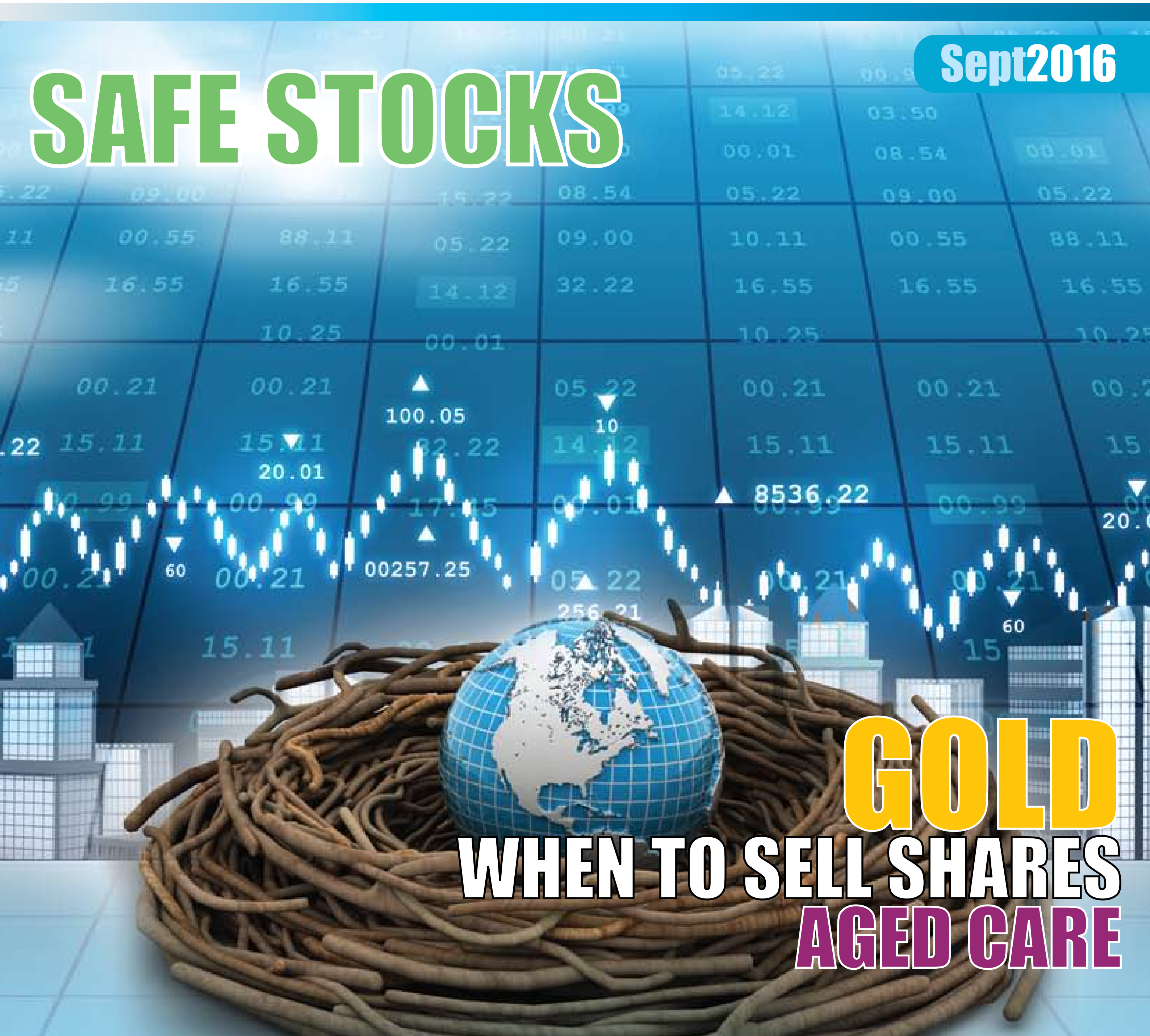
the INVESTORS voice

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



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Investors Helping Investors
The Australian Investors Association (AIA) is a national, non-profit , independent association of investors dedicated to helping other investors achieve their goals through education and advocacy.

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President's Message
By Graeme Bottrill

Reporting Season

The investing climate continues to be challenging. As I write this, w the full year reporting season, and so far, the standout has been a $ reported by BHP. Since 2007, BHP has traded generally above $30 several occasions in 2007, 2008, 2010 and 2011, but has trended d early 2015, to now trade around $20. A loss of more than $100 billion in shareholder value. There are other much less significant but similar stories. Insurers seem to be struggling, and Moody has just put the four big banks on negative ratings outlook.

One of the gems that I took away from our conference (more on the conference later) was Charlie Aitken's comment that if you want to know which companies will do well, just look at what your kids and grandkids are doing. In this light, we could have expected results like JB Hi-Fi (which hit another record high after reporting a strong result) and Domino's Pizza (which reported a 29% jump in profit). Our kids are all playing on their smart-phones whilst eating pizza in front of their new mega TV screens!

On the interest rate front, former US Federal Reserve chairman Alan Greenspan forecast that interest rates will begin rising soon, perhaps rapidly. He said "I cannot perceive that we can maintain these levels of interest rates for very much longer." I have read other pieces suggesting the contrary, so which is it? None of us really have any idea!

On the jobs front, we see that there has been no growth in full-time employment in the past year. Our Federal Treasurer Scott Morrison said '"A job is a job, and more jobs is always a good thing". Australian jobseekers filled 71,600 new positions. But not a single one of those positions was full-time - according to the Australian Bureau of Statistics, all were part-time. I expect that the average family might disagree with Mr. Morrison, and they would rather that the breadwinner had a full-time job. Our economy has many bright spots, but some sectors are struggling.

Obviously, our task of finding safe investment growth and return is not going to get easier anytime soon.

The conference

Our annual conference was held one week ago, and what a fabulous event. We have attendance figures for the past 16 years, and this year was a near record. The theme was all about Strategies for an Uncertain World, and the general opinion was that we covered the topic very well. There seemed to be a real buzz this year and everyone seemed to participate. I witnessed many in-depth conversations during the breaks, and this is partly what our conference is all about.

The success of the event is no doubt due to the hard work of everyone involved. The committee worked on the theme and the session details, and then invited the best speakers for each topic. The general consensus was that we had an incredible line-up of great speakers this year. Our AIA staff did a fabulous job and the staff and volunteers on the registration desk, etc., attended to the members needs with a calm efficiency. We are very proud of our sponsors and grateful for their support.

The 2017 conference will be held on the Gold Coast from Sunday 30th July to Wednesday 2nd August. Planning for next year's conference will commence shortly. We also have some plans for other events for next year, and further ideas to add even more value to your membership.

Superannuation

Discussion continues in the media regarding the proposed changes to superannuation. I have seen three articles this week, one from Darryl Dixon of Dixon Advisory, one in Eureka Report, and one from MLC's executive general manager of superannuation and investment platforms, Paul Carter; all arguing for a rethink. Your board has been active in keeping the matter alive by writing to various politicians. More about this in the next Investor Update.

Until next time, regards to all.
Graeme Bottrill

Finding safe stocks likely to outperform

COLIN NICHOLSON

Over the long term, investing in stocks will give a higher return than most other asset classes, especially if the return is considered after the corrosive effect inflation has on purchasing power. However, investing in stocks is not without risk. Some companies fail. Most stock prices fluctuate over time. If there was no risk, then the return would be much lower. The task for investors is to know how to select stocks for their portfolio that are truly investment grade businesses and that can be bought at a price that is low relative to value. Here are some guidelines.

Only Buy Investment Grade Stocks

There are over 2,000 securities listed on the Australian Securities Exchange. Most are not investment grade. To get to a short list of potentially investment grade stocks is simple: run a filter that lists stocks that make a profit (Price Earnings Ratio > 0), pay a dividend (Dividend Yield > 0) and have a liquid market (say a Market Capitalisation > $500 million). That will generate a list of around 200 stocks and will keep you away from the real rubbish stocks. I publish a scan each week on my members website www.bwts.com.au. The scan may also be done in Stock Doctor.

That are Rising in Price

A good way is to look for stocks that are making new 52-week highs in the last week, which can be done by running a simple scan of the above investment grade stock list. My ideal is to find the ones that have been going sideways for a year or more and are now starting to rise, rather than stocks that have been rising for a year or more, where it may be late to join the party. This is based on my two models that are explained in my book Building Wealth in the Stock Market. I publish a scan each week on my members website www.bwts.com.au.

With Growing Earnings and Dividends

This is best seen in visual form by graphing earnings per share and dividends per share for at least the last ten years. Most leading broking websites have the data from which to do this. Some companies publish a graph in their investor presentations, available on the ASX website Announcements page.

