Andrew Main finds a top fund manager looking beyond bank stocks for yield. The answer may surprise you in **WEALTH** on Tuesday.

Family ties can backfire in DIY super funds. What's more, they can fall foul of the ATO. Find out why with **Tony Negline** in **WEALTH** on Tuesday

The time for investors to get active

The US presents itself as the year's standout opportunity

STIRLING LARKIN
GLOBAL INVESTOR

IT is beyond question that this will be a tumultuous and, at times, haphazard year for the global investor.

Over the past two years, passive investing — a low-maintenance investment strategy of buying and holding assets for longer term gains — has proven to be a successful investment strategy allowing ultra-high-net-worth (UHNW) investors and retail investors alike to profit.

In contrast, the aggregate of global active managers in 2014 underperformed comparable passive index funds by the worst margin in more than a decade, highlighting that many are unfit to the task.

Adding to their woes, a multitude sat on the wrong side of several key trades throughout the year; most notably involving global oil, Swiss Francs and copper.

Such errors in judgment were extremely costly for some active investors while it remained paradoxically easy for passive investors to continue holding their relatively complacent positions.

Such placidity, however, could be dangerous, as the emerging view is that 2015 is to be the year in which the wheat is separated from the chaff.

In investing terms, that means we will find out who the skilled investors are and who have just been going along for the ride.

In this light, if there was ever a right moment to advocate the merits of active advice, now would be that time.

Active advice, albeit provisioned at a cost to the investor, becomes highly valuable when conditions are too tricky for the passive investor to navigate alone.

Active participation in markets will not be for the faint of heart this year but, equally, it would be a folly to presume that 2015 will be a continuation of the comparatively stable conditions enjoyed in recent times.

Therefore, leaving passively placed investments unsupervised during such times would be a mistake and put at risk the gains enjoyed since 2012.

Because the markets and the financial sector are ultimately the servants of the real economy, their recent global divergence should be closely studied.

The Australian stockmarket and real economy are without a doubt, running on half steam, while the US is powering ahead.

China is successfully in the process of changing their driving engine while Europe is still deciding how many carriages it should lug and who should pay for which tracks.

Russia, South America and "MENA" (Middle East & North Africa) appear to have run off the rails altogether.

Facing such contrasting global conditions, seeking active advice will allow the global investor to be prepared for the greatest "known unknown" this coming year: what will happen to equity, debt and credit markets when the US Federal Reserve begins "lift off" from "zero lower bound" interest rates?

Australian UHNW investors, in particular, are proactively positioning for this eventuality, primarily because the return of positive US interest rates has serious implications for their internationally exposed portfolios, initially seeded with Australian dollars.

This is due to the fact that even with lowering domestic interest rates, the Australian dollar itself looks ever more attractive to an increasing number of affluent American UHNW individuals.

This, in turn, could very likely strengthen, not weaken our Australian dollar.

As the graph illustrates, North American private wealth remains dominant, considerable and unchallenged.

Traditionally, sophisticated American private investors sought to diversify their US dollar concentrations into stable foreign currency reserves; predominantly Swiss francs, euros and Japanese yen.

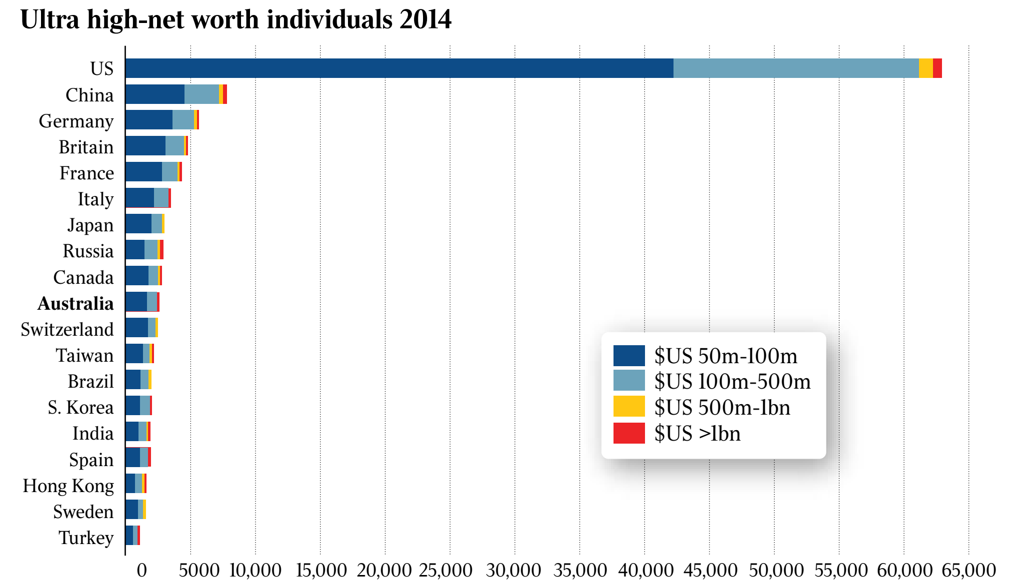
However, following the unprecedented volatility in all three over the past two years — and particularly the snap announcement on 15 January by the Swiss National Bank that they were unpegging the Swiss Franc to the euro — they have turned to the next two preferred stalwarts, the Australian and Canadian dollars.

