WEALTH

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EDITED BY JAMES KIRBY

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> The only asset you would have needed was a rocking chair. No mines, no strategy documents, no budgets and no highly paid management teams.
> ROGER MONTGOMERY

Beware the lure of the 'cheap' index fund: it's full of junk

ROGER MONTGOMERY

MARKETS around the world are taking another dive. It's not much help to Australian investors, and particularly those who have been advised to invest in cheap index funds.

Before the decline, The S&P/ASX200 had reached an auspicious level — the same level it was at in 2006. Eight years had passed and apart from the gains that might come from reinvesting your own dividends, there has been little or no return. And then the market starts falling again.

There is little comfort in index investing in Australia unless you take comfort from the false economy of paying low fees.

Don't get me started on the Australian appetite for "always lower prices". It is destroying our businesses, which can't earn the revenue to pay for their ever-increasing wages, annual leave, time-and-a-half and leave loading. In turn they are vulnerable to foreign businesses with superior finance that our government invites in with open arms to save them from the embarrassment of inadequacy.

Index funds market themselves as a cheap alternative to managed funds that evidently charge too much because — the argument goes — the majority of active fund managers don't beat the index. Well this fund manager does and after I have presented my case today, you should be convinced that it shouldn't be that difficult.

Let's take a company. We'll pick a blue chip like BHP (I could have used an airline, a construction company, a steel maker, or a bank such as NAB).

In 2006 BHP reported earnings of about $14 billion. In 2014 BHP reported that it earned about the same. Sure there's been some variability in between, but in essence there has been no growth in reported earnings over eight years. That in itself is a problem of course but the picture deteriorates rapidly when one considers the additional capital that has been employed by the company's owners and lenders to achieve that rather mediocre result over eight years. You see, in 2006 the company was employing about $33bn of its shareholders' equity and about $12bn of debt to generate that $14bn. In 2014 the picture is very different. In order to achieve the same profit, the company now employs $84bn of equity and three times as much debt.

If you owned a business outright, you might have hoped that the debt had been substantially paid down over eight years. Tripling your debt without growing earnings is not such a great picture. And if I gave you $50bn of additional equity, you could have dropped that into a term deposit, and even though interest rates have declined over the period, you'd still be earning more interest now than you did then. And by the way, the only asset you would have needed was a rocking chair. No mines, no strategy documents, no budgets and no highly paid management teams.

With an understanding of those business economics, it should come as no surprise that BHP's share price is exactly where it was in May 2006.

And this is a company whose shares many have been advised should form a "core" part of everyone's portfolios. If you are told to invest for the long-term only, it only makes sense if you are investing in businesses with superior economics.

Suffice to say, these types of companies have never made it into a Montgomery portfolio.

And of course, thanks to its size, BHP also makes up a sizeable chunk of the major stock market benchmarks. Surprise, surprise, when the benchmarks are dominated by large but mediocre companies, those benchmarks perform similarly to their underlying constituents and mediocre returns are the name of the game.

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If you are frustrated with the performance of your super fund, you now have the explanation. It's nothing to do with interest rates, oil prices or the latest economic data from the Australian Bureau of Statistics. Your returns have everything to do with the companies that have been selected for your portfolio and which have hitherto been described as blue chips.

Understandably, the more enlightened investor has now turned to index investing. The fees are lower and hey, few managers have beaten the index anyway. Right? Well sort of. Those who invest in the mediocre blue chips will always find it hard to beat the index but there is a recipe for beating the market and in theory it shouldn't be that hard. You simply remove mediocre companies from your list of potential candidates. Doing this should, as we have demonstrated so far, produce long-term returns that are commensurate with the underlying business performance.

So the next time you see an index fund offered at a "cheap price", understand that it deserves to be cheap. Like a Royal Easter Show bag, it's full of junk, and should be priced accordingly.

Roger Montgomery is the founder of Montgomery Investment Management.

Get ready for the great borrowing squeeze of 2015

Tighter conditions are set to shut out some investors

JAMES KIRBY

The crackdown on risky finance practices will make it harder to get a property loan

FOR Australian investors the theme of 2015 has suddenly become crystal clear: it's simple, but people are only beginning to digest its ramifications.