With a Moderate Price Earnings Ratio

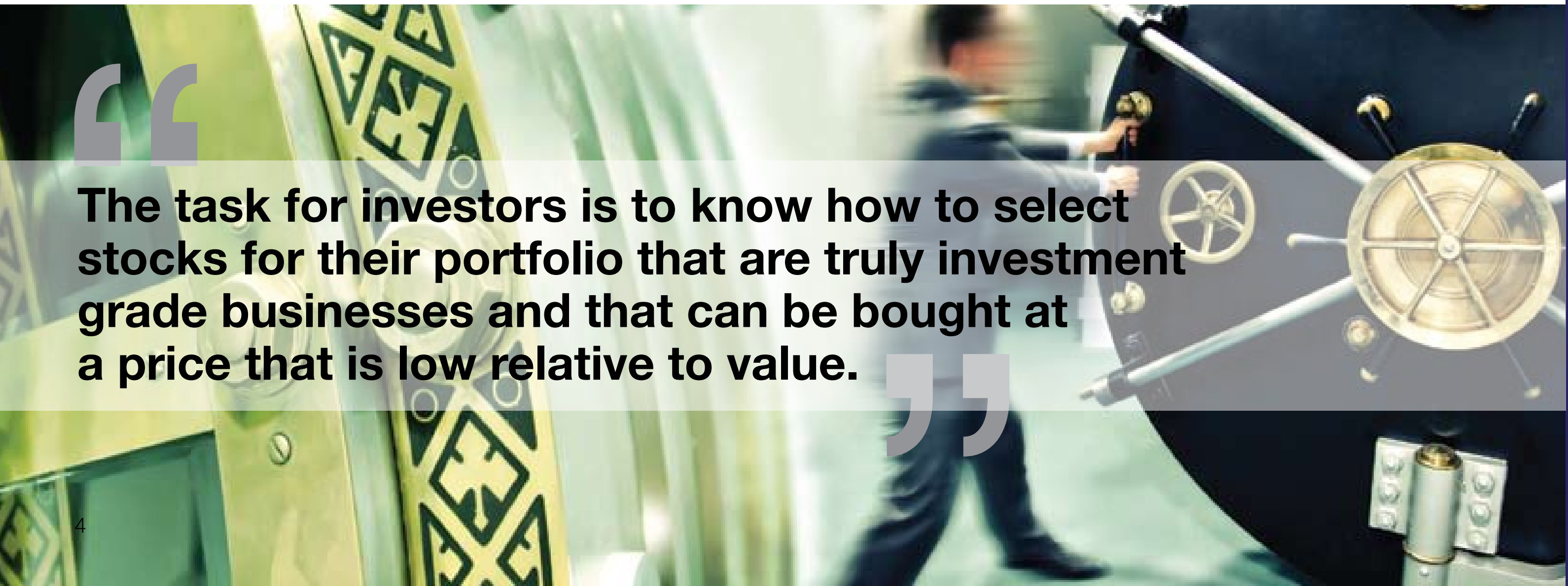
There are various definitions for price earnings ratio, so understand your source and use it consistently. Moderate is in the eye of the beholder, and must take into account the characteristics of the business that underlies the stock. I use these guidelines: For value stocks that are generally in cyclical industries, I prefer a price earnings ratio that is significantly below the market average. For growth stocks that are often in less cyclical industries, I prefer a price earnings ratio that is not too far above the market average. The market average is published weekly in the Weekend Australian Financial Review.

With a Relatively High Grossed-up Dividend Yield

Relatively high is again in the eye of the beholder. My guidelines are: for value stocks that are generally in cyclical industries, I prefer their dividend yield to be above the market average; for growth stocks that are often in less cyclical industries, prefer their dividend yield to be not too far below the market average. The market average is published weekly in the Weekend Australian Financial Review and may be grossed up assuming 75% franking.

With an Appropriately Low Debt to Equity Ratio

The word appropriate is important. What is appropriate depends heavily on two things. Firstly, on the nature of the industry the business operates in: the more cyclical the industry the lower the appropriate debt to equity ratio. Secondly, on your level of risk tolerance and experience: the lower your risk tolerance and the less experience you have, the lower the appropriate debt to equity ratio. My rule of thumb, is a maximum of 40% debt to equity for a cyclical business and 60% for a non-cyclical business. There are varying definitions of ratios here, so understand the ratio you are using and adjust the rule of thumb accordingly. The ratio is easily calculated from the Statement of Financial Position (balance sheet): Non-current financial debt divided by Shareholders Equity expressed as a percentage.



“The task for investors is to know how to select stocks for their portfolio that are truly investment grade businesses and that can be bought at a price that is low relative to value.”

With a Strong Return on Equity

Of course, strong here is in the eye of the beholder. I base it on my cost of capital, which is a term that describes the return I want that will compensate me for the inherent risk of investing in stocks. My cost of capital is 12.5%. So, I want a return on equity that is higher than 12.5%. The ratio is easily calculated from the accounts: earnings before tax from the Statement of Financial Performance (P&L account) divided by Shareholders Equity from the Statement of Financial Position, expressed as a percentage. It is important to look at the trend over recent years. The ratio is available in Stock Doctor. One point to remember is that the ratio is affected by the level of debt and some analysts prefer using a return on assets ratio.

This article has been designed as a basic guide to keep private investors generally safe in the market. However, it must be recognised that any business can get into trouble. It is therefore a good policy to recheck the key measures above each half year to make sure the business remains on track. It is even better to work at improving your understanding of the business. After all, by investing in a stock, you have become a part-owner of the business, not just someone who is trading the stock price. There is no real substitute for sifting through the list based on the above guidelines and selecting the best businesses that will have good management and a strong competitive advantage in their market.

Colin Nicholson teaches investing in his books Building Wealth in the Stock Market and Think Like the Great Investors and through his website www.bwts.com.au.

GOLD
Is the strongest form of money

PETER HALL, AM

There are some fundamental reasons why the gold price has more upside. Here are some golden opportunities to consider.

We started our journey investing in gold in 2014, observing that a stock we sold out of the funds in 2012 – at average prices of over $2 per share – had fallen to below 10c. That stock was St Barbara Limited.

As we researched St Barbara, we discovered that the gold sector was profoundly out of favour. There were a number of stocks selling at low valuations compared to their likely cash flows at the current gold prices.

We did not invest with the expectation that the gold price would rise. Rather, it was on the premise that it would stay flat, or go down. We purchased two stocks – St Barbara and Doray Minerals – which shared the characteristics of the highest production grades and margins so they would still be profitable even if the gold price fell.

Why gold should rise

However, at the same time, we recognised the potential for the gold price to rise at some, unknowable, time in the future. For two reasons. First the amount of gold in the world is growing at a very slow rate, particularly when compared to the rate of growth of paper money, given fiscal deficits, quantitative easing and the growth of derivatives. Put simply, if the volume of paper money is growing quickly and the volume of gold (a form of money) is rising slowly, the price of gold, expressed in paper money, will inevitably rise.

The second reason for gold to rise is that people want to hold more gold in an increasingly risky and incomprehensible world. The world is divided into four large economic and political blocs - China, Japan, Europe and the United States. Of course there are many other players but the balance of the world lies in the relationships between these four. For the last few decades they have lived in an uneasy and fragile truce where the relativities of interest rates, currencies, trade and capital flows have been acceptable
to all.

However, I used the word "fragile" to indicate that balance is not guaranteed and is vulnerable to shocks. One such shock has just occurred in the form of Brexit which is likely to lead to significant changes to the European Union and the Euro. One possible scenario is a collapse of the Euro and/or the European banking system. This could be followed by a crisis of national finances as sovereign debt increases rapidly, possibly exacerbated by a recession which would reduce tax revenues and increase government spending. The only way out would be further creation of paper money and further degradation of its quality.

The interest rate game

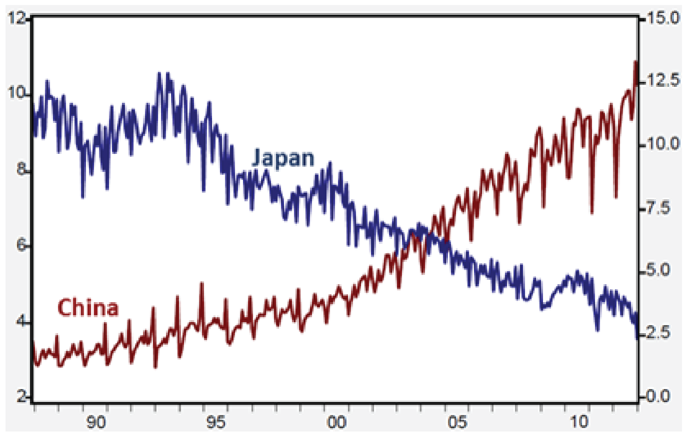
Interest rates have declined to very low levels and many government bonds now have negative real interest rates. This threatens the balance of interest rates and currencies between the Big Four. Whenever the Americans put interest rates up the Chinese devalue their currency and that means their goods become cheaper which greatly impacts the industrial activity of Japan, Europe and the United States.

China – the workshop of the world

Over the last 40 years, China has become the workshop of the world through innovation, human enterprise and central government assistance.

The graph shows the share of world trade of China and Japan. In the late 80's, Japan had a 10% share of world exports. This has fallen to about 2.5%. China, on the other hand, has risen to 12.5%, winning share from Japan, Europe and the United States. Wealth is being transferred to China from the other three and is destabilising their relationships at many levels.

Japan and China's share of world exports (%)



Source: Grants Interest Rate Observer Conference, April 2016. Scott Bessent, Keysquare.

The bar bell portfolio structure

Hunter Hall is a value manager with a flexible investment mandate that can invest anywhere in the world. That generally leads us to investing in small to mid-cap stocks. The stocks that have driven most of the performance have been stocks where the ratio between risk and reward is tilted towards reward. These are stocks that have a payoff profile by having operating or financial leverage, they may have debt or if sales go up or down there is a big impact on profit or loss.

Gold has a wonderful future because the ratio of paper money to physical gold is in gold's favour.

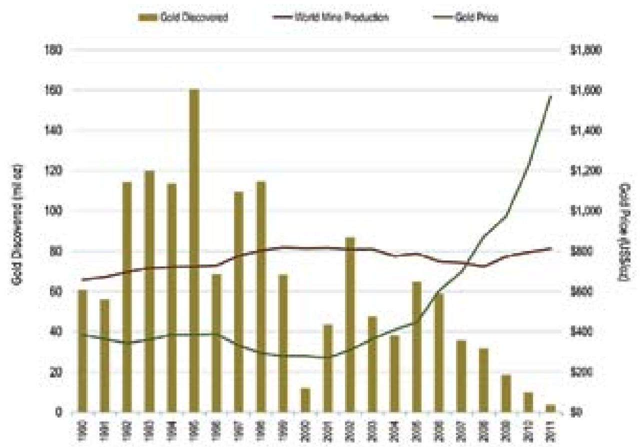
The gold rationale

We think gold has a wonderful future because the ratio of paper money to physical gold is in gold's favour. As mentioned previously, more and more paper money is being generated as governments overspend and keep interest rates low.

You would think that as the price of something goes up production would increase but this has not been the case with gold. Mines are going deeper, which is costing miners more money; gold is so rare that it is economic to mine ore with one part of gold per one million parts of rock! (1 gram a tonne); there is only a finite supply of gold; and there haven't been any significant technological innovations in gold production since the 1980s when heap leaching was developed. The bottom line is that the rate of gold discoveries has fallen and production is growing very slowly even while the gold price has moved up considerably.

This chart shows how gold discoveries have fallen over time, production remains weak, and the price of gold has been rising.

