Beware unregulated property spruikers targeting SMSFs

More sharks are circling in these times of low interest rates

ANDREW MAIN

Superannuation expert Tom Garcia says it would be a problem for all taxpayers if SMSFs were to fail through bad investment advice

AARON FRANCIS

THE next big failure in the Australian financial sector could quite probably involve property spruikers and self managed super funds, warns Tom Garcia, chief executive of the Australian Institute of Superannuation Trustees.

"Someone's probably working on it now," said Mr Garcia, who is concerned that the combination of a search for yield by retail investors in a low interest-rate environment, the ability to borrow in SMSFs and a big push to market "get rich quick" schemes to SMSF trustees by unregulated property spruikers is creating an environment where a lot of people stand to lose a lot of money.

Melbourne-based AIST is the peak industry body for the $500 billion not-for-profit super sector, which includes industry, corporate and public sector funds covering the super interests of the majority of the Australian workforce, particularly blue-collar.

"While we don't represent SMSFs, we recognise they have a legitimate role to play in our super system and it would be a problem for all taxpayers if SMSFs were to fail through bad investment advice, resulting in disappointed super investors having greater reliance on the age pension," Mr Garcia said.

"If that happened, more retirees will be dependent on the age pension and more people will lose confidence in the system, as we saw with the collapse of Storm Financial and Westpoint."

Mr Garcia said one of his biggest concerns was the lack of diversification.

"It is not well understood that an SMSF trustee has a fiduciary duty to act in their own best interests to provide for their retirement," he said. "By law, SMSFs are required to have a documented investment strategy.

"While it is up to trustees to determine this strategy, it's generally agreed that a diversified investment portfolio will provide the best outcome, both in terms of risk and return. We would caution against an SMSF being invested in a single asset class such as domestic property."

Investors are increasingly seeing advertisements and inducements to members of conventional pooled super funds to open an SMSF, with the clear intention of then getting them into a property, using a specially created non recourse loan vehicle provided by the same group offering the service.

The Weekend Australian is aware of one Wollongong-based financial services company offering free overseas holidays to people who sign up to set up an SMSF and make an associated property investment. No mention of diversification is made in the advertising.

Mr Garcia said he was not aware of that instance but said that as the SMSF sector grew towards $500bn, or one third of Australia's superannuation pie, "more sharks are circling".

"As a former financial planner, I found that risk was a poorly understood component of investing," he said.

"Most people don't know their ability to cope with risk until they experience an adverse outcome, by which time it may be too late."

And it was not just older members taking a chance, he said.

"Risk changes with age and circumstance. And, arguably, there is just as much risk with a young person leaving all their super in cash as there is with an older person investing their super in the one property."

He said leaving investments in cash left the saver exposed to the risk of being left behind by inflation and unable to finance a comfortable retirement.

Mr Garcia also noted that having one single illiquid asset in the SMSF could make life very difficult for a trustee moving into pension phase.

"SMSF trustees need to be aware that in pension phase there is a legislated level on income that must be drawn down that increases as they age," he said, referring to the minimum 4 per cent per year drawdown rule.

"A risk of being heavily weighted into a single, relatively illiquid asset like domestic property is a possible forced sale due to pension income requirements which could produce a lower capital return on the investment."

Bullion left for dust by gold stock upswing

RICHARD HEMMING

UNDER THE RADAR

IF you've read the headlines about Newcrest Mining you would think the stock is headed for the dustbin, but it's up 34 per cent off its lows.

The fact is, for the first time in two years, gold stocks are outshining the gold price. In the past few months many have more than doubled.

It has been a wild ride for the gold stocks. The Australian gold index stood at 6259 in October last year and plummeted 68 per cent to 1984 in mid-June this year. It's now standing at 2783, up 40 per cent on its lows. In contrast, the gold price at $US1361 an ounce is up 13 per cent on its 12-month low late last month of $US1206. It is still 24 per cent below its 12-month high of $US1793.

David Coates, a resources analyst, who has been involved in the sector for the past 15 years, managing money and analysing the stocks, says: "The market is saying the gold price has bottomed and is expecting the gold price to continue rising. Nothing goes up in a straight line but it looks like we've seen the bottom, and there is a long way back to the top from here. There is a lot of money to be made."

This could challenge the gold-based exchange-traded funds, which have been a recent phenomenon in Australia with the first gold ETF introduced in 2003. These funds act as a proxy for the gold price, and value of the gold ETFs early last year was estimated at $140 billion, well more than the total of all listed gold companies on the Australian Securities Exchange. That differential has widened since.

But the fact is, as illustrated by the recent share price moves, gold companies offer investors substantial leverage to the gold price because they have the potential for exploration success, and it is getting harder and more expensive to find the stuff. Just ask the management of any of the big goldminers like Newcrest or Barrack.

Plus, with the weakening Australian dollar, it is easier for domestic miners to profit from the yellow stuff.

At US89c an Australian dollar, this translates to $1520 an ounce. The marginal cost of production for a goldminer is about $1200. Many are making big money.

It is the bulk producers with quite high costs of production that can be the most lucrative in a bull market. These companies have the potential to produce a lot of the yellow stuff but need a relatively high gold price.

Bullabulling Gold (ASX code: BAB) is definitely one such company. It's trading at about 6c and its stock has more than doubled this month. To give you an idea why, its market cap is $20 million, but it's sitting on a 3.7 million ounce resource of gold, worth $5.6bn.

It owns the Bullabulling gold project near Kalgoorlie, which is a marginal operation. With the currency weak and if you think the gold price will rally, this stock will be in the money.

It could easily get back to 38c, where it was about a year ago, which means it's a potential multi-bagger. You just have to be the biggest gold bull around.

Richard Hemming (r.hemming@undertheradar report.com.au) is an independent analyst who edits a fortnightly newsletter: www.underthe radarreport.com.au.

Domino's topping out

ROGER MONTGOMERY

DOMINO'S is a company that has revolutionised the way pizzas are sold, not just in Australia but in Europe as well. In doing so, the company has been able to increase earnings per share by more than 30 per cent annually from 2004 to last year.

With such an impressive record, investors have developed high expectations of management to maintain these returns. Yet the company's latest results indicate that management may be finding it more difficult to maintain this earnings trajectory.

In its recently released 2013 full-year results, Domino's earnings per share increased by only 11.5 per cent.

This number by itself would have disappointed the market were it not for management also announcing the purchase of a 75 per cent stake in Domino's Japan. Investors were certainly buoyed by the news, sending the share price up 9 per cent on the day. While the market interpreted the acquisition as a positive development for the company, a closer look at the performance of the core divisions is warranted to understand if growth can return to historical levels.

Domino's pursues growth by increasing the number of stores in its network, and increasing the number of sales within the stores. At the end of the 2012 financial year, management was aiming to open 80 new stores and expected that same-store sales (or sales from prior year stores) would increase by 3 per cent to 5 per cent. The full-year result was disappointing on both counts: same-store sales increased by 2 per cent, while only 67 stores were opened.

For the most part, Australia and New Zealand appear to be performing well in what are mature markets with intense competition. The company increased the number of stores by 26 to 585, and same-store sales have been supported by the company's new line of "game-changing" gourmet pizzas. Long-term growth will be limited though as management estimate that the markets can accommodate only 750 stores.

Domino's entered the larger European market to supplement the declining Australian market, and it has achieved good growth by operating a central commissary model that supplies dough and ingredients to franchisees.

This year management was unable to increase the number of franchisees to expectations and instead chose to open a higher number of corporate stores operated by the company. This stretched the management team and resulted in sub-optimal food and labour management. The French commissary operation also has been affected by labour and logistics costs, predominantly due to capacity constraints. These issues resulted in earnings before interest, tax, depreciation and amortisation falling from 6.5 per cent of sales to 5.6 per cent.

These issues are not likely to be resolved in the short term. The company is planning to relocate and upgrade the facilities over the coming 12 months. It is also in negotiations with third-party suppliers to effectively manage the French commissary's constraints. Domino's appears reliant on the new acquisition to fill the earnings gap.

Domino's Japan has a network of 259 stores and management expect that this can be increased to 600. About 85 per cent of these stores are run by the company, which is the inverse of the franchisee-centric Australia and New Zealand divisions. If the company can successfully increase the number of stores via franchisees, it has the potential to result in margin improvement. Management is also confident that it will be able to increase same-store sales through improved site locations, formats and marketing expertise.

Japan appears to be a market that is conducive to Domino's management style and it should be well placed to support earnings. Yet the company is expecting that same-store sales in Japan will increase by only 1 per cent to 2 per cent for 2014. Europe is still the growth driver for the business and it is important that the Japanese acquisition does not distract management's attention.

At Montgomery Investment Management, we believe that Domino's is still a quality business that has attractive economics, but at the present share price the Montgomery Fund will sit back and wait for evidence that management can deliver on these reforms to its core business.

Roger Montgomery is the founder of Montgomery Investment Management and the author of Value.able: How to Value the Best Stocks and Buy Them for Less Than They're Worth, available at www.rogermontgomery.com.

Time to get your head around the aged-care overhaul

PAUL DWYER

IF you think you don't know a lot about the new rules on aged-care policy, you are not alone. The recent election debate showed that neither Kevin Rudd nor Tony Abbott was a repository of wisdom on the Living Longer, Living Better package that parliament passed in late June.

The reform represents the first significant changes since 1997.

The government is indicating a total investment of $3.7 billion for the future of the industry, but it is residential care that will attract the most interest.

For residents who cannot meet all their accommodation costs, government will increase the accommodation supplement paid to providers from $33.29 to $52.84 a day, but this will be available only if a significant refurbishment or build was started after April 20 last year.

From July 1 next year, the difference between high and low care will be removed. An aged-care assessment is a prerequisite for entering such care. At present an assessment is valid for 12 months, but this will become open-ended.

An accommodation bond (an interest-free loan to a facility) will be applicable for all new residents with the means to contribute to their care. At the moment a bond is applicable only to low-level facilities or those high-level facilities that offer extra services. A wider understanding of this among potential residents will undoubtedly lead to a last-minute rush of high-care applicants ahead of June 30 next year.

An important aspect of the new rules is that all providers must provide transparency with their pricing. The lump sum amount and its daily periodical equivalent must be disclosed on the government's website (My Aged Care) and any other published material such as providers' websites.

A resident entering a facility will have up to 28 days to decide whether to commit to a lump sum, a daily periodical payment or a combination. In 2011-12, 89 per cent of residents entering care that required an accommodation bond chose a lump-sum payment.

Government has decided on a three-tier daily pricing strategy: $0-$50, $51-$85 and above $85 a day. The first price point has no requirements, the $51-$85 has to follow guidelines and pricing higher than $85 will need approval from a pricing commissioner. The lump-sum equivalent of the daily price is calculated by use of the government's maximum permissible interest rate, which is presently 6.82 per cent. The maximum tier-two pricing of $85 a day allows for a maximum lump-sum bond of $453,666.

> The income test will be replaced by a means test

Of concern to providers is the interest rate of 6.82 per cent being at historical lows, but if the MPIR returns to a longer-term average of about 8.8 per cent, the maximum lump sum for a tier-two price of $85 would be $351,590. This would induce a rush of applications for tier 3 approvals.

Representative groups and multi-site providers now reliant on accommodation bonds are concerned about the possibility of a significant uplift in periodical payments decisions. Lump-sum amounts are predominantly used by facilities to offset current liabilities with their lenders.

Banks in the aged-care market are also concerned about the same potential in payment restructure by residents as it will affect their credit policies, loan-to-value and debt-servicing ratios. The repayments of accommodation bonds to the estate of previous residents may reduce or drain the liquidity of a provider if it is significantly replaced by periodical payments.

Facilities that have not previously charged an accommodation bond will find the new regime administratively demanding but potentially advantageous. The prudential regulations concerning bonds, the reporting to government and residents, and other requirements are in addition to deciding price parameters. Such places are mostly in regional, rural or remote locations.

Providers will no longer be able to receive a monthly retention bond, now set at $331 a month (up to five years) and accessed from the accommodation bond. For many providers the removal of these monies will be a drain on their cashflow but could be recouped if included in tier 2 pricing.

Consumers will be affected, with a focus on greater co-contribution. Many of the methods used to minimise costs and increase aged-pension entitlements will be unavailable.

The existing income test will be replaced by a means test (incorporating both assets and income). An important change is that an accommodation bond will be assessed under the asset test. Based on current information, the family home will also be assessed, but capped at $144,500.

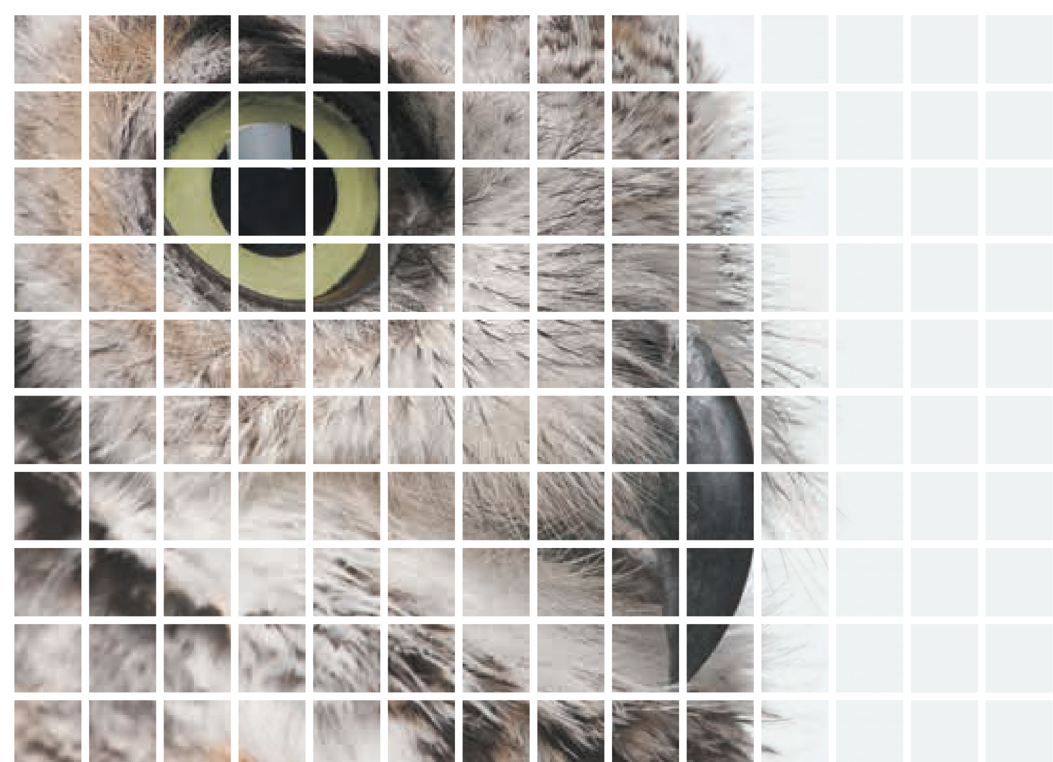
A means test will have a long-time cap of $60,000, part of which may be taken up with community services at home under the Home Care program.

In addressing the issue of an accommodation bond, residents will have other options to consider. First, they may consider borrowing to pay an accommodation bond through a reverse mortgage or accommodation bond loan, and this liability will be an offset in the assets test.

Additionally, some residents may chose to pay periodically, or a combination of lump-periodical. In doing so, the family home can be rented and the rental income is exempted from the income test and the home from the asset test for aged-pension entitlements.

Understanding aged-care rules and regulations will become even more important for residents and families from next year.

Paul Dwyer is a credit adviser specialising in seniors' credit and aged care.



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Since its beginning in 2000, Paradice Investment Management has developed a solid track record of producing outstanding returns.

Our aim has always been to add value for our investors and, since inception, all our funds have exceeded their benchmarks.

We believe that too much FUM spoils performance, so we close funds when they grow to optimal size.

Annualised returns since inception to 31 July 2013

Strategy	Return	Benchmark	Value Add	FUM	Inception Date
Small Caps (closed)	18.07%	4.97%	**13.10%**	$1.74b	30 June 2000
Mid Caps (closed)	8.28%	0.36%	**7.92%**	$1.55b	25 Sept 2006
Large Caps (closed)	3.99%	0.89%	**3.10%**	$4.40b	11 May 2007
Global Small Mid Caps*	17.76%	13.27%	**4.49%**	$557m	1 August 2010
Total Funds under management				**$8.25b**	

* Available through the BT and Asgard Wrap Platform. Please contact your Financial Adviser.

Please visit our website or call us on 02 8227 7400 to find out more. www.paradice.com.au

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