In the year ahead we have the delightful prospect of rock-bottom interest rates and ample opportunities across both the sharemarket and the property sector — the problem is not the cost of financing investment, it's the issue of availability. As of this week it's going to get harder to finance investment plans.

In the blink on eye three powerful agencies have moved to choke off the provision of super cheap finance, which has been pumping up the investment property market and making possible selected segments of sharemarket action.

Within days of each other the Murray inquiry recommended the complete scrapping of gearing in DIY funds, ASIC — the market regulator — said it was going to investigate "interest only" loans to make sure they were being offered "responsibly" and most ominously APRA — the prudential regulator — introduced long anticipated "marcoprudential controls", which are designed to arrest the banks dishing out investment loans to investors, especially for residential property.

Each of these three initiatives will combine to tighten the provision of finance:

● The government now has a green light for closing off gearing in DIY superannuation funds. This is a very narrow-minded policy. Why should the majority of investors who are careful and conservative pay to protect a small portion of investors who make silly decisions in property?

Moreover, if the measure goes through, an investor will not be able to borrow to buy, say, an investment property they fully understand. Paradoxically, they will still be able to buy, for example, a geared hedge fund, which is borrowing furiously to trade in a manner which very few investors — or indeed regulators — understand.

● In announcing its investigation into the level and condition of the "interest only" lending sector ASIC released the remarkable statistic that in the three months to September 43 per cent of new home loans were interest only. This is dramatic, but then when you can borrow at 5 per cent and get 4 per cent or more in rental income is it any surprise? Perhaps some pointed macroprudential policies that aim to peel back interest-only lending is in order. Such a measure automatically favours those who are already luxuriating in low rates and easily achieved positive gearing. But if it regulates the inner-city apartment market without making the entire economy endure an unnecessary hike in rates then it is a reasonable price to pay.

● The most striking of the new initiatives is APRA's warning to all banks or "approved deposit taking institutions" which are growing their mortgage books by more than an annualised 10 per cent that they will face "intense supervisory action" (i.e. they will have to keep more reserve, and consequently face a tightening of profit margins). A close look at the numbers suggests that over the past 12 months Macquarie Bank did not just exceed the new limit but broke it by a multiple of five with a 55 per cent growth in its mortgage business. Other players in the market, mostly lesser-known banks such as Members Equity (42 per cent) or Defence Bank (36 per cent) are all well in excess of this limit, the big four are broadly within the limit.

If only the new kids on the block — the peer-to-peer lenders — such as RateSetter and SocietyOne, which the Murray inquiry so clearly hails as welcome sources of new innovation, had managed to penetrate the market a little more before now. Unfortunately, for most investors the blitz of new efforts to rein in risky finance practice means it is going to be much harder to get a loan from the bank, it is going to be particularly more difficult to get an interest-only loan.

For experienced investors the irony of the measures is that rates are so low that it is actually quite difficult to get any decent level of negative gearing into an investment. Sharemarket dividend yields and residential rental yields at 4 per cent plus are very close to financing costs. As a result, some investors seeking negative gearing have to take out very large loans or multiple loans to get the level of tax deductions they might have achieved when interest rates were closer to normal, i.e. that is twice as high as they are now.

What is going to happen early next year looks like this: the investment property market will remain attractive; rates will stabilise or may even fall further (if we are to believe leading institutions such as Goldman Sachs, NAB and Westpac). In turn that means banks will be more selective with whom they do business and the investors who will be hit hardest are those at the margins: with the worst ability to repay, with the least attractive properties, with the poorest credit histories. All up we are heading up for a borrowing squeeze and a related clean-out in the investment property sector.

Most pertinently, investors who did not move quickly enough to move on our too-good-to-be-true low interest rates will now find it very hard to get into the race unless they have sizeable deposits whereas until very recently it looks like all you had to do was ask.

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Putin could play Russian roulette with our dollar's value

DAVID SOKULSKY

THE Russian economy has deteriorated sharply during 2014 as a result of sanctions imposed by the US and UN following the Ukraine crisis and the sharp decline in the price of oil.

As a result the Russian currency, the rouble, has declined by almost 40 per cent thus far this year, including a 25 per cent fall in November alone. There also appears to be further downside for Russia and the rouble given OPEC's decision not to cut the supply of oil, the possibility that US/UN sanctions may intensify as Vladimir Putin appears unlikely to back down over Ukraine, and Russian inflation is likely to increase above 9 per cent next year, which will further dent confidence in the currency.

On the surface, this does not seem to have much of an impact on Australia or indeed our financial markets, but this may change if the deterioration continues. The Russia-Australia link comes via the Central Bank of Russia's decision to diversify its foreign exchange reserves into Australian dollars and assets such as Australian government bonds as a result of the eurozone sovereign debt crises in 2011 and 2012. At the time, Russia had overall currency reserves of about $US500 billion and decided to allocate 1 per cent (or $US5bn) to Australian assets.

This overall figure has now fallen closer to $US418bn, but more importantly only about $US200bn of this total is available for use as Russia holds $US45bn in gold and $US171bn in two special savings funds — the National Wellbeing Fund ($US81.4bn) and the Reserve Fund ($US89.6bn). As such, if the economy deteriorates and Russia slips into recession in the first half of 2015 as expected, the magnitude of Russia's foreign exchange reserves may be more of an issue than people think.

The possibility of this scenario playing out was obviously a concern for Russia as it decided to abandon its managed (dual-band) exchange rate on November 10 in favour of a free-floating currency regime. This change means that Russia is no longer required to defend the value of the rouble, which would lead to further declines of its foreign exchange reserves if the currency came under attack. This is sound in theory, but the Russians did not count on the rouble falling as sharply as it did upon floating and despite the regime change, the CBR intervened again on December 1, selling another $700 million of foreign exchange. This latest intervention was important as it showed that the government is still willing to use its foreign exchange reserves to support the currency.

This signal from the government has important implications for Australia as it suggests that if the rouble continues to decline, the CBR will sell additional reserves, which could include the Australian assets it holds as part of its reserves. If this were to occur, the Australian dollar would probably come under pressure while Australian government bonds would also probably be sold. This implies that there may be further downside for the dollar despite its recent weakness and this should benefit both the Australia economy and investors with allocations to foreign assets.

Conversely, a sell-off in bonds would see market rates move higher, which would hurt bond investors and potentially see borrowing rates increase beyond what the strength of the domestic economy warrants.

Australian investors should watch the situation in Russia closely with the view to pragmatically adjusting their portfolios if the Russian economy and the rouble continue to weaken.

David Sokulsky is head of investment strategy at UBS Wealth Management Australia.

THE COACH

I have some small parcels of shares, mostly inherited. I would like to sell some of the parcels but can't work out the most cost-effective way to do so. Fees with commercial brokers are high which almost negates the sale! How do I sell the shares with a decent return on them?

AS it's Christmas we might point out a very impressive and laudable service that has linked charities and the sharemarket.

An alternative to selling the shares via a broker or an online broking service is to donate the proceeds of small parcels of shares to charity. Sharegift Australia is a not-for-profit organisation that gives shareholders an easy and tax-deductible way to sell and donate small parcels of shares. The service is free and 100 per cent of the market value of the shares is donated to the charity nominated by the shareholder, provided the charity has deductible-gift recipient status. Donations of $2 or more are tax deductible to the shareholder. Sharegift can be contacted at 1300 731 632 or visit sharegiftaustralia.org.au.

> Donate the proceeds of small parcels of shares to charity

Sharegift is run by a collection of highly-regarded executives in the market, it is endorsed by the ASX and the Australian Shareholders Association. The chairman of the group is Christopher Thorn of Evans and Partners.

More commonly the way to sell odd lots of shares is through a broker or online broking service. A full-service broker will give you advice on whether to sell or hold your shares. Fees are usually based on a percentage of the value of the shares. A minimum fee will start at about $100, which can be expensive depending on how small the parcels are.

If you don't need advice and are only looking to have the sale of shares executed, an online broking service may suit. The cost of selling the shares online starts from about $15 a trade. Online comparison sites give a guide to features and costs of the various online broking services available.

From time to time listed companies may offer to buy back small parcels of shares direct from shareholders. The advantage is that there is typically no charge for brokerage. But there is no guarantee a buyback will be offered for the shares you own.

Visit the Wealth section at www.theaustralian.com.au to send your questions, which will be answered by Andrew Heaven, an AMP financial planner at WealthPartners Financial Solutions.

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