMSF could only repair but not renovate the property. This has created a really "fun" strategy for SMSF owners who can now renovate their SMSF investment property. This means that you can now renovate the kitchen, the bathroom, slap on new paint, fix the roof or whatever needs to be done as long as you don't change the underlying character of the investment property. For example, you can't build a high rise block of units on a single dwelling site and say that was the "house reno".

SUMMARY: Enjoying the journey every day for you may well mean building your wealth by improving your assets. Get the bucks into the SMSF wisely, then use the bucks in the fund to improve the asset. Improved asset = higher value. Higher value = higher rent = wise wealth building. So, buy it with a SMSF loan and the reno will come.

With all of the capital growth that your SMSF is enjoying, what is your Plan B should something go wrong? Now is the best time for you to read about Strategy Number 3.

STRATEGY Number 3 - BUILDING THE FAMILY SAFETY NET

Okay, we are building all of this great wealth by being engaged with our SMSF and employing the first two strategies. But will having all of these loans and using the money from the SMSF expose my family to greater risk if I pass away?

Well, the answer lies in Strategy Number 3, BUILDING THE FAMILY SAFETY NET. It is always wise to ensure that there is a backup plan in place as a safety net for the family if anything happens to you or to your spouse. The backup plan for young people whilst they are growing their wealth is to have ample insurance in their SMSF to cover off on the risk of incapacity or death. The really good thing is that this insurance can be paid for by the SMSF, so you are again putting your retirement savings to great use for your family. In fact, since recent changes to the SMSF laws, the Trustees of a SMSF are now required to regularly consider the need for insurance in their SMSF. That way if fate (which happens to be a 4 letter word) comes along and bites you or your spouse on the bum by removing you from the workforce, or causing loss of life, the able bodied/surviving partner will be protected by insurance paid into the SMSF. This insurance money covers the loans, pays the bills, and compensates on a financial basis if not an emotional basis in the event of a catastrophe.

SUMMARY: Build your safety net for your family (your Plan B if Plan A should fail), by having adequate insurance within the SMSF. Regularly review the insurance inside your SMSF.

Stay tuned for Strategy 4.

Calendar of Events

Please Note:
As AIA events are confirmed, details are posted to the AIA website www.investors.asn.au
Please note topic is subject to change.

DECEMBER 2014

02/12/2014	Perth Information Meeting	6.00pm	Wembley Downs Tennis Club, Cnr Morden & Ednah Streets, Wembley Downs WA
02/12/2014	Melbourne Information Meeting	6.30pm	Telstra Conference Centre, Room 1, Level 1, 242 Exhibition St, Melbourne
03/12/2014	Frankston Discussion Group	1.00pm	Private address, please contact event coordinator Bill Shirley, E: aiavic@investors.asn.au
03/12/2014	Brisbane Information Meeting	1.00pm	Broncos Leagues Club, Fulcher Rd, Red Hill QLD
03/12/2014	Blackburn Discussion Group	7.15pm	Naturalist Club of Victoria, 1 Gardenia Street, Blackburn VIC
08/12/2014	Canberra Discussion Group	7.30pm	Canberra Labor Club, Chandler Street, Belconnen ACT
10/12/2014	Sydney North Shore Information Meeting	7.00pm	The Chatswood Club, 11 Help St, Chatswood NSW
16/12/2014	Gold Coast Information Meeting	9.30am	Robina Community Centre, Robina Town Centre Drive, Robina QLD
16/12/2014	Brisbane Investment Management Discussion Group	6.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD

JANUARY 2015

06/01/2015	Perth Information Meeting	7.30pm	Wembley Downs Tennis Club, Cnr Morden & Ednah Streets, Wembley Downs WA
13/01/2015	Geelong Discussion Group	7.00pm	St George Workers Club, 212 Pakington Street, Geelong West VIC
29/01/2015	Bayside Discussion Group	9.30am	Contact Coordinator Kevin Macdonald for details Tel: 0417 328 748 Email: km.macdonald@bigpond.com Hampton VIC

FEBRUARY 2015

03/02/2015	Perth Information Meeting	7.00pm	Wembley Downs Tennis Club, Cnr Morden & Ednah Streets, Wembley Downs WA
03/02/2015	Sydney South Discussion Group	1.00pm	Miranda Community Centre, Wattle Room, 93 Karimbla Road, Miranda NSW
04/02/2015	Brisbane Information Meeting	7.30pm	Broncos Leagues Club, Fulcher Rd, Red Hill QLD
04/02/2015	Sydney Hills District Discussion Group	1.00pm	B Davis & Associates, Suite 17, 35 Old Northern Road, Baulkham Hills NSW
04/02/2015	Blackburn Discussion Group	7.30pm	Naturalist Club of Victoria, 1 Gardenia Street, Blackburn VIC
09/02/2015	Canberra Discussion Group	7.00pm	Canberra Labor Club, Chandler Street, Belconnen ACT
10/02/2015	Adelaide Information Meeting	7.00pm	German Club, 223 Flinders St, Adelaide SA
10/02/2015	Melbourne Information Meeting	6.30pm	Telstra Conference Centre, R1, L1, 242 Exhibition St, Melbourne
11/02/2015	Sydney North Shore Information Meeting	7.00pm	The Chatswood Club, 11 Help St, Chatswood
16/02/2015	Chermside Equities Discussion Group	6.30pm	Chermside Library, Hamilton Road, Chermside
17/02/2015	Perth Equities Discussion Group + 2014 AGM	7.00pm	Wembley Downs Tennis Club, Cnr Morden & Ednah Streets, Wembley Downs WA
17/02/2015	Brisbane Investment Management Discussion Group	4.00pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD
17/02/2015	Gold Coast Information Meeting	9.30pm	Robina Community Centre, Robina Town Centre Drive, Robina
18/02/2015	Brisbane Share Investments Discussion Group	7.30pm	Carindale Library, Carindale Shopping Centre, 1161 Creek Road, Carindale QLD



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