Anything wrong with 'default super'? **Andrew Main** takes a fresh look in **WEALTH on Tuesday**

Tony Negline. You can make an investment property held by your super fund your home in the future. Find out how to do it in **WEALTH on Tuesday**

Year of the new China billionaire

AS reforms kick in, canny investors see new opportunities

STIRLING LARKIN
THE GLOBAL INVESTOR

IN a year in which double-digit returns are expected for US investments, some Australian ultra high net worth (UHNW) investors are asking whether they should still consider mainland China as a viable investment alternative?

To answer this question, one needs to understand the phenomenal transformation afoot within the Asian wealth market and China in particular.

Many investors don't fully recognise what is happening in these economies and choose instead to concentrate on more sensationalistic reports that focus on China's current headwinds.

Asia is changing and driving this from the centre is the Middle Kingdom of China.

This trend is more than simply a story surrounding the successes of Alibaba or any one-off stockmarket rally, as seen on the Shanghai Composite in late 2014.

For example, what is widely known but poorly appreciated is how President Xi is transforming China from an industrial driven to a consumption-led economic model.

Further compounding these misconceptions is that much of Australian commentary focuses on the immediate implications for Australian counterparties — such as listed iron ore or coal exporters — and too little is made of the bigger picture which has long-term ramifications for the actual prosperity of the Chinese economy itself.

Ironically, on this point, the majority have failed to notice that as the graph suggests, the consumption of coal in China fell outright in 2014, for the first time since 1998.

All that aside, for informed Australian UHNW investors considering sophisticated Chinese investments in 2015, several key transformation criteria are, thankfully, being met and in so doing presenting lucrative investment windows that may not be readily apparent to other investment communities.

The boom in Chinese stockmarkets in 2014 was an interesting case in point.

The China Securities Regulatory Commission, China's primary securities regulator, made it well known in early 2014 that they were working closely and collaboratively with China's federal government to reform stockmarket margin lending.

These efforts were intended to help redirect domestic investment away from speculative real estate investing — often being financed via "shadow banking" institutions — and towards China's largely under-supported stock exchanges.

Although this sharp rally has since dissipated, savvy global investors are still closely watching these markets, with good reason.

For example, before this week's new Lunar Year began, China minted 24 new billionaires in the month of January alone via 20 new initial public offers on China's bourses.

In another timely example, following the exceptionally successful NYSE listing of Alibaba in 2014, the company's finance arm, Ant Financial, is rumoured to be seeking its own public listing in early 2016, which will, no doubt, also be well received by global investors.

However, not all is boding well for China's listed entities given the collapse in global commodity prices, falling profits of China's industrial sector, weakening property investment and the recent sharp fiscal contraction made by the Chinese government.

Since heavy industrial corporations make up a sizeable proportion of China's publicly traded sector, this fall is bad news for listed company earnings.

State-owned banks, which make up another large portion of China's stock market indices, also face earnings pressure as expected interest rate cuts hurt their margins and bad loans writedowns accelerate.

Of course, many of these factors are interrelated and you cannot expect success in all while transferring the emphasis from one economic model to the next. Savvy global investors fully accept this.

Given the re-emphasis towards domestic Chinese consumption, the recent news that, with the exception of the property and utilities sectors, the Chinese private sector has recently performed very well is being celebrated by the long-term foreign investor.

This was exemplified by the recent announcement that profit growth at private companies exceeded those of state-owned enterprises by an average 7 per cent in third-quarter 2014.

Australian UHNW investors are also taking comfort from the news that to ensure continued financial stability the People's Bank of China has taken decisive steps this month to shore up support for financial institutions, supporting private companies during the particularly demanding Chinese New Year period.

In any expectation to outperform double-digit US returns this year, the global investor requires some confidence in the currency denomination of the investments being made. On the question of Chinese yuan strength, there is an argument circulating that even with the US Federal Reserve expected to raise interest rates, which is likely to lead to a rise in the US dollar, the strength of the yuan may be greater still in the foreseeable future.

This is because after years of keeping their currency undervalued, Beijing has learned that a strong currency serves its needs best: cutting its commodities import bill, giving consumers more purchasing power and forcing low-end exporters up the value chain.

China's vision for the yuan to be Asia's anchor currency would be significantly undermined by any competitive devaluation and therefore a strong and possibly even stronger yuan is here to stay.

