WEALTH

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‘THE MAGIC OF COMPOUND INTEREST IS AN ESSENTIAL ELEMENT OF SUCCESSFUL INVESTING’

DON STAMMER

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Direct approach to bonds pays off

LIZ MORAN
SMART INCOME

WHILE a number of self-managed super fund investors are using bond funds to gain exposure to fixed-interest investment, by doing so they are giving up the advantages conferred by investing directly in bonds.

The growing number of SMSFs is a testament to investors seeking to take charge of their investments. Self-determination, higher returns and lower costs are some of the main reasons for the growth seen in the sector.

Any allocation to bonds is a positive step as SMSFs recognise the need for diversity and the lower risk attributes of the fixed-income asset class. However, direct bond investment aligns more closely with most SMSF investors' psyche and the advantages of direct investment are lost if they are invested in a bond fund.

When investing through a fund, investors hand over control to a fund manager and do not have any voice in how their funds are invested. Direct investment allows a tailored approach to each investor's individual goals, whether it is income, risk, return, maturity date, or a preference for fixed, floating or inflation linked bonds.

Direct investors build a relationship with a bond broker who makes suggestions to holdings; it is very much a personal approach and not a "one size fits all". Generally, most managed funds will disclose the top investments, but there is an element of trust as typically not all investments are disclosed. Further, as a rule, managed funds must allocate to low risk, very liquid government bonds to meet day-to-day withdrawals, yet returns on government bonds are low.

Interest rates change and actively managed bond funds trade securities to maximise returns. Income on the fund will also fluctuate. Many funds will actively target a return over a benchmark, which by definition is low due to the significant volume of government bonds and low-risk senior bank debt that make up a high proportion of the overall market.

In contrast, direct investors have the certainty of income and the exact dates when the income will be in their account, so can plan to use the funds; particularly important for retirees needing to know future cashflows.

Bonds mature and repay the initial face value of the bond, preserving capital (assuming the company continues to operate). Direct investors can buy bonds that mature before large future expenses, so have funds on hand when needed.

Managed fund investors lose the natural maturity of direct investment. They must decide to sell to recoup capital and will be reliant on the price of the managed fund at that future date. This may subject them to a loss depending on economic conditions and other market forces.

Fees vary between funds and are ongoing. Direct investors pay a once-off brokerage on purchase and may pay brokerage if they sell prior to maturity, but do not pay any ongoing fees.

Returns shown to direct investors at the outset are what investors can expect to achieve in future, assuming they hold the bonds to maturity. Managed funds rely on past performance as an indicator of future returns.

One of the strongest arguments against direct investment is the diversification of a managed fund. It is true that they can have hundreds of investments, but how many investors will understand the risks associated with each investment? Would investors, given the choice, invest in the same assets as the fund manager?

Broad diversification has benefits but careful selection of a smaller number of bonds and individual assessment of risk can reap higher rewards and provide the total control SMSFs are seeking.

Elizabeth Moran is a director of education and research at FIIG Fixed Income Specialists www.fiig.com.au.

Appreciating the art in forex

STIRLING LARKIN

GLOBAL INVESTOR

BLOOMBERG

A recent drop in the iron ore price sent the Aussie dollar up, not down

LAST month, the iron ore spot price, our largest bulk commodity export, suffered its biggest one-day price fall in more than four years.

Then a curious thing happened. Our dollar nudged higher, not lower. Conventional wisdom would have it the dollar should have fallen, given the supposed importance of iron ore to the Australian economy.

It appears that many ultra-high-net-worth investors have enjoyed timely advice surrounding these events and positioned accordingly, while many other investment communities have not.

This is partly due to the legacy of merchant banking in Australia. This legacy saw today's institutions inherit their current grasp of these flows from the era when both Australia's terms of trade relied on wool and grain exports and when our dollar was pegged to the US dollar.

Even in light of the fact our dollar was freely floated in 1983 and our terms of trade have significantly shifted, this understanding has not kept up with the times.

There remain practical ways whereby we can better monitor these flows and make smarter trading and investment decisions.

We can also better understand why we are seeing the dollar strengthen as we are told it should be weakening.

The first step is to avoid "Pamplona" herd behaviour, which will see us running with the bulls. Too many investment communities base their decision-making on consensus that can also be referred to as "groupthink".

This groupthink has been helpful for those who make reactive decisions but ineffective for those who try to pre-empt the future.