Gold Discoveries—Fallen Since 1980s



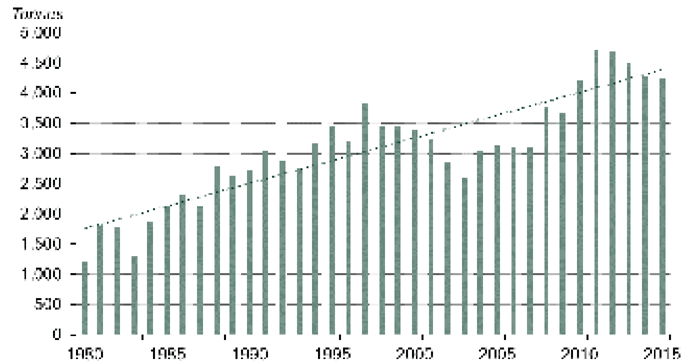
Source: Grants Interest Rate Observer Conference, April 2016. Pierre Lassonde, Franco Nevada Corp.

The demand for gold

Gold demand is rising. In 1980, demand for physical gold was about 1,800 tonnes a year. It is now over 4,000 tonnes a year, rising around 3% per year since 1980.

Part of the reason for the recent spike in the gold price is to do with interest rates, because when you have negative interest rates which we have in a large part of the world's bond markets - why not put your money into gold rather than a currency that gives you a negative return?

Gold demand up about 3% a year since 1980



Source: Grants Interest Rate Observer Conference, April 2016. Pierre Lassonde, Franco Nevada Corp.

To our initial portfolio of two gold stocks (with high margin gold production which make up 75 - 80% of our gold portfolios) we have added some more speculative plays which make up 20% - 25% of our gold portfolios. Beadell Resources owns the third largest mineral mine in Brazil and has substantial exploration potential. Two other names we hold are Blackham Resources and Aphrodite Gold.

Australian domiciled, St Barbara, has been a strong performer for Hunter Hall; we have turned $8m into $221m at the time of writing. St Barbara is one of the lowest cost gold miners in Australia; it has large reserves; it was financially and operationally leveraged when we acquired our stake; but it has very impressive management that has done a brilliant job in turning it around. The long term development of that company will be to further pay down debt and then deploy the free cash. Looking at the valuation numbers, our calculus of the current price is about 4x their cash flow in 2018 so there is definitely room for the stock price to move up.

Peter Hall, AM is Founder & Chief Investment Officer, Hunter Hall Investment Management Limited

Three good options in a low-interest rate environment

ELIZABETH MORAN

Global interest rates remain low, and domestic inflation at just 1% year on year is a good indication that our cash rate should move lower. The question is, how low can it go and what protection do you have in your portfolio?

A 1% cash rate is a possibility.

Paul Dales from Capital Economics, who pretty much was the only economist to accurately predict the official cash rate would fall below 2 per cent (that was his base forecast for more than a year), now thinks it will fall to as low as 1 per cent… "Our conclusion is that underlying inflation will remain below the RBA's 2 per cent to 3 per cent target range for longer than we previously thought, which may prompt the RBA to cut interest rates to 1 per cent next year," said Dales. – Philip Baker, AFR June 2016

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The Reserve Bank is likely to cut the official cash rate to just 1 per cent to head off deflationary pressures and get economic growth up to speed according to big global investment bank JP Morgan.

In a research note, the bank's fixed income team said the cash rate was likely to edge down another 25 basis points to 1.5 per cent by the end of the year and a further 50 basis points to 1 per cent by the middle of next year. – Stephen Letts, ABC News May 2016

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If the low point of the cycle is 1%, we are still in for multiple cash rate cuts. If we are headed in this direction, growth should slow and growth investments – such as equities – should struggle in coming years.

The way that global investors have hedged against lower interest rates for longer is by locking in fixed rate returns.

Three good options in a low interest rate environment

1. Deposits
Low risk, shorter dated fixed rate examples include deposits. Five year term deposit rates for personal investors vary considerably. Two good five year rates, both available from regional banks, are as follows:

- 3.00% per annum, minimum $500,000
- 3.45% per annum, minimum $20,000

The best major bank rate over the same term is 2.80% per annum, for a minimum $20,000.

However, maximum terms for term deposits are for five years, which may not be long enough if you think interest rates will be low for a long time. Alternatively, longer dated fixed rate government and corporate bonds can extend the term of the investment out to ten years or more.

2. Long-dated, investment grade fixed rate bonds
Long dated fixed rate bonds are protective in declining interest rate environments. Not only do they ensure known income, but bond prices will rise as the expectation of interest rates falls, providing higher than expected returns.

The downside is that if there is an expectation that interest rates rise, the bond price will fall.

> ***While I think you want some longer-dated protection in your portfolio with an exposure to longer-dated bonds, I would still recommend holding investments with a range of maturity dates.***

Below is a sample of some longer dated fixed rate bonds.

The lowest risk option is the Queensland Treasury Corporation, a very long dated bond maturing in around 17 years in 2033, paying 2.60% per annum. This bond's face value has risen to over $150 since it was first issued – a great investment for those who bought it a few years back.

An Apple bond investment, which is similarly highly rated, but has a shorter term to maturity of six years, has a slightly lower yield to maturity of 2.53% per annum. This investment would make a fine addition to a portfolio but few will find that rate of return attractive.

Moving out on the risk curve; one I've liked for a while is the Rabobank 2024 bond. The yield to maturity has compressed since I first suggested the bond, but at 3.19% pa until 2024 it still provides a reasonable level of certainty for longer.

Two corporate bonds with the same credit rating – Asciano and Downer – have bonds maturing in 2025 and 2022 respectively. The Asciano bond has a yield to maturity of 4.52% per annum while Downer is 4.06%, showing a 0.46% pick up for an additional three years to maturity.

The Westpac subordinated bond remains a favourite, with a first call date in seven years and a yield to maturity of 4.02% per annum.

Investment grade fixed rate bonds with more than 5 years to maturity

Company	Maturity/ call date	Capital structure	Yield to maturity	Minimum investment
Apple Inc	28/08/2022	Senior Debt	2.53%	$10,000
Asciano Finance Ltd	19/05/2025	Senior Debt	4.52%	$10,000
Downer Group Finance Pty Ltd	11/03/2022	Senior Debt	4.06%	$10,000
Qantas Airways Limited	19/05/2022	Senior Debt	4.14%	$10,000
Queensland Treasury Corporation	14/03/2033	Senior Debt	2.60%	$50,000
Rabobank Netherlands AU	11/04/2024	Senior Debt	3.19%	$10,000
Westpac Banking Corporation	14/06/2023	Subordinated Debt	4.02%	$200,000
Sunland Capital Pty Ltd	25/11/2020	Senior Debt	7.15%	$10,000

3. High yield fixed rate bonds

The other option to counter low interest rates is to extend your risk profile. Higher risk investments should provide higher returns. However, with so much volatility you need to think about what the downside was for these investments during stressed markets such as the GFC.

High yield bonds are higher risk but still the legal obligation of the company issuing them, giving investors some confidence about income and repayment of capital at maturity, assuming the company continues to operate.

Below are three examples. Plenary is involved in public infrastructure projects, SCT Logistics is Australia's largest private rail freight operator and Sunland is an ASX listed residential property developer. These bonds have yields to maturity that range from 5.63% for Plenary, through to 7.15% for Sunland.

High yield fixed rate bonds

Company	Maturity/ call date	Capital structure	Yield to maturity	Minimum investment
Plenary Bond Finance Unit Trust	16/06/2021	Senior Debt	5.63%	$10,000
SCT Logistics	24/06/2021	Senior Debt	6.35%	$10,000
Sunland Capital Pty Ltd	25/11/2020	Senior Debt	7.15%	$10,000

Note: Rates accurate as at 29 July 2016 but subject to change
All bonds listed are fixed rate
Black = retail and wholesale investors; red = wholesale investors only

This list is not exhaustive but meant to give you an idea of the returns available.

Elizabeth Moran is Director of Education and Fixed Income Research at FIIG Securities

The 3 Biggest Mistakes Investors make when it comes to selling their stocks ...and a simple three step solution

ROB MARKHAM

In this article I hope to give you a few quick and easy techniques to know when to sell your stocks.

Have you experienced:
- Holding onto a stock, watching it drop and hoping it will come back?
- Having a profit in a stock, not selling it and then eventually selling it for a loss?
- Buying a stock and watching it go down right after you bought it?
- Having a few losing trades kill your portfolio?
- Market volatility causing you to sell a stock only to watch it rebound the next day?
- Feeling the market is against you?

You're not alone. Knowing when to sell a stock is the most difficult thing for most investors. Not knowing causes frustration & anxiety and typically leads to losing money. Suffering losses shakes your confidence.

You begin to take unnecessary risks to make the money back you've lost which leads to bigger losses.

Understanding the three biggest mistakes investors make when it comes to selling stocks will reveal WHY selling a stock is so difficult for most people.

BIG MISTAKE #1
YOU THINK OF THE MONEY FIRST

One of the biggest mistakes you can make is to think of money first. I know, the main goal of investing is to make money, right? Well, isn't that true for any profession? How would you feel if you were sitting in the dentist chair getting ready for a filling and you knew your dentist was thinking about how much money he was making off of you rather than doing his job well?

Successful people go into work and concentrate on doing their job well. That is the key statement. If you are successful with your job, you do your job well. If you do your job well, you get paid for your good work.

The point of this is that successful investors don't treat investing as a hobby. They treat it as a job and think about doing their job well. If you do your job well, the money will follow.

So your goal as an investor is to make the best trades. You should write that down and underline it. "My goal is to make the best trades" If you make the best trades, money will follow from that.

> *"As an investor, you must survive. By setting a maximum you are willing to lose per trade, you are minimising your losses. This is key to your survival."*

BIG MISTAKE #2
YOU TRADE BASED ON EMOTION

We've all been there. We let emotions get the best of us. Put a tick next to any point below that has happened to you.

- GREED—You had a profit in a trade, but didn't sell because you wanted to make more.
- HOPE—A stock you own is down, you don't sell because you hope it will come back.
- FEAR—You own a stock and are afraid it may drop quickly. Perhaps you risked a little too much of your money on that trade.
- FRUSTRATION—You sell only to watch the stock continue to rise.
- ANGER—The stock you once had a profit in drops and you now sell it for a loss.
- DESPAIR—Losing trades add up and your portfolio is hurt.