The recent IMF COFER report, which tracks foreign currency reserves of international central banks, reflects this trend.

AFP

US markets clearly look like the place to be this year with expectations of a double-digit return on S&P 500

Ultra high-net worth individuals 2014



Source: James Davis

This is significant in that it is generally accepted that central banks shadow the private currency reserves of their respective elite and vice versa.

For Australian UHNW investors in turn, US markets clearly look like the place to be this year even in light of the "known unknowns" of rising US interest rates and expected political jousting ahead of the 2016 presidential elections.

While the cross currents of growth without inflation concern some, it is generally broadly accepted that the US business cycle is midcourse and faces no imminent threat of stalling.

Furthermore, many of the key indicators this year, thus far, augur for a bright future for the US real economy. These are also reflected in the expectation of a double-digit total return on the S&P 500 in 2015.

They are justified by the proven solid momentum in US economic growth, continued improvement in consumer fundamentals and importantly, the bettering dynamic within the domestic US housing market — a source of great concern until recently.

Benchmark S&P 500 valuations remain reasonable, corporate capital deployment is accelerating and their balance sheets appear healthy.

Within this benchmark, the preferred opportunities this year appear to be found in US healthcare, technology, financials & consumer discretionary sectors.

Of course, the next challenge is determining whom to seek this active advice from and to decide what is the wheat and which is the chaff. In answering that Socratic question all paths lead to the same place and that is the United States of America.

Larkin Group is a Wholesale Wealth Adviser focusing on high yielding global investments www.larkingroup.com.au

Baby boomers ignore China lag and bond bubble at their peril

ROGER MONTGOMERY

ON Monday the Australian sharemarket rallied two-thirds of a per cent, even after the US markets were 1.5 per cent lower on the previous Friday.

Such is the power exerted by the chase for yield ... and that was before the Reserve Bank of Australia cut rates again, this time to 2.25 per cent.

Baby boomers, desperate to earn something, anything above the paltry sums offered by term deposits, are frog marching themselves into riskier and riskier products.

You might recall in August last year the Commonwealth Bank issued it's PERLS (Perpetual Exchangeable Repurchaseable Listed Shares) VII hybrid securities at $100 each, offering 2.8 per cent above the bank bill rate, and raised $3 billion.

Investors who chased that 2.8 per cent margin over bank bills suffered a 3 per cent capital loss on the first day. (Elizabeth Moran delves further into bank hybrids elsewhere in this section today.)

As the period of low interest rates gets longer and the time to retirement gets shorter, investors are desperate to shore up their income.

Anyone and anything that can produce even the slightest promise of a higher yield is being pursued with almost reckless abandon.

But investors need to be very cautious this year. One of my major concerns for the Australian economy and market place is plunging growth in China with some experts forecasting growth ultimately slowing down to 3 per cent.

The other concern is what may just be a bubble in Australian bonds — interest rates are now the lowest they have been since the depressions of the 1930s and 1890s. But we don't have a depression.

Low growth will produce a hard landing for countries dependent on Chinese growth — particularly through commodities — and that includes Australia. And ultimately higher interest rates will produce a hard landing for investors who have been chasing high yields.

For the moment, many experts believe declining oil prices will bring benefits that might offset the impact of some of these forces.

They also believe that the slowing Chinese economy will keep interest rates low in Australia. "They" are the same people who failed to forecast the fall in iron ore and oil prices, and depression-level interest rates, in the first place.

The reality is that countries exposed to a slowing China and those that are exposed to slumping oil prices tend to adjust adversely much faster than the economies benefiting from declining oil prices adjust favourably.

