Seven opportunities to consider

From stocks to property to gold, there are many prospects

JAMES KIRBY

SOMETIMES it's fun just to stand back and look across the markets to determine where the good investment opportunities are at any given time. In mid-2014 we've got some clear basics to work with: record low interest rates, a lively sharemarket and an improving property market. Obviously every idea here carries conventional warnings: shares can be volatile, property is prone to cycles and unlisted trusts are illiquid (not easy to buy and sell). Separately, some — but not all — of these ideas have been recent recommendations at *Eureka Report*. With these key factors in mind, we offer seven interesting investment ideas.

Unlisted property trusts: They have a mixed history and they lack the transparency of listed trusts but they have been making very good returns and there are specific tax advantages in this area. Big players in the space would be operators such as Charter Hall and Cromwell Group.

Some of the best financial advisers have been pointing investors towards unlisted trusts in recent times because open-ended continuous trusts have substantial non-taxable income due to significant depreciation deductions — income yields average about 8 per cent a year.

An ASX 200 Index fund: Here's the thing: seven years ago the ASX 200 was at 6800 while today it is at 5480. We have a considerable way to go before we get back to where we were in 2007. Keep in mind that the US passed its 2007, pre-global financial crisis high many months ago. What's more, the sharemarket — unlike the residential real estate market — is not expensive on a range of key measures. In the absence of inflation, worldwide equity markets have an ongoing catalyst from easy monetary policy.

There will be shocks along the way but the ASX has returned 12 per cent a year in total returns on average for a century and it's a reasonable assumption that it will manage that number in future years. Index funds remove all thinking and worrying from the sharemarket process; you simply buy the index with all that's good and all that's bad and get an average return, which may suit many people these days.

Direct property: It must be Brisbane's turn. The two larger cities of Sydney and Melbourne have been racing ahead for 18 months with returns in double figures.

Oddly, Brisbane, though it was hit hardest post GFC with the flooding of the Brisbane River, has failed to get back on track.

The city's price growth trails the Sydney and Melbourne returns for no obvious reason other than a "time lag" — property yields across the city are as good and regularly better than the larger cities.

Virtually every property analyst says Brisbane is next in the national recovery. And with one in four new properties in Queensland being purchased by foreign buyers, according to RP Data, Brisbane is the standout residential opportunity this year.

A takeover target: With the blitz of activity around Treasury Wines, Goodman Fielder and David Jones, takeover fever is in the air. The nature of takeover activity is something akin to a domino effect — once the first moves are made, everyone must get into the game.

If you want evidence, recall how Saputo of Canada's bid for Warrnambool Cheese and Butter last year triggered a doubling in the share price and the arrival of at least four international food companies to the bidding process.

There are dozens of targets to choose from in the current market: One lesser known candidate is the healthcare stock Azure, a "buy" recommendation at *Eureka Report*. The healthcare group recently rejected a takeover attempt from an unnamed suitor but the stock price remains firm, a sign surely that this company is capable of making it on its own. That said, sooner or later another predator could arrive on the scene.

BHP Billiton: In anyone's eyes it's a "value opportunity" though patience may be needed. It's one of the world's greatest mining companies, locally listed and planning a spin-off. Even with $100 a tonne iron ore prices, when you are producing at $40 a tonne you can only win when the smaller miners get crushed.

Moreover, BHP is being named as a buy across the world; stockbroker Cazenove of London and *Barrons* magazine of New York have recently added their weight to the recommendation.

For many Australian investors the issue is that they already have BHP in their portfolios and may have witnessed the stock soar and drop through different phases of the mining cycle.

For newbies, though, it looks awfully attractive on a price-earnings ratio of 11 times and a dividend yield of 3.47 per cent.

A gold exchange-traded fund: Every diversified portfolio should have gold — and, unlike a lot of rival asset classes, gold is now thought to be nearing the end of its downward price cycle as it hovers at $US1300 an ounce. It is the great bulwark against inflation, and inevitably — as we are endlessly told by the best minds in business — global money printing is going to unleash inflation.