If you made at least one tick, keep reading. You're in the right place. Being emotional has a place, but its place is not the stock market. When you are emotional you are not thinking clearly and you make poor decisions. You make decisions you would not make otherwise. Anytime you are emotional, your decision making process becomes cloudy.

BIG MISTAKE #3
YOU GO INTO THE TRADE WITHOUT A CLEAR EXIT STRATEGY

The main reason emotions creep into your investing is because you enter a trade not knowing exactly when you will sell it. If you currently have stocks in your portfolio, ask yourself if you know exactly what will cause you to sell them. If so, do you have it written down? Even more important, will you follow it? So whether things go the way you want or not, you must know how to exit. You need to have the same thought process in place for each of your trades. If things go well, when will you sell? If things don't go well, when will you sell?

If you've been making these mistakes where do you want to be?
- You want more winners and fewer losers
- You want steady gains you can rely on
- You want to buy stocks and have them go up after you buy them, not down
- You want to be able to make money consistently
- You want to be confident in yourself and your ability to invest successfully

The **3 Step Portfolio Management System** that follows will help you decide how to sell and buy a stock.

STEP #1— SET YOUR MAXIMUM LOSS

The first thing you need to do as an investor is ensure your survival. If you were to look at your investing history and sorted it by the gain or loss, there are probably a couple of trades that you wish you could take back. Trades that most likely killed your portfolio for the whole year or worse yet, killed your portfolio entirely. If you didn't let those trades get away from you, your portfolio might even be OK. By setting a maximum amount you are willing to lose on each trade, you are actually minimizing your losses. This is key to your trading survival. If you allow yourself to lose too much on each trade, you can only have a few losers in a row before your portfolio is crippled. Remember, not every trade you make will be profitable so you need to ensure your survival in case you do run into a string of losing trades.

To set your maximum loss, follow this guideline: Only risk losing 1% of your total capital on each trade. In other words, set your stop price so your maximum loss on any trade is no more than 1% of your total capital. Here is a helpful formula you can use. If say for example, your trading account is $100,000, 1% of that would be $1,000. If you choose to put $20,000 into a single position, you would need to use a 5% stop loss to ensure the most you lose is $1,000. However, you may think 5% is too tight and doesn't give your stock enough room to move. If that is the case, you can invest $10,000 in that stock and that will allow you to use a wider stop loss of 10%. For a $5000 position you would use a 20% stop loss.

STEP #2— NEVER GIVE BACK MORE THAN HALF YOUR PROFIT

How many of us have invested in a stock to see it rocket up, say 80%, only to see the profit fall to 60%? "I can't sell now, I used to be up 80%, I'll give it time to come back" Then the 60% profit turns to 40%. "I might as well hold on now and see what happens." Eventually, the trade loses 100%. We should never watch a profitable trade turn into a loser and I suggest you do this by never giving back more than half your profit. You should have a profit objective and never lose more than half of that. I would suggest starting with 10% and once you hit 10%, make sure you walk away with at least 5%.

STEP #3— BUY THE RIGHT STOCKS AT THE RIGHT TIME

What are the right stocks and what is the right time you ask? I think it would be better to start by explaining what the wrong stocks are.

Wrong Stock # 1

Stocks moving down in price. One of the worst things that investors get taught is to buy a stock that is moving down in price. After all, isn't it getting cheaper? There is hardly a worse thing you can do. There is a well-known saying, "Don't try and catch a falling knife." If you do, there is a high probability you will get hurt. When is it safe to catch the knife? Once it has hit bottom. The key with stocks is to know when they have hit bottom. I once heard an investor ask Dr. Bart DiLiddo, Founder of VectorVest Inc. when he knew a stock had hit bottom. His reply was very simple, "When it begins to go back up."

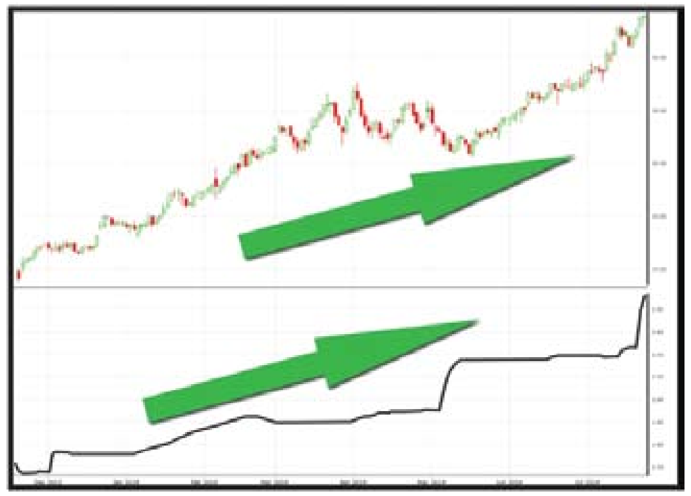
Wrong Stock #2

A Volatile Stock. Owning a volatile stock makes you nervous & worried about what the next day's trading may bring. Even the slightest down move in that stock may panic you to sell because you think it will drop drastically. Some investors think that once they buy a stock, things will change. Remember this, what you see in the past is most likely what will happen in the future. If a stock has a volatile past, it will most likely continue to be volatile moving forward. While there is a possibility the stock may rise over time, it is going to be a wild ride. Most investors can't (and shouldn't) handle it.

Now that you have an idea of what the wrongs stocks are, let's look at what we mean by buying the right stocks at the right time.

Buy Steadily Rising Stocks with Steadily Rising Earnings in a Rising Market. Guess what? It works! There is no need to get complicated. You can look at other more sophisticated techniques once you've nailed this for 6-12 months. It will take 6-12 months to completely break old habits and prove to yourself you can consistently get the returns you want. That doesn't mean you won't begin to see results sooner. In fact, you should start to see results after the first 30 days. The next piece of information is the most important so keep reading... Since you don't want to buy a volatile stock that is moving down in price, it only makes sense that you should focus your attention on stocks that are steadily rising in price and are not volatile. Let's look at an example. Ideally, you want to look for a stock that looks like the one in the graph below.

PRICE & EARNINGS GRAPH



Here are some qualifying questions to ask yourself.
- Over the past year in particular, does the price move from the lower left corner of the graph to the upper right corner?
- When the stock does pull back, what is the percentage of the pull-back before it starts to move back up?
- How quickly does it drop? (3-5 days, 3-5 weeks?)
- Can I handle that if it were in my portfolio?

We've found there is one main thing that drives stock prices higher and higher over time…Rising Earnings. Earnings is the engine that drives stock prices higher. When a company's earnings are rising, that company can grow. We've found that companies with rising earnings have stock prices that tend to go higher. Wouldn't you rather invest in a company that is making more and more money every year?

Three steps to know when to sell shares *continued...*

The single most important thing you need to know before you place any trade is the Market's Trend. You might have heard or been taught that no one can 'time the market'. There is a huge difference between 'timing the market' and 'predicting the market'. I agree that no one can predict what is going to happen in the stock market. However, it is possible to determine the trend of the market. Conventional wisdom says that stock prices move in a random fashion and you cannot 'time the market'. I would agree if you looked at the prices of individual stocks you would think the market is chaotic. However, look at the graph below showing the market since 2007.

TOTAL MARKET SINCE 2007 GRAPH

It is clear to see that the market moves in a remarkably deliberate fashion, forming up and down waves as time goes by. The key then is to determine the direction of these trends as they are unfolding. Never try to predict what will happen. Remember, "Don't try to catch a falling knife." If you buy stocks at the wrong time or don't protect your stocks while the market is in a down-trend, your portfolio can suffer losses which may take years to recover. (Remember 2008!) If your Portfolio drops 50% you will need to gain 100% to get back to break even.

What do you do now? Get Started!

You will begin to grow your confidence. You will begin to see your winning trades increase. Your losing trades will decrease in number and severity.

Whatever you do, don't give up!

Like anything in life, it will take practice before you get the hang of it. Keep at it! You WILL improve your portfolio!
For more go to www.vectorvest.com.au and visit our blog.

Rob Markham – Managing Director VectorVest Asia Pacific

Waiting for the world to change

JULIA LEE

If you want the value of a company to go up or down, you need something to change. If everything was to remain the same, then the value of the company should not change.

Have you ever made an investment into a solid, good company, only to have the share price remain static for a number of years? Or seen a company announce a record profit, only to watch the shares fall? Or held a non performing company, only to see the share price rocket higher? What is it that moves share prices?

The key inputs into the value of a share are forecast earnings and a risk free rate. Hence for a share price to move, you usually need a catalyst which means different earnings growth in the future. That catalyst could be new management, new strategy, new product or better sentiment.

At the heart of an increasing stock price are changing conditions. This is usually positive for the earnings outlook of the company. Most fundamental analysts favour buying strong, good quality companies. However, it is often the companies that are out of favour, with bad news priced into the stock, that have the most stunning recoveries when the business shows signs of turning.

Here is a share price chart of Bluescope Steel 2012-2016. Not many people would describe Bluescope steel as a fundamentally strong company and yet the share price has increased 462% from the lows in 2012. The market went from pricing in the possibility of bankruptcy to entering into an upgrade cycle and a rapid increase in the share price. Year to date, the share price is up 28%. The point is that the company managed to turnaround its fortunes and the share price also recovered.

Time and money
If I gave you $10,000 today, what would you do with it? I'm sure you can think of lots of interesting answers, but one (very boring!) option would be to put it in a term deposit, earning a fairly safe 5%.(should this be 3%) If you did that, you'd have $10,511 in a year's time. Leave it in for another year at the same rate, and you'd have $11,049.

So what would you do if I asked you to wait two years for the money instead of giving it to you today? How much more would I need to give you to make waiting worth your while? Looking at those figures, you might say "at least $11,049". So, if we take 5% as our theoretical base rate of return, we can say that $11,049 in two years' time is worth the same as $10,000 today.

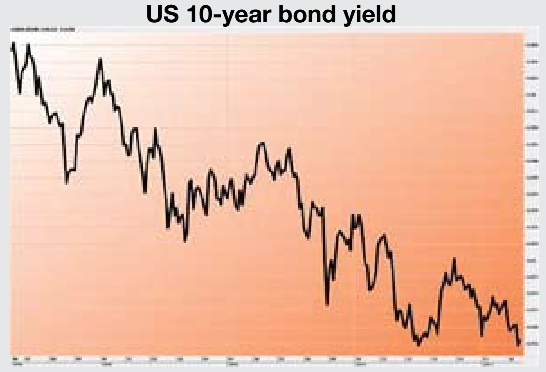
That's where the 'discounted' part of discounted cash flow comes in. When we look at a company's future earnings, we need to discount them back to today's dollars. That also means we have to choose a base rate of return, or discount rate; 5% in this case.

"it is often the companies that are out of favour, with bad news priced into the stock, that have the most stunning recoveries when the business shows signs of turning."

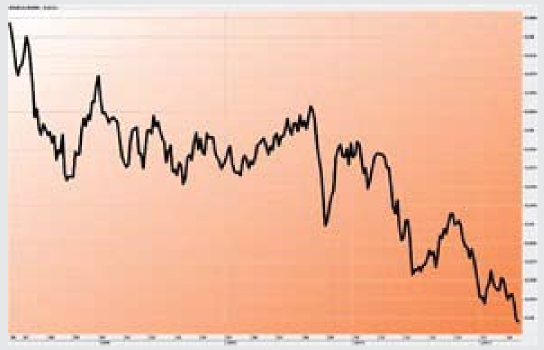
The problem with the risk free rate at the moment is that it has been distorted by central bank intervention. It is at artificially low rates. In some parts of the world we are seeing negative interest rates. What happens to share valuations when interest rates return to normal levels?

Looking at bond yields
Looking at the 30-year bond yields for the US and you can see that there has been a multiyear downtrend in place. With the US Federal Reserve now looking at raising rates off historical lows, what implications does this have for asset prices around the globe?

US 10-year bond yield



Australian 10-year bond yield

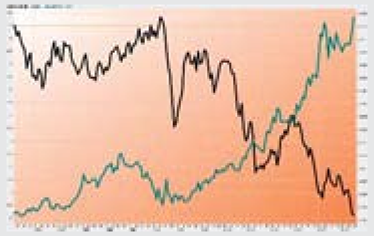


Source: Bell Direct, IRESS 27.07.16

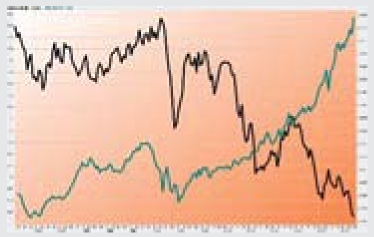
In Australia, the trend has been similar with bond yields falling down to record lows. As interest rates normalise, what will be the impact and where will the impact be the greatest?

The greatest impact will most likely be in those stocks that are being priced like bonds. In the following table, APA, Sydney Airports and Transurban in blue are being compared to the 10-year Australian Commonwealth Government bond yield in black from 2002-2016. As you can see the inverse relationship between the share price and bond yields has intensified over the last few years.

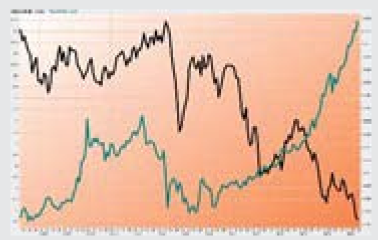
APA vs 10-year bond yield



SYD vs 10-year bond yield



TCL vs 10-year bond yield



Source: Bell Direct, IRESS 27.07.16

Looking at Sydney Airport
Sydney airport has seen its share price up 400% since 1 July 2008. That compares to the Australian sharemarket which has gained 5% in that time. Driving the gains have been falling interest rates. What happens when interest rates begin to rise?

The bullish scenario is that the stronger economic growth that higher interest rates suggest would offset rising interest rates. The bearish case is that the debt burden would become more cumbersome and with the risk free rate used to value companies rising, the valuation for Sydney Airports would fall dramatically.

Conclusion
The point is that if nothing changes, the value of the business should not change. When investing it's important to ask: "What is the catalyst that will move the share price?" Is it a new product, a new strategy, new management or changing investor sentiment? All these things can be triggers for positive earnings momentum.

The market is at or close to an important inflection point where we could now be seeing rising interest rates in the US. If that was the case, it would be a game changer for companies with large piles of debt and/or high stable dividend yields.
When investing, it's important to identify companies that have a reason to move upwards and onwards.

Happy investing!
Julia Lee, Equities Strategist - Bell Direct

Prepare to pay more for aged care

RACHEL LANE

Aged care facilities in Australia are funded by a combination of resident and government payments. In 2013-14, the government spent $14.8 billion on aged care services, with about $10 billion of that going towards residential aged care.

Through a range of different measures, the government is withdrawing about $2 billion of funding from the industry over the next four years, which has left aged care operators with a tough choice – cut their costs to make ends meet or maintain their current standards and ask the residents to pay more. Given that personal care is the greatest expense of an aged care facility, it is not surprising that many operators are choosing the latter.

Levies on aged care residents

While most aged care fees and charges are government regulated, aged care facilities can levy other payments on residents by mutual agreement.

When it comes to accommodation payments, aged care facilities set the market price for each bed. Those who wish to set a price above $550,000 require approval from the Aged Care Pricing Commissioner. The price of the beds must be published in the facility's marketing materials, on their website and on the government's MyAgedCare website. Residents must also be given the choice of paying for their accommodation by a lump sum (known as a Refundable Accommodation Deposit or RAD), a daily charge (known as a Daily Accommodation Payment or DAP) or as a combination of the two. The daily charge equivalent is regulated, with the government setting the interest rate for the calculation, which is currently 6.01%.

So if the market price is $500,000 the resident can choose to pay $500,000 as a lump sum or $82.33 as a daily charge. If they chose to pay $200,000 by lump sum then the daily charge would be reduced to $49.40.

A number of aged care providers have introduced additional accommodation payments. These payments are set by the individual facilities and take a number of different forms – some are fixed daily amounts, some only apply to residents who pay by lump sum, some are pro-rated (based on the amount of lump sum paid) and some are capped at a dollar amount or after a period of time.

Examples of specific charges

Let's look at some examples. At one group of facilities residents who pay any amount of their accommodation cost by lump sum are charged an additional $10 per day as what the facilities call a 'Capital Refurbishment Fee'. The fee is charged for as long as the resident stays. So if they stay there for two years they will pay an extra $7,300 and if they stay for five years it will cost them $18,250.

At another group, the facilities are graded and the residents are charged an 'Asset Replacement Contribution Fee' of between $13 per day and $18 per day, depending on the facility. Those in the lowest grade only pay the $13 if they choose to pay towards the cost of their accommodation by lump sum, while those in the highest grade pay the $18 regardless of how they pay for their accommodation. So in the lowest grade, residents who pay by lump sum will pay $9,490 after two years or $23,725 if they stay for five years and in the highest grade everyone will pay an additional $13,140 for staying for two years or $32,850 if they stay for five years.

The bottom line is that consumers should expect to pay more, and in some cases a lot more.

There is at least one group who both pro-rata and cap their fee, which they call an 'Asset Replacement Contribution'. That fee is a maximum of $13.70 per day and is charged for up to 2.5 years and prorated based on the amount the resident pays by lump sum. So if the resident pays entirely by lump sum the cost would be $12,501 after 2.5 years, whereas if they paid entirely by daily charge the Asset Replacement Contribution fee would be zero.

While there are a handful of operators currently levying these fees and charges, there are many more considering following suit. We have already seen significant increases to what residents are paying for additional services such as wine, Foxtel and personal therapies and I expect there will be an expansion in both the services offered and the costs associated with them as operators look for more revenue opportunities.

Call the fees and charges what you like. The bottom line is that consumers should expect to pay more, and in some cases a lot more.

Rachel Lane is the Principal of Aged Care Gurus. Article courtesy of Cuffelinks www.cuffelinks.com.au

2016 AIA National Conference

Our 2016 National Investors Conference has turned out to be our best conference yet.

300 delegates spent three days in the enjoyment of networking with each other, hearing from Australia's most respected financial and investment specialists and enjoying the beautiful surrounds of the Marriott Resort and the Gold Coast.

The title of the National Conference – Volatility, Risk and Return – Strategies for an uncertain world, set the scene for the three days of the conference. Delegates heard over 40 presentations on investing and came away full of ideas, strategies and trading tips for these uncertain times.

Engagement was the real benefit for all, with attendees regularly engaged with presenters, sponsors and other delegates. The best networking function of year.

Just a snippet of the feedback we've received.

"Thank you and the AIA team for such a wonderful Conference. How organised was it, the quality of the Speakers you choose, the easy check in at your registration desk, the information in our beautiful grey fashion carry folders, the on time starts, and not forgetting last Night's wonderful AIA Dinner."
~ Kel A, Tasmanian Member

"I really enjoyed the AIA conference, not only to gain knowledge from the speakers, it is the food, the accommodation and fellowship with fellow members.   The Gala dinner was great!"
- Thomas L, Vic Member

We're already head down planning our 2017 National Conference – Save the dates 30 July to 2 August 2017

Introducing the Australia Ratings Listed Debt Security Indices

PHIL BAYLEY

Australia Ratings is pleased to announce the creation of a family of indices that track the returns generated by debt securities traded on the ASX. The indices are based on the securities that are rated by Australia Ratings.

Australia Ratings was appointed by ASX Limited to assign credit ratings to debt and hybrid securities traded on the ASX in late 2014. The appointment was made under the ASX Debt & Hybrid Research Scheme.

Over the intervening period, Australia Ratings has assigned credit ratings to most listed securities that consist of an assessment of the creditworthiness of the security issuer and an assessment of the complexity of the security. The rating assigned thus consists of both alphabetical and colour indicators.

The alphabetical indicator follows the typical rating scale of 'AAA', 'AA', 'A', 'BBB' etc., and the colour indicator follows Australia Rating's proprietary Product Complexity Indicator (PCI) scale of GREEN to RED.

A PCI of GREEN is applied to simple, senior ranking corporate bonds, while RED is used for the most complex hybrid securities, typically Basel III compliant Tier 1 Additional capital. In between, various forms of subordinated debt are allocated PCIs of BLUE, YELLOW or ORANGE.