In between the two lies what many are suggesting is a recession.

Concerns about Australia's exposure to China and a possible economic slowdown are responsible for the decline in the Australian dollar.

Of course, a lower dollar should help our competitiveness but as I mentioned recently, capital expenditure and investment doesn't occur immediately.

The currency needs to remain stable at lower levels for some time before the decision to invest capital is made. In the meantime, jobs and income aren't created and the risk of a recession emerges.

> For many markets there is a heightened risk of adjustment in the next 12 to 18 months

Of course, what I am describing are normal business or economic cycles. For the moment, however, asset prices appear to reflect the thinking that such cycles are dead — that central banks and their quantitative easing have killed the business cycle.

That may be true for a time but it won't be permanent. It cannot be permanent and high yield chasers may find the little extra they made on their income was not worth the extra risk to their capital.

I think the risks are simply too high and simultaneously our investment process has The Montgomery Fund holding 20 per cent cash, while the Montgomery (Private) Fund is holding more than 30 per cent cash.

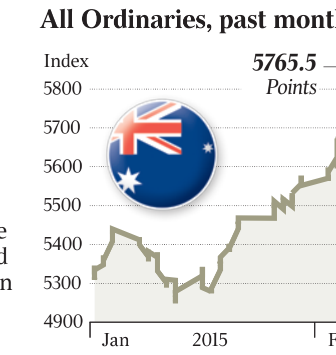
While I cannot forecast interest rates, economic growth or the currency, I can see when asset prices seem to have disengaged from the risks that inhere in them.

For many markets there is a heightened risk of adjustment in the next 12 to 18 months.

And as my friend Hamish Douglass of Magellan Funds pointed out recently, it is better to be six months early than six minutes late.

Roger Montgomery is the founder of Montgomery Asset Management.

All Ordinaries, past month



Source: Bloomberg

Medical stocks are risky but a good call can transform your portfolio

RICHARD HEMMING
UNDER THE RADAR

LAST month, little-known Australian-based medical technology company Medical Developments delivered the much awaited news it has received approval to sell its analgesic Penthrox into Britain, France, Belgium and Ireland.

The shares have returned more than 70 per cent since I recommended them in May, and the big reason for the excitement is the kind of supercharged earnings growth that medical technology stocks can get when they gain access to a global marketplace.

In financial 2014, Penthrox achieved sales of about $6 million in Australia. The British market alone represents three times that amount.

Managing director John Sharman told Under the Radar: "Now that Penthrox has been approved, theoretically we can roll it out into the rest of Europe in 90 days, and then it's on to the US."

Australians have been getting "high" on Penthrox for years, as it is used here by emergency services and dentists as an inhalant for pain relief. It is a safe alternative to morphine, being based on the halogenated ether chemical methoxyflurane.

The return from Medical Developments pales in comparison with those made by early investors in diagnostic product producer ImpediMed and radiation-based tumour buster Sirtex Medical.

These stocks have more than quadrupled in value because of their success in the global marketplace for medical technology.

In the main, the stocks in this sector contain big risks, but as you can see, when you get it right, they can transform your portfolio.

This has never been more important than now, where much of the sharemarket's return is simply based on continuing low interest rates, which translates to rising asset prices. There is a limit to how much these yield-based trades can produce strong returns.

To invest in medical technology you must spend as much time analysing the regulatory environment for each product as you do the science.

It is easy to get carried away with cutting-edge science, such as immunotherapy, and the "billions of dollars" of potential seductively sold to potential investors.

But the probability of success is extremely low.

It is not uncommon for shares in the sector to plummet more than 80 per cent in a day when the science does not measure up with commercial reality.

Stocks such as Prana, QRX, Pharmaxis, Prima Biomed and Alchemia come to mind.

At one time we said punting on Alchemia was a better bet than going to the track. It turns out you would probably have had a better time at Flemington.

The stock fell 80 per cent in one day in October after the company announced its big hope, the HA-Irinotecan cancer treatment, failed to meet targets. But one factor that drew us to Alchemia was its worth wasn't simply based on research and development.

A recent announcement by the company indicates it is far from a lost cause, as it prepares to return to investors the more than $10m a year in revenue from fondaparinux, its generic treatment for deep vein thrombosis.

Similarly, when we first looked at Medical Developments, we were impressed by its historic strong annual operating cashflow of between $2m and $4m.

Medical technology companies are no different from other investments — cash today talks louder than potential tomorrow.

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