The second and most important step is respecting the fundamentals of monetary economics — all that is currently being faced has been experienced before and much can be taken from those experiences, such as last week's "Abenomics" example.

Both Keynesian and Hayekian schools of economics respect the important role the monetary base plays in all markets and it is front and centre in Friedman's monetarist theory.

In 2014 this conversation has centred on the unorthodox monetary easing policies known as "quantitative easing" or "money printing" throughout much of the world and its impact on others.

Even though foreign exchange appears, at times, to be allergic to reason, the global investor respects that there are sound economic principles at work.

The third step is a good understanding about the role and limitation that a central bank can have.

The Reserve Bank of Australia, our central bank, has been effective on many fronts but has had little influence over the flow of the Australian dollar.

This limit to efficacy is thanks to two equally important realities.

One is that the tools it has, namely those controlling interest rates, have been proven to have limited influence over currency flows. Coupled with this, the RBA itself acknowledges that its other primary currency tool, known as "foreign exchange market intervention", also suffers inherent limitations.

The other reality is that the depth and scope of other central banks' unorthodox monetary policies, namely zero interest rate policies and quantitative easing, have led to currency devaluation wars that Australia is not partaking in — and cannot.

Australian UHNW investors have received the advice that the decisions made at the US Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan have far more direct impact on Australian dollar flows than anything else.

This conflicts with the heavily institutionalised advice afforded by the consensus that our currency is high because of the influences of international interest rate arbitrage opportunities (known as a "carry trade") and our link to commodity markets, namely iron ore.

But the consensus analysis has been flawed. When the RBA has named successive interest rates cuts over the past two years, again our dollar moved contrary to what one would expect if it were high due to carry trades.

UHNW investors have placed more credence towards the advice grounded in economic fundamentals than that advocated by the popular consensus. They know to pay more attention this year to the events of the global currency devaluation wars than anything else. For all Australian investment communities, there are more ways than ever before to trade and invest in the Australian dollar.

Currency pair trades — in which you buy and sell two different currencies and arbitrage the spread — are not new but have enjoyed increasingly popularity.

This is because transactions can now be executed using a broader array of instruments than have been previously available.

These include quoted trading warrants, over the counter products and even bespoke exchange traded funds that have encapsulated both legs of these transactions in one tradeable parcel.

A topical pair trade has been the Australian dollar and South African rand spread on the back of the David Jones bid.

A derivative product known as a dual currency deposit has also seen a recent resurgence thanks largely to the continued expansion of the currency devaluation wars. A DCD is a money market-linked deposit that attempts to attract higher yields in another jurisdiction.

The managing director of the SILC Group, Koby Jones, says they are also seeing more foreign investors, particularly from Southeast Asia, undertaking off-market transactions on a direct, syndicated and fund basis.

"There is no reason why more Australian investors cannot also participate in these transactions," he says, and goes on to say "Today we have far more Australian dollar hedging options than ever before."

UHNW traders saw this first-hand when in November 2012 the International Monetary Fund announced that the Australian and Canadian dollars would be included in the Currency Composition of Official Foreign Exchange Reserves report.

After this inclusion the Australian dollar has been an increasing part of many central bank portfolios.

This inclusion meant they had to rebalance their portfolios on a daily or weekly basis to keep the value of their portfolios within the risk limits prescribed by their mandates.

So in practice, if the Australian dollar went up, they sold and if it went down, they bought. This therefore compresses the price action within the fluctuating range and is often referred to as "top and tail".

UHNW traders closely monitor these central bank portfolios and include this information in their future Australian dollar decisions.

There is legitimacy in the belief that foreign exchange is more art than science and respecting this helps us connect to our investments and the world.

Larkin Group is a wholesale wealth advisor focusing on high-yielding regional investments.

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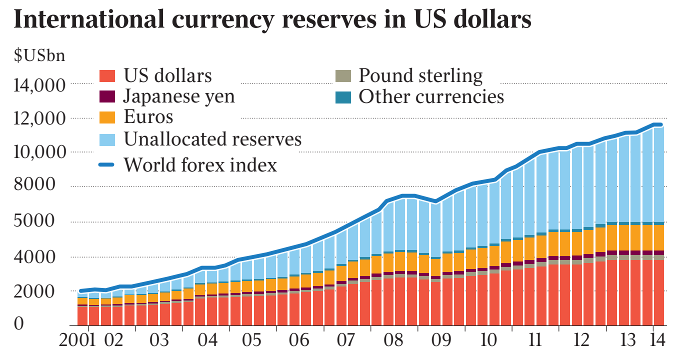
International currency reserves in US dollars



Source: IMF

PRODUCT WATCH

WaveStone Wholesale Australian Share Fund

WHAT•IT•IS
IT'S a new long-only Australian equity fund from a small organisation well regarded for its Absolute Return Fund and Dynamic Australian Equity Fund.

WHAT•IT•DOES
It's designed to capture the growing demand for growth-style portfolios, now that investors have become aware that dividends alone may not make us rich. WaveStone was set up as a boutique in 2006 by former Colonial First State fund managers Ian Harding, Graeme Burke and Catherine Allfrey. The only obvious absentee is Greg "The Freak" Perry, who has retired.

WHAT•WE•LIKE
WaveStone isn't high profile but it does well and the long-only mandate it's had since 2007 has delivered 8.2 per cent a year for the seven years to March, a top quartile effort. We'd also agree that the growth sector is where to look for value and professionals are a lot better than us amateurs at finding it. WaveStone wants to find companies that grow their earnings at a double-digit rate over the next five years. The targets are mostly outside the top 20, which have been well and truly raked over.

WHAT WE DON"T LIKE
Not a lot, frankly. It calls itself wholesale but it's available to retail investors with a $10,000 minimum.

COST
That retail offering is available at 0.97 per cent a year plus a 15 per cent performance fee subject to a high-water mark for excess return above the ASX 300 index.

ANDREW MAIN

R&D may well yield extra value

ROGER MONTGOMERY

THE essence of value investing is to consider separately a company's quality and its price. If you can identify high-quality companies and not overpay for them, you should do very well. Isn't it frustrating, though, when you discover such a company that does not appear particularly cheap?

Consider Ainsworth Gaming Technology (ASX: AGI). The company's economics are of extremely high quality. Looking back, we see revenue growth north of 20 per cent a year, sustained earnings-before-interest-and-tax margins above 30 per cent, and similar returns on equity. Further, AGI's balance sheet has been in a net cash position since the 2012 financial year.

Why was AGI able to achieve stellar financial results? When assessing company quality, the answer typically lies in the assessment of various forms of entry barriers to the market. For instance, gaming markets are regulated by government licenses and approvals — which create an entry barrier for would-be competitors. High switching costs for hotels and casinos represent a form of customer captivity: another entry barrier.

So quality is high, but what about price? Well, over the past 12 months AGI has generated about 20c per share in earnings. Against its current share price, this represents a trailing earnings yield of just 5.1 per cent. Is that a good deal? Consider that you can put your cash in a five-year term deposit bank account and receive almost the same return, for bearing essentially zero risk. On this simplistic basis, AGI does not seem an attractive investment. So, should you abandon AGI and wait for the next high quality company to come along? Not so fast.

On closer examination, we see that the company spends 11c of every dollar of revenue on research and development. This drives innovation in gaming technology, which can improve user engagement, machine yield and ultimately market share for AGI. The accounting rules require R&D to be fully expensed during the current period. Yet investors need not necessarily view such expenditures from the same perspective. To the extent you believe AGI's R&D will provide benefits in the future, you should think of it as a capital investment.

A capital investment is amortised over the number of future periods during which the company extracts a benefit. That is, a $100 investment today that will benefit the company over the next five years should perhaps be viewed as a $20 annual expense for five years. By expensing R&D, the company is effectively understating its earnings. We can do a rough adjustment by replacing the R&D expense with an estimate of annual "capitalised R&D amortisation" expense. This gets us to an adjusted 24c per share in earnings for the past 12 months.

Viewed this way, the reinvestment rate jumps to about 60 per cent, from about 20 per cent when R&D was expensed. Here, the reinvestment rate refers to all capital investments and acquisitions expressed as a proportion of net profit.

So of AGI's 24c earnings per share, about 14c is reinvested and 10c is available for dividends and share buybacks. Historical returns on incremental equity were around 24 per cent, suggesting that the present value of such profitable reinvestments is about 33c per share. So all in, the total effective economic earnings per share is closer to 43c (10c plus 33c reflecting the present value of profitable reinvestment). As a yield on the current share price, this equates to about 11 per cent. Suddenly an investment in AGI looks a lot more interesting.

So what is the moral to this story? On identifying a quality company, think about valuation carefully. It is not just about price-to-earnings or earnings-to-price or any other simplistic ratio. Think about the company's current and future opportunities to reinvest its earnings profitably.

Roger Montgomery is the founder of Montgomery Asset Management.