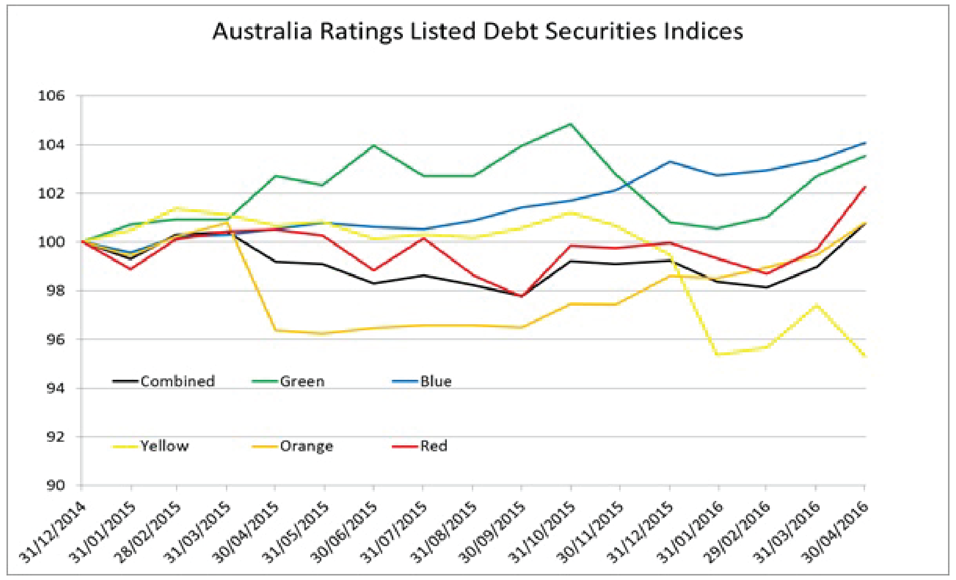
The family of indices created consists of individual indices following the PCI scale, and a composite index that includes all securities tracked in the individual indices. There are also sub-indices for securities that make franked and unfranked distributions.

The indices are accumulation indices with a start date of 1 January 2015. This coincides largely with the appointment of Australia Ratings under the ASX Research Scheme

The indices track security price movements and distributions since that date. And at present, are compiled at the end of each month but this will change if demand warrants it.

Included in the indices are only those securities with a call or maturity date more than twelve months off, and only those with floating rate distributions. The pre-tax equivalent value of the distribution is used when distributions are franked, and each security is volume weighted.

Chart 1 presents index movements to the end of April 2016.



The Blue index has been the strongest performer. This index represents the Basel II compliant subordinated debt issued by the major banks (this subordinated debt does not include a non-viability clause).

The Green index follows but performance has been constrained by the lesser credit quality of the issuers (relative to the major banks) of these senior ranking securities.

The performance of both indices will be impacted by the relatively few securities included in each. Therefore, some volatility can be expected over time, especially as securities fall out of the index as the call or maturity dates approach.

While the price performance of constituents of the Red index has been weak in recent times, it is the consistent credit quality of the mostly bank issuers that has held the index up. The Yellow and Orange indices have been adversely impacted by idiosyncratic factors affecting some issuers.

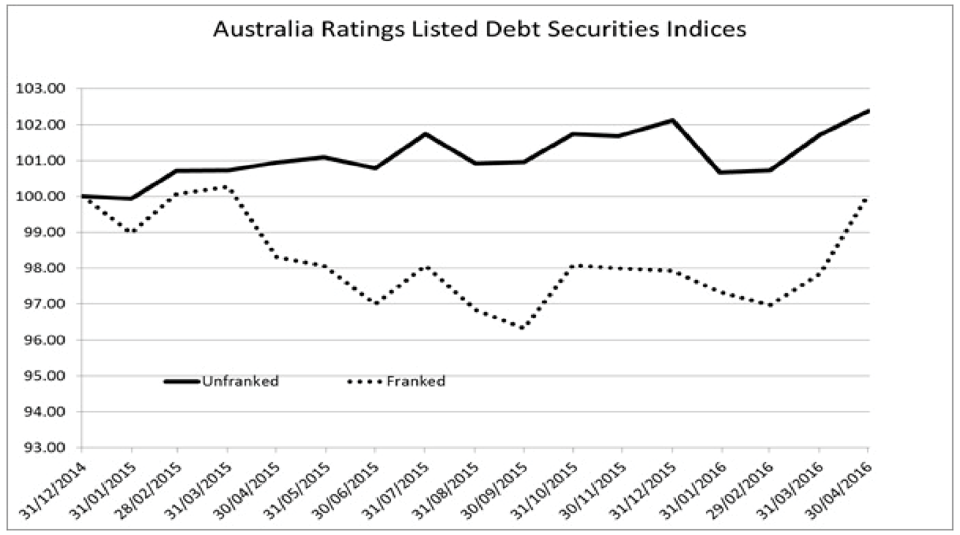
The performance of the three indices has turned up since February, with the return of more bullish investor sentiment. Indeed, the Red index jumped by more than 2.5% in April and the Orange index increased by 1.3%.

The Yellow index was impacted by the departure of the Colonial Group subordinated notes, which are due to be called at the end of March 2017.

The combined index is influenced by the larger number of constituents in the Yellow, Orange and Red indices. The index increased by 1.8% in April.

"These indices will become a valuable benchmarking tool for investors and fund managers specialising in this part of the market."

Chart 2 presents the franked and unfranked sub-indices.



It is expected that the Australia Ratings Listed Debt Securities indices will become a valuable performance measurement tool for both individual investors and fund managers specialising in this part of the market.

Fund managers wishing to prove superior skill will no doubt be keen to measure their outperformance against one or more of the indices.

The indices will be published on Australia Ratings website (www.autraliaratings.com) shortly after the end of each month. Fund managers keen to use the indices for performance benchmarking should contact Australia Ratings on (03) 8080 6684.

Phil Bayley – Director Australia Ratings

Covered calls strategy guide

PETER MOUSSA

A covered call involves owning or buying a share and then selling a 'call option'. The seller of a covered call needs to determine what price they are prepared to sell their shares at (the strike price). If they are comfortable to commit to a sale price today for a predetermined date in the future (the expiry date) they will receive a credit for that commitment (the premium/income).

If the underlying share continues to trade below the nominated strike price, the sold call would expire worthless, and they will keep the premium received and may continue to hold the share. The following month they can choose to sell another call with a new strike price and expiry date. This can be repeated as long as the investor holds the underlying share to generate an ongoing income.

Key features

- Enhance the yield from your blue-chip portfolio
- Suitable in a flat or gradually rising market
- Cushion losses in a falling market

For example
Cleo buys 1000 shares in Company A through his margin loan, which is trading at $76.50. Giving him a total investment value of $76,500.

Cleo decides that he is prepared to sell his shares in company A at $80. He sells a call with a strike price of $80, which expires 30 days from today. In return for the commitment to sell at $80 he received a credit of $0.70 per share, in total $700 for the 1000 units held.

If Company A is trading above $80 at expiry Cleo will most likely need to give up his shares at $80. If the stock is trading below $80, the sold call will expire worthless and he can choose to sell a new call at a new strike price.

Factors to keep in mind

If Company A trades above $80 on any day before the expiry date he may not be exercised, which means he will continue to hold the share. It is up to the buyer of the call whether or not the call is exercised. The option is often automatically exercised if it is trading above $80 after the expiry date.

If Cleo does not want to carry the risk of being exercised prior to expiry, he can choose to sell a 'European' style call instead of an 'American' call. As the European call can only be exercised at expiry, this is especially beneficial for investors who want to sell a call before a share goes ex-dividend, but do not want the risk of being exercised on the call before the share goes ex-dividend.

You can also sell a call for a period longer than one month which will give you a larger credit amount. For clients not looking to actively manage/trade in their portfolio they can look at selling a much longer dated call.

What happens if the share remains flat or increases gradually?

Let's assume the share closes anywhere between $76.51 and $79.99 on expiry. This is the most ideal scenario with a covered call, because Cleo is profiting from his underlying position in Company A as well having the sold call expire worthless, which means Cleo will keep the $700 premium with no further obligation to the sold call. In a flat market, covered calls tend to outperform a long only portfolio.

Cleo will also have the ability to sell another call at a new strike price where he would be prepared to sell the shares at a new expiry date. This can be done as often as the investor chooses.

What happens if the Company A share increases in value dramatically?

If the share increases to $82 at the options expiry, Cleo will most likely be exercised on the call, which means he will need to sell the share at $80 (the chosen strike price).

> "You may choose to **diversify your investment strategy** by allocating a portion of your portfolio to **covered calls**."

Here Cleo has still profited from the trade, as he will keep the $3.50 profit from the share, which increased from $76.50 to $80. In addition, he will keep the $700 premium from the sold call along with any other dividends or franking credits he may be entitled to.

The downside in this scenario is Cleo will not benefit from any further increase in the share price above $80. In a quickly rising market, coved calls tend to underperform a long only portfolio.

What happens if the Company A share declines in value?

Let's assume that, at expiry, the shares for Company A are trading at $72.00.

Given that Cleo purchased his shares at $76.50, he will be down $4.50 per share if he does not sell the call, being a total loss of $4500 on the 1000 shares held.

Given he sold the call and received a $700 credit, his loss would be reduced to $3800 ($4500 loss in the share less the $700 credit from the sold call premium). While this is still a loss, he is still in a better position than if he had not sold the call at all. If Cleo had been receiving a number of credits from the months prior his net loss would be even less. In a falling market covered calls tend to outperform a long only portfolio.

While this is still a loss, it has put him in a better position than if he had just purchased the share without selling a call.

Is this strategy right for you?

Investors need to choose whether they prefer to aim for growth or income from their portfolio. Historically, covered calls have been shown to produce more consistent returns in a flat, slowly rising or even a falling market but tend to underperform in a quickly rising market.

Investors may also choose to use this as a tool to diversify their investment strategy by allocating a portion of their portfolio to covered calls so they can benefit from a flat or slowly rising market, while leaving a portion of their portfolio for growth.

Peter Moussa, Leveraged Equities
Leveraged Equities Limited ABN 26 051 629 282 AFSL 360118 is a subsidiary of Bendigo and Adelaide Bank Limited ABN 11 068 049 178 AFSL 237879. The views of the author may not represent the views of the broader Bendigo and Adelaide Bank Group of companies. www.leveraged.com.au

Are bonds failing us as a warning signal?

Are bonds failing us as a warning signal?

ROGER MONTGOMERY

The Montgomery team has written extensively about the stunning decline in bond yields. This is occurring despite terrorist attacks, political turmoil in the UK, violence in the US and the prospect of 'last resort' helicopter money in Japan. Life isn't changing, which makes one wonder, are investors frogs in a pot full of gradually heating water?

Since the US Federal Reserve raised rates in December 2015, usually a sign that the economy is strengthening, US 10-year government bond yields have fallen from 2.3% to 1.47%.

Traditionally, a rising stock market signaled an improving economy while falling bond yields signaled deflation or disinflation, implying the virtual certainty of a recession. We have both. Tradition doesn't apply when the source of the declining bond yields aren't regular investors but massive, globally coordinated central banks. This then begs the question, are the signals we, as equity investors, are used to seeing being obscured by 'official' central bank activity?

In others words, perhaps the recent new highs in the S&P500 are anything but a sign of a strengthening economy. The reality is that the rally has been confined to 'minimum volatility' or defensive stocks, those that might be seen as a substitute for bonds like utilities, telcos and REITs. The same is true in Australia, with the likes of Transurban and Sydney Airport benefiting the most from investor affection. In the past, such behaviour has presaged a fall in aggregate corporate profits and a recession.

Putting aside the probability that declining bond yields will continue to fuel equity price appreciation as capital continues to pursue higher yields, it is worth considering the deeper issues that may, like rust, be now emerging through the paint on the surface of equity markets.

Some commentators took delight from the recent US jobs numbers with one TV personality writing, "the pessimists on the US economy have been proved wrong." Such responses are simplistic. While the payroll gains of 287,000 jobs beat economists' expectations, the trend numbers remain firmly negative. Monthly payrolls in the second quarter averaged 25% less than the first quarter and were half the average number for the fourth quarter of 2015. More importantly, the one million new jobs created in 2016 is still 33% below the total increase in working age people. In the past six-and-a-half years, the total number of new US jobs created has lagged the growth in the working age population by 1.6 million.

According to a report by Deutsche bank, $US15 trillion or 40.5% of the $US37 trillion in developed market sovereign bonds are carrying negative yields and 80% are carrying yields of less than 1%.

Think about that for a moment. If you lend CHF100,000 to Switzerland for 30 years by purchasing a 30-year Swiss bond, you will receive CHF96,172 in three decades' time. The same thing happens if you lend money to the governments of Germany and Japan for 10 years, and the list over five years includes The Netherlands, Finland, Austria, Denmark, Belgium, France, Sweden and over two years you can add Ireland, Spain and Italy to the list. Italy's banking system is in crisis and in need of a bailout. It is estimated it is harbouring $US400 billion of problem loans or 25% of the country's GDP. Yet despite this, Italy can borrow at lower rates than when times were good.

All of this has been driven by heavy-handed central banks, not the weighing scales of the market's price discovery process. The combined central bank balance sheets of Switzerland, the UK, the European Central Bank, the US and Japan have grown from $US3.5 trillion in 2007 to $US12.5 trillion today.

Faulty price signalling

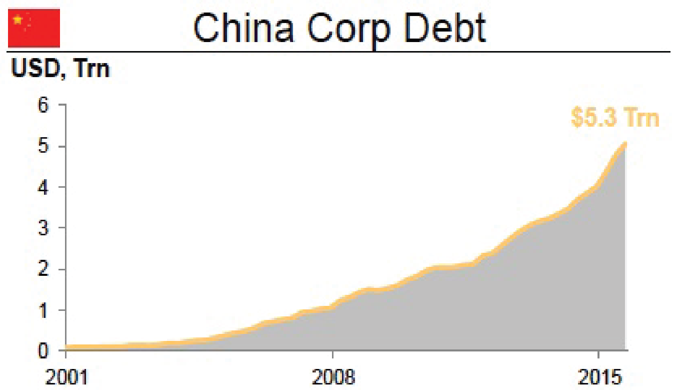
The justification for many equity investors to be fully invested is that the earnings yield – the inverse of the price to earnings ratio – on equities is more attractive than bond yields. But if bond yields are an artifice created by central bank buying, should they be the benchmark against which we measure the attractiveness of stocks?

Where would bond yields really be if not for central bank buying? Where would they be if the market were allowed to adjust for risk and uncertainty, without central bank intervention? Would earnings yields of stocks trading on 25, 35 or 55 times earnings look attractive?

Corporate debt has expanded to epochal levels, used to drive shareholder returns through share buybacks and dividends and to fund mergers and acquisitions.

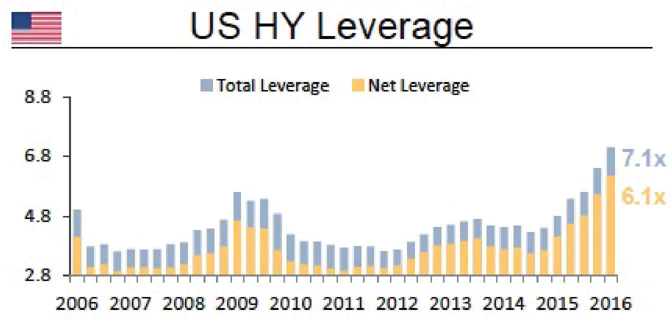
In the first half of 2016 alone, US corporates issued a record $US700 billion. As the following two charts demonstrate, the level of corporate debt puts us in unchartered territory. And don't forget, it's the level of gearing that ultimately determines the toxicity of a burst bubble.

Chinese corporate debt and US leverage



Source: DB Global Markets Research

Chinese corporate debt and US leverage



Source: DB Global Markets Research

Perhaps because the accumulating debt has been used for 'financial engineering' rather than productivity or productive capacity improvements, US business capital expenditure is at six-year lows and corporate earnings have not grown.

Since 2011, dividend payout ratios in the US have increased from about 25% to 37% today. In Australia, the payout ratio since 2010 has increased from 55% to approaching 80%.

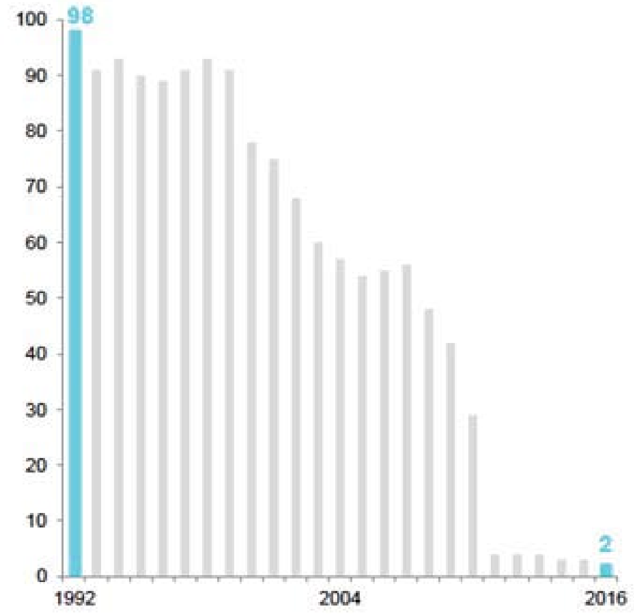
When companies don't retain earnings to reinvest in earnings growth, the only other avenue to grow is to borrow money or raise capital. Given companies are borrowing record amounts to buy back their shares, it effectively rules out borrowing more money or issuing new shares.

In the US, S&P500 companies have, in aggregate, posted negative earnings growth for six consecutive quarters. The S&P500's peak earnings was in 2014, and earnings stand at 18% less today, although the fall is not as great as the 36% slumps registered in the four worst recessions. The decline is more concentrated among commodity companies, but excluding them reveals earnings growth since 2014 of just 0.2%.

Margins will come under further pressure. Wages are rising in the US, and when combined with full employment and declining productivity, it becomes very hard to maintain profit margins.

Low growth, pressure on prospects and high debt unsurprisingly has reduced the credit ratings of many companies. In the US, the number of S&P AAA-rated companies has fallen from 98 in 1992 to just two today – Microsoft and Johnson & Johnson.

Number of S&P AAA rated companies



Source: S&P, Deutsche Bank

If credit quality is low, the risks for equity investors are high. But if risks are high, why are bond rates at record lows? It doesn't make sense and it means that bond markets have lost their ability to provide appropriate signals to investors.

Any serious break in confidence, the emergence of inflation, or even the flight to safety of US company pension funds, whose aggregate liabilities trounce their assets, could cause apathetic investors to dump their now highly profitable bond positions.

Of course equities would not be immune to such an exodus. As John Authers wrote in the Australian Financial Review on 18 July 2016 "There is no enthusiasm, but ever-pricier bonds leave no choice but to buy stocks … Is this a secure basis on which to invest? No … anyone trying to make money or preserve capital must be calm and relaxed."

Bill Gross the founder of the Janus Global Unconstrained Bond Fund perhaps summed it up best: "Global yields lowest in 500 years of recorded history and $10 trillion of negative rate bonds. This is a supernova that will explode one day."

It may be some years before there is any sign of panic by investors and in the long run, you will do best being invested in businesses able to retain profits and generate high returns on that incremental equity. In other words, you will do well if you can hold your best quality assets through thick and thin.

However, when the primary justification for the rally in most asset prices is a bond price signal that is broken, holding some cash and perhaps taking some profits on the most highly geared and overpriced assets (Australian apartments anyone?), may well turn out to be a good strategy.

Those free options are a mixed blessing

BOYD PETERS

Many AIA members love LICS. Often LICs issue Options in order to grow the company. While essential to get an IPO away the sooner they are out of the way the better the share price will perform.

It costs around 2c to list an LIC on the ASX meaning the starting NTA is around 98c. To encourage investors to participate in the IPO the LICs issue Options, usually with exercise price of $1.00. An LIC that lists with say 25m shares on issue would thus have 25m Options on issue. Most of the time these Options also trade on the ASX and in the last few years they have commenced trading at around the 5 cent mark.

This Option value has made a market for shares because shareholders are prepared to sell the headstock even at $0.98 because they can lock in a 2c tax loss but still own the Option valued at 5c. They are effectively 3c ahead and of course the broker has earned a nice commission for putting them in the IPO.

Even better these Options can have a shelf life longer than 12 months so if they are sold or exercised after 12 months the shareholder can claim the 50% CGT relief. From the Broker's perspective especially everyone wins.