Unlike Australia's Reserve Bank or even the US Federal Reserve, which cannot persuasively intervene in the trajectory of their own currencies, when it comes to the yuan, the PBOC in China can meaningfully intervene, if required or desired.

At a time when Chinese, Americans, Europeans and Australians have become accustomed to asset values going up due to the massive monetary expansion of the past 30 years, it is critical to remember that as the "cheap money" dries up, even in the Chinese domestic market, our investment focus in China must be squarely on those opportunities that will not heavily rely on easy credit in this next stage of the cycle.

Informed global investors who know what to look for will be able to identify these opportunities which are readily attainable in the viable investment alternative of China.

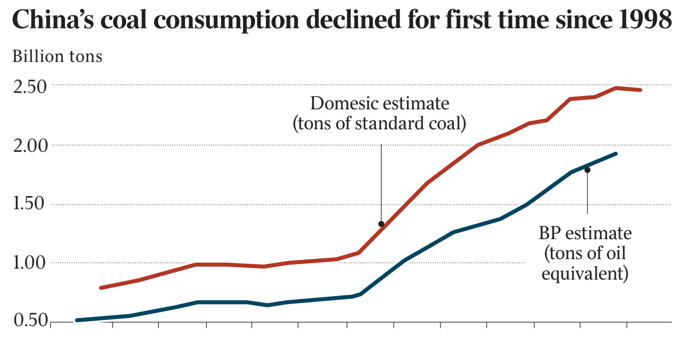
Larkin Group is a Wholesale Wealth Adviser focusing on high yielding global investments.

www.larkingroup.com.au

AP

The year of the goat will mint more new tycoons in China, with 24 new billionaires in January alone via 20 new IPOs

China's coal consumption declined for first time since 1998



Source: CEIC Data

Telstra's market value doesn't really ring true

ROGER MONTGOMERY

DIVIDENDS ... it seems pre-retiree baby boomers can't get enough of them. With interest rates shrinking to sub-inflation levels, a millionaire now earns less in interest on cash than the poverty line.

In contrast, when franking credits on dividends are taken into account, the yield on offer from some of Australia's largest corporates looks like a no-brainer. If a business like Telstra can deliver a gross yield of close to 6.5 per cent (that is 6.5 per cent returns after tax credits are included to the investor) and there's no reason to think its earnings are at risk of decline, why on earth would anyone in their right mind choose to leave money in cash earning less than half that?

Well, for one I would. Let me explain why.

When you own an appreciating, dividend-paying share for a period of time, your return has two components — the dividend yield and the capital gain. Over long periods of time, the dividend yield (excluding franking credits) tends to average somewhere near 4.5 per cent and the capital gain tends to be about 6 per cent, for a total return of around 10.5 per cent.

Excluding franking credits, Telstra offers a yield in line with that long-term market average, so if the capital gain on Telstra shares works out in line with long-run averages then the total return from today would be, hypothetically of course, somewhere close to 10.5 per cent. As well as a yield that beats cash by a handy margin, investors would enjoy a significant annual average capital gain.

Unfortunately, averages can be dangerous things in the equity market, and on my analysis, Telstra is a far from average investment.

Firstly, let's consider growth. Earnings growth is the driver of that 6 per cent per annum capital gain mentioned above. Most companies achieve this growth by retaining some of their profits each year, and reinvesting them in expanding the firm's asset base. This means that the dividend is smaller than it could have been, but shareholders are compensated by the future growth delivered via the reinvested profit.

Telstra is a little different. It tends to pay out pretty much all of its earnings as dividends, and retains very little to reinvest in growth. This is not necessarily a bad thing — it may be that given Telstra's size it has few opportunities left to reinvest — but it does mean two things:

- Telstra's dividend is higher than it would be if the business were investing for growth; and
- Telstra hasn't really grown very much. While it has delivered some improvements in operating performance in recent periods, over longer timeframes the growth story is unimpressive. Indeed, its current earnings are not far from where they were a decade ago.

What this means is that Telstra probably doesn't have the driver that fuels long-term capital growth — the 6 per cent per annum figure mentioned above may just remain hypothetical.

But wait, you say. Telstra shares have rallied from below $3 in 2011, to more than $6.50 recently. Clearly, investors have enjoyed bucket loads of capital growth making Telstra shares a spectacular investment.

And it's true: Telstra's shares have soared in recent years. Investors have done extremely well.

However, when share prices rise strongly in the absence of corresponding earnings growth, it usually means one of two things:

- Either the shares were too cheap to begin with, and the market has merely adjusted them to the correct level; or
- They were not too cheap to begin with, and the market has now pushed the price well above intrinsic value.

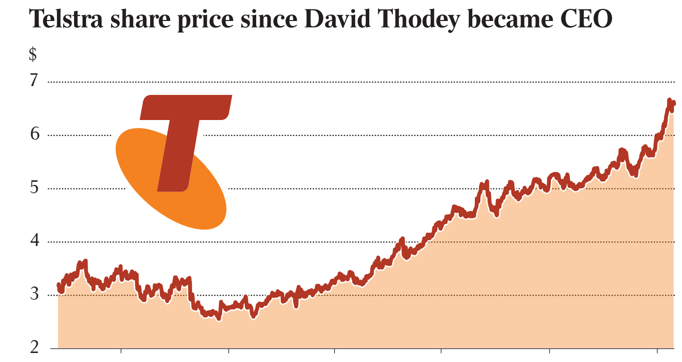
In the case of Telstra, it looks very much like the latter. More specifically, it looks like yield-hungry investors might have bought Telstra for its dividend in recent years, and turned a blind eye to the underlying value.

The higher the shares rise presently, the more hypothetical a future 6 per cent capital gain becomes. In the long run, share prices tend to find their way back towards intrinsic value. That means that an investor buying Telstra today needs to consider that instead of that average 6 per cent per annum capital growth, they might experience something closer to zero. Or less than zero and possibly even a negative number that wipes out the positive return from dividends.

And when that happens the fully franked dividend yield will not provide much comfort.

Roger Montgomery is founder and CIO at The Montgomery Fund.

Telstra share price since David Thodey became CEO



Source: Bloomberg

Fate of small cap explorer shows size matters in oil price plunge

RICHARD HEMMING
UNDER THE RADAR

THE 60 per cent slide in the oil price between June and January has brought some companies in the sector to their knees, but it has provided others with opportunities to make big money.

As the global financial crisis did for all companies, it highlights the risks involved in the small end versus the big.

Take the fortunes of small cap Neon Energy and industry big cap Santos. Both companies embarked on failed expansion strategies, but only the minority shareholders at Santos will live to fight another day.

Neon is now at the mercy of a partial takeover offer by corporate raider Evoworld, based in the Perth suburb of Subiaco.

From the little information provided about Evoworld, it would appear those involved have little history in the sector, while the company has no obvious history of investing. What it has done is spend less than $4 million to get control of the cash in the company of about $16m, which is quickly being eaten up by "administration" payments ($3m were made last quarter).

Neon's shares have plummeted from about 40c-plus levels in late 2013 to about 3.3c now.

Evoworld has accumulated just under 20 per cent of the company and is now offering 3.8c a share for 50 per cent of each investor's shares in Neon. The offer had originally been for 3.5c for 30 per cent of investors' shares, and was presumably increased to gain the support of outgoing directors.

Neon is a cautionary tale of a speculative exploration stock that got into trouble because well costs blew out, forcing it to sell productive assets to ensure survival.

Similarly, Santos has been hit by the double whammy of the oil price fall and an expansion that cost more than expected.

The lower profitability at Santos has been compounded by a $2.4 billion before-tax writedown, mostly of oil assets and the NSW coal-seam gas business.

This put the company's balance sheet under pressure just when it was attempting to fund its multi-billion-dollar liquefied natural gas project.

Investors believe Santos will have to raise equity if something goes wrong — but, importantly, there is no possibility a corporate raider will come in and snatch the cashflow potential out of minority investors' hands.

If you are going to invest in the oil sector, it is the companies that can take advantage of the turmoil that will do best.

Giants Woodside and Oil Search are in a much better position than Santos because of their low-cost production and strong balance sheets. Both have ample amounts of cash to pick up assets on the cheap. Even if Santos wanted to, it could not contemplate doing that — it may have to do the opposite and sell assets.

Small caps are heavily leveraged vehicles whose stocks can easily double in size because they're coming from a small base.

But in times of commodity price weakness, you want to remember the Robert Holmes a Court investment philosophy, which was akin to buying the lowest-cost dominant player in any industry. In the cutthroat world of resources, size counts.

Richard Hemming is an independent analyst. r.hemming@undertheradarreport.com.au