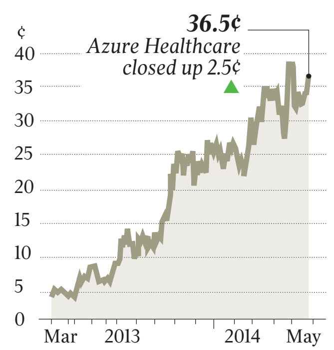
For many years the only way to buy gold was in the form of gold bars. (Obviously gold stocks are another possibility, but here we are talking about gold the commodity.)

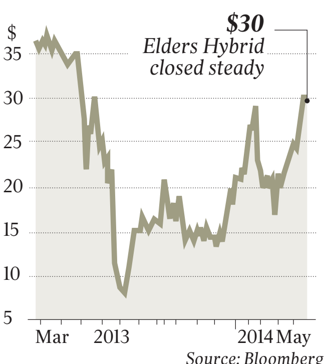
Traditionally, storage was the key problem: though gold bars look good they are actually awkward to keep and costly to secure. Now ETFs such as that offered by stock code GOLD or the Perth Mint's at stock code PMGOLD can track the pure gold price, allowing retail investors a new way into the precious metal.

A hybrid hopeful: If you are looking for a speculative opportunity in the fixed income market rather than a conventional income return, then the Elders Hybrid is a clearly very special security at a very special time. Basically this note (stock code ELDPA) and the company behind it have been doing it very tough for a very long time, but in recent months there is at last a sense of turnaround with new chief executive Mark Allison and a return to operational profitability. Just now there is the possibility this hybrid will improve strongly and it may soon start paying its "coupon" (or regular income) as well. It is trading at $30.

James Kirby is the managing editor of Eureka Report.

Although Brisbane's price growth trails Sydney and Melbourne returns, property yields are regularly better than the larger cities





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Exercise caution when it's PE time

ROGER MONTGOMERY

"THE great enemy of the truth is very often not the lie — deliberate, contrived and dishonest — but the myth — persistent, persuasive and unrealistic."

These words of wisdom from John F. Kennedy apply to many areas of our lives and surely to many aspects of investing.

One myth that seems to continually plague investing frameworks is the efficacy of the price/earnings, or "PE", ratio in stock valuations. While ubiquitous in the process of many fund managers, it is eerily absent at Montgomery.

Any investor in the stockmarket has surely come across the PE ratio.

It is the ratio of a company's stock price to its earnings per share.

It is a sensible first step in trying to provide some meaning to otherwise meaningless parameters in isolation.

Indeed, we estimate as much as 85 per cent of equity research reports are based on relative multiples and comparisons, so investors can be forgiven for being led down the road of conventional wisdom.

Ask an investor what comes to mind when a PE ratio of, say, six times is offered.

"Cheap" will likely be the first word that comes to mind.

On the other hand, test reactions to a PE ratio of, say, 25 times. "Expensive" will be the response, of course.

If only investing were so easy.

Most investors intuitively understand that a higher PE ratio can be justified if a company's earnings-per-share is growing more rapidly. After all, if earnings per share are growing at 15 per cent per annum, then in five years, the earnings per share will have doubled.

In a sense, this is like saying the five-year PE ratio of the stock is half the level of the current PE ratio. Those who subscribe to such thinking often point to the PE ratio as their tool of choice.

This logic, however, may or may not be valid. To a man with a hammer every problem looks like a nail. The missing ingredient is the investment required to achieve the growth in earnings per share. If earnings per share can grow at 15 per cent per annum without the company having to make any material reinvestments into its business — a rare but highly desirable situation — then a higher PE ratio can absolutely be justified. But what if the company needs to make significant reinvestments into its business, or acquisitions, to achieve such earnings growth? Imagine that, for every incremental dollar of earnings, the company had to spend, say, $20 in capital investments or acquisitions.

Should this company's earnings per share be worth the same PE multiple as the company described above that does not have to spend anything to achieve its earnings growth? Absolutely not.

Actually, in the latter scenario the more the company invests to grow, the more shareholder value is destroyed and the lower its PE ratio should be. As an aside, the market frequently and perversely gets this back to front, sometimes presenting short selling opportunities.

Another myth associated with the PE ratio is that it is comparable between the stocks of different companies.

It is certainly more comparable than, say, a company's stock price — which in isolation is an entirely meaningless number.

But there is a key problem with comparing the PE ratios of different company shares: it implicitly assumes the companies being compared are funded with similar proportions of debt and equity. This is often untrue in practice.

If the revenue line and/or the EBITDA of a company slumps, a shareholder who purchased the company's shares on a PE ratio of, say, 10, with a large amount of debt, will suffer a much sharper fall in wealth than a shareholder who purchased on the same PE ratio, the shares of a company that had the same earnings but had less debt. Two businesses, identical in every way except for how their assets are funded, will have very different PE multiples, especially if there is a hit to the revenue line.

Investors should proceed with caution when comparing PE ratios of different companies — particularly when they are in different industries.

The PE ratio can be a helpful first step in providing some meaning to otherwise meaningless isolated parameters.

Yet investors should not be hasty in drawing conclusions from PE ratios without further analysis, particularly with respect to the drivers of earnings growth within the business.

Finally, investors should remember that comparing PE ratios between companies is only valid in particular circumstances.

Roger Montgomery is the founder of Montgomery Investment Management.

Education stocks rise as unis lose their subsidies

UNDER THE RADAR

RICHARD HEMMING

SMALL-CAP education stocks look set to get a big boost from the federal government's decision to deregulate tertiary education.

The cut in subsidies to universities and the increasing subsidies to private educators will benefit private providers of after-school education, which provide access to diplomas and courses that deliver professional qualifications.

Gone is the 25 per cent extra that students are now charged if they wish to get a loan to pay for private tertiary education, encouraging them to pay upfront, meaning it will cost less to borrow.

Navitas is the bellwether of the private education sector, providing step-up courses for students who didn't get the marks to get into university.

Last financial year it achieved just under $730 million in sales, and made a net profit of $75m. Goldman Sachs was lukewarm, however, in its assessment of the 2014 budget's impact on the company whose market cap is $2.8 billion.

This could be because the details of the degree of subsidies to private educators aren't yet known, but it could also be because Navitas trades on a price-earnings ratio of about 30 times.

The real beneficiaries will be those private tertiary education providers that are much smaller (and newer), namely Redhill Education (RDH) and Academies Australia (AKG), which trade on multiples closer to 10 times.

These companies have market caps of $30m and $60m respectively. Both educate domestic and international students at all levels, providing English language courses through to "Master degree courses", as Academies Australia's website puts it.

This company's sales last year were $36m, delivering a net profit of $3.3m.

One investor across the smaller end of this sector is Mike Taylor, founder of New Zealand-based fund manager Pie Funds. Not surprisingly, he is in favour of the new education policies.

"Deregulation is positive because (private educators) can now can compete on a more even footing with public universities.

'Private operators look more attractive'

MIKE TAYLOR
PIE FUNDS

"The fee increases for higher education because of the funding cuts mean private operators look more attractive." He says beyond the budget's measures, these educators should deliver profit growth because of an increasing flow of students to Australia from overseas.

Not all education providers are set to benefit, however. Vocation is a provider of training services such as literacy support, and introductory courses and it listed on the Australian Securities late last year. One of the 10 programs the government pulled to cut $1bn across five years was the National Workforce Development Fund, which provided about 7 per cent of Vocation's revenues, according to one analyst.

Richard Hemming is an independent analyst who edits www.undertheradarreport.com.au. The author does not own shares the stocks mentioned.

Bankers come out swinging over FoFA

ANDREW MAIN
FINANCIAL ADVICE

THERE were 33 organisations pitching their ideological wares on Thursday in Canberra over possible changes to the Future of Financial Advice legislation, but really only two opposing factions.

The fault line was exposed yesterday more clearly than at any point in the past when the Australian Bankers Association, a supporter of the Coalition's planned changes, came out swinging yesterday against Industry Superannuation Australia, which hates them.

They had both presented to the Senate economics committee for and against the Coalition's planned changes to Labor's FoFA legislation, which came into law on July 1 last year, and ISA subsequently accused the banks of wanting to dilute the "best interests" duty of advisers to their clients, and wanting to re-allow the payment of conflicted payments, among other things.

The changes look likely to be generally adopted and recommended in a report from the bipartisan committee, due to be published just before July 1 when the Senate sees the arrival of the unpredictable Palmer United Party.

Diane Tate

The most contentious proposals include taking a "catch-all" clause out of a seven-clause definition of the "best interest" duty that binds adviser's to their clients, and removing the "opt-in" rules that forces planners to be effectively re-engaged every two years.

Diane Tate, acting chief executive of the Australian Bankers Association, said yesterday her industry had been misrepresented by ISA. "The banking industry strongly supports the original policy intent of the FoFA reforms, including the best interests duty and the ban on conflicted payments," she said.

'FoFA was never intended to include bank tellers'

DIANE TATE

"The ABA is not seeking changes to enable banks to charge or reintroduce commissions. The ABA is not seeking changes to dilute the best interests duty."

She said the banks had been granted a number of exemptions in the original FoFA to provide advice to customers but that they did not work properly.

"We're not asking for the existing basic banking exemptions to be expanded; we simply want them to work properly together."

The exemptions were granted for a year from July 1 last year because the matter had not been fully resolved, meaning that the future after July 1 this year is still uncertain even though that is the start date for a new workplace agreement covering how bank employees are paid.

They are part of the regulations that accompanied the introduction of FoFA and, unless they are changed, after July 1 there is a danger that payments for general advice by bank employees may be considered to be "conflicted."

Ms Tate said that bank staff did not get paid commissions but received a salary "and may have access to a performance bonus paid subject to a balanced scorecard". She said the banks were merely seeking "technical amendments" that would still allow customer protections such as the ban on convicted payments to be maintained.

"General advice is freely available from banks through branches and websites," she said.

"You don't even have to be a customer to get this advice.

"All we are seeking is to make sure that banks don't have to put in place new compliance processes, which make providing this information more difficult.

"FoFA was never intended to include bank tellers and bank specialists who provide information for customers wanting to open a bank account or get advice on other banking products."

RMB securities are an indirect route to property for all levels of risk

LIZ MORAN
SMART INCOME

THERE'S something innately attractive about property. It's tangible, it can be beautiful — for high-income earners, the asset class has a lot going for it. However, direct property investment may not always be the best way to have property exposure in your portfolio. The fixed income asset class offers alternatives.

For example, investors can acquire a senior bond in Stockland, Mirvac or Lend Lease offering a known return and a known maturity date. There is no guesswork in trying to locate growth hot spots or uncertainty regarding return. Investors are beneficial owners of the bonds and can buy and sell at their discretion.

Another way to gain property exposure through fixed income is via residential mortgage-backed securities.

According to the Reserve Bank, as of December 31 last year, RMBS on issue totalled $104 billion. For the 12 months to April 15 this year, there has been more than $6bn of new RMBS issued.

Investors in individual residential properties face concentration risk, illiquidity (it's hard to sell 10 per cent of the value of a property to fund a holiday or family emergency) and unknown returns given vacancies, unplanned maintenance and expenditure, and variable interest rates.

However, by combining many mortgages into a large and diversified pool via a trust, then breaking the pool into smaller, marketable classes, the RMBS becomes attractive to investors.

Different classes of RMBS offer a spectrum of risk although they are typically low-risk due to high underwriting standards, conservative loan-to-value ratios (averaging about 70 per cent) and the fact loans retain full recourse to the borrower if selling the property can't recover the borrowed funds.

RMBS passes through the principal repayments from the pool of mortgages, unlike bonds that pay interest and principal at maturity, so RMBS terms can be quite short. The concept of breaking the pool into varying classes of securities allows investors with specific risk appetites to target the appropriate class and returns.

In this way the classes act like a normal company capital structure, where investors with the lowest risk appetite target senior bonds (or in the case of RMBS, the highest classes) and those with a higher appetite target lower ranked capital, such as hybrids or shares (or in the case of RMBS, the lowest ranking classes).

The example shown was an RMBS issued by AMP in March, which originally targeted capital of $500 million, but due to strong investor demand was upsized to $1bn. The loans on average have been operating for three years. All the loans have lenders' mortgage insurance, which completely covers any losses. RMBS developed due to the need of financial institutions to source funding for their lending activities. Virtually all Australian Prudential Regulation Authority regulated lenders use RMBS as a source of funding.

RMBS is a low-risk investment that is in high demand and tightly held. If you are interested in these securities, contact a bond broker as they are available only in the over-the-counter market.

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