> "Options have a valuable place, but care needs to be given to how many are issued, their duration and the exercise price."

Overhang effect

So now the investment portfolio commences, and let's say for example sake it has a good year and the investment portfolio rises 22%, and after fees and costs the NTA rises by 20%.

What happens at this point is that many shareholder wonder why the share price isn't trading at $1.20- bemoaning the "discount the NTA". What some misunderstand is that the larger investors in particular- who move the dial in share prices- will not want to pay more than $1.10 to acquire shares. This is because they value the company on the basis of the number of shares that will be on issue if every Option is exercised, in this example that will be 50 million. Mathematically the 1:1 dilution effect would see 25m new shares issued at $1.00 added to the existing 25m shares at NTA of $1.20, resulting in a total of 50m shares with post dilution NTA value of $1.10. Hence why shareholders won't want to pay more than $1.10 for the shares even though the headline NTA says $1.20! This is one headwind to an LICs share price

Early in the LIC's existence trading volume is often thin. Shareholders retain shares recognising the manager skill and remembering the asset allocation reason they invested in the IPO. However, new investors are reluctant to buy shares because they do not know how many options will be exercised thus cannot calculate the impact of dilution to the NTA.

Doldrum Effect

This is another headwind impacting the supply/ demand equilibrium and results in the newer LICs existing in a thin trading volume "doldrum" until the Options are out of the way.

For LICs with NTAs and share prices around $1.00 it is even harder to break the $1.00 barrier as they are stuck in a "conundrum". After all, who would pay over $1.00 to buy shares when they could simply buy the Option- itself often trading at a fraction of a cent- and exercise that to buy shares at $1.00? Exactly, so investors typically won't pay more than $1.00 to acquire shares on the market.

Conundrum Effect

Here is the conundrum, if people aren't paying more than $1.00 to buy the shares, then the Options won't rise beyond a fraction of a cent in value. Why would anyone pay 1 cent to buy the Option to exercise shares at $1.00 when they can buy the shares for $1.00 anyway? This is a prime reason shares struggle to break through the option price of $1.00, irrespective of the value of the NTA, and why Options struggle to get beyond 1 cent in value closer to their expiration date.

Broker headwind

Those LICs that can break through $1.00 struggle to overcome the "Broker head-wind" in that brokers whose clients helped the LIC IPO get awaymay prefer clients to not exercise their Options. After all brokers want their client trading, not to buy and hold more LICs.

Back Door Option

Brokers now see few Options exercised in the normal course and expect the LIC to subsequently approach them to fund an Options Shortfall Placement (which will pay a nice commission of around 3% to them).

Naturally the LIC would like the share price to be above $1.00 to get the Options in the money and avoid the necessity to engage the broker, but unless their NTA and share price are well above $1.00 there are too many headwinds for that to happen.

Thus we see that while the Options are necessary to get the LIC away they are also a prime reason share prices struggle to get above $1.00 once listed.

One recent example is Bailador Technology Investments (ASX: BTI). Prior to its options expiry date of 31 March 2016 the share price struggled to exceed $1.00 even though the NTA was $1.26 (refer chart 1). Once the options were out of the way (red vertical line) shareholders knew the new number of shares on issue and the post-dilution NTA of $1.18. Following this we can see how the share price and trading volume then acted. It would appear investors and shareholders were simply waiting for the options to get out of the way before they bought in.

Chart 1: BTI Share Price and Volume

Source InvComs

Barrack Street Investments Ltd

The next LIC with options soon expiring is Barrack Street Investments Ltd (ASX: BST), a mid-small cap portfolio – managed by noted stock picker Manny Pohl – whose options expire on 17 August 2016. Listed in 2014 it is typical of new LICs in that – even with an NTA of $1.12 – it is struggling to breach the exercise price of $1.00 and is thinly traded. Once BST gets through the overhang of options it will be interesting to see how the share price and volume respond. The company has recently given guidance that it will pay a minimum 1.5 c.p.s. dividend by October, which may be an additional hook for investors to acquire shares.

Take care

Options have a valuable place, but care needs to be given to how many are issued, their duration and the exercise price. Unfavour-able terms neuter an IPO, too generous hold back the share price. An LIC board needs to be well experienced to structure them correctly and work hard to see them exercised as quickly as possible.

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.

DATE	DAY	TIME	EVENT	VENUE
NSW / ACT				
12-Sep-16	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
14-Sep-16	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
10-Oct-16	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
12-Oct-16	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
09-Nov-16	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
14-Nov-16	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
12-Dec-16	Monday	7.30pm	Canberra Discussion Group	Ginninderra Labor Club
14-Dec-16	Wednesday	7.30pm	North Shore Information Meeting	The Chatswood Club, 11 Help Street Chatswood
VIC				
06-Sep-16	Tuesday	6.45pm	Geelong Discussion Group	St George Workers Club, Geelong West
27-Sep-16	Tuesday	7.00pm	Greensborough Discussion Group	Diamond Valley Library, Greensborough
28-Sep-16	Wednesday	7.00pm	Kew Discussion Group	Phyllis Hore Room, Kew Library
28-Sep-16	Wednesday	1.00pm	Frankston Discussion Group	Private address; contact Bill Shirley for details: wshirley@hotkey.net
29-Sep-16	Thursday	4.00pm	Melbourne Bayside Discussion Group	Private address; contact Kevin Macdonald for detail: km.macdonald@bigpond.com
04-Oct-16	Tuesday	6.30pm	Melbourne Information Meeting	Telstra Conference Centre, Room 1, Level 1, 242 Exhibition Street Melbourne
05-Oct-16	Wednesday	7.30pm	Blackburn Discussion Group	Naturalist Club of Victoria, 1 Gardenia Street Blackburn
25-Oct-16	Tuesday	7.00pm	Greensborough Discussion Group	Diamond Valley Library, Greensborough
08-Nov-16	Tuesday	6.45pm	Geelong Discussion Group	St George Workers Club, Geelong West
16-Nov-16	Wednesday	1.00pm	Frankston Discussion Group	Private address; contact Joy Stirling for details: 03 9782 5069
24-Nov-16	Thursday	4.00pm	Melbourne Bayside Discussion Group	Private address; contact Kevin Macdonald for details: km.macdonald@bigpond.com
29-Nov-16	Tuesday	7.00pm	Greensborough Discussion Group	Diamond Valley Library, Greensborough
30-Nov-16	Wednesday	7.00pm	Kew Discussion Group	Phyllis Hore Room, Kew Library
06-Dec-16	Tuesday	6.30pm	Melbourne Information Meeting	Telstra Conference Centre, Room 1, Level 1, 242 Exhibition Street Melbourne
07-Dec-16	Wednesday	7.30pm	Blackburn Discussion Group	Naturalist Club of Victoria, 1 Gardenia Street Blackburn
07-Dec-16	Wednesday	1.00pm	Frankston Discussion Group	Private address; contact Joy Stirling for details: 03 9782 5069
QLD				
07-Sep-16	Wednesday	1.30pm	Brisbane Information Meeting	Cromwell Property Group, L19, 200 Mary Street Brisbane
19-Sep-16	Monday	7.00pm	Chermside Equities Discussion Group	Chermside Library, Hamilton Road Chermside
20-Sep-16	Tuesday	7.00pm	Brisbane Managed Investments DG	Carindale Library, Carindale Shopping Centre
21-Sep-16	Wednesday	7.00pm	Brisbane Equities Discussion Group	Carindale Library, Carindale Shopping Centre
21-Sep-16	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
05-Oct-16	Wednesday	1.30pm	Brisbane Information Meeting	Cromwell Property Group, L19, 200 Mary Street Brisbane
17-Oct-16	Monday	7.00pm	Chermside Equities Discussion Group	Chermside Library, Hamilton Road, Chermside
17-Oct-16	Monday	9.30am	Gold Coast Information Meeting	Helensvale Community, Centre 31 Discovery Dr Helensvale
18-Oct-16	Tuesday	7.00pm	Brisbane Managed Investments DG	Carindale Library, Carindale Shopping Centre
19-Oct-16	Wednesday	7.00pm	Brisbane Equities Discussion Group	Carindale Library, Carindale Shopping Centre
19-Oct-16	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
02-Nov-16	Wednesday	1.30pm	Brisbane Information Meeting	Wesley House, 140 Ann Street Brisbane
15-Nov-16	Tuesday	7.00pm	Brisbane Managed Investments DG	Carindale Library, Carindale Shopping Centre
16-Nov-16	Wednesday	7.00pm	Brisbane Equities Discussion Group	Carindale Library, Carindale Shopping Centre
16-Nov-16	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
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07-Dec-16	Wednesday	1.30pm	Brisbane Information Meeting	Wesley House, 140 Ann Street Brisbane
21-Dec-16	Wednesday	6.30pm	Sunshine Coast Discussion Group	The Old Post Office, Buderim
SA				
12-Sep-16	Tuesday	7.00pm	Adelaide Information Meeting	Fullarton Park Community Centre, 411 Fullarton Road Fullarton
17-Oct-16	Tuesday	7.00pm	Adelaide Information Meeting	Fullarton Park Community Centre, 411 Fullarton Road Fullarton
14-Nov-16	Tuesday	7.00pm	Adelaide Information Meeting	Fullarton Park Community Centre, 411 Fullarton Road Fullarton
WA				
06-Sep-16	Tuesday	7.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
10-Sep-16	Saturday	9.00am	Perth Half Day Seminar	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
20-Sep-16	Tuesday	7.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
04-Oct-16	Tuesday	7.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
18-Oct-16	Tuesday	7.30pm	Perth Discussion Group	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
01-Nov-16	Tuesday	7.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
15-Nov-16	Tuesday	7.30pm	Perth Discussion Group	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs
06-Dec-16	Tuesday	6.30pm	Perth Information Meeting	Wembley Downs Tennis Club, cnr Morden & Ednah Streets Wembley Downs

AIA Membership Refer a friend

Regardless of your age or present level of wealth, the AIA can assist you with education and information to make better investment decisions. If a friend or relative joins as a result of your recommendation, both of you will receive an additional three months free membership. Simply write your name and member number on the back of the referral card. This is our way of saying thank you for your recommendation. We also draw your attention to a new membership category, Student. Full time students under the age of 30 are welcome to join the association at the discounted rate of 50% off regular membership and no joining fee. ~ The AIA Board

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