The myth of the misspent lump sum. **Andrew Main** investigates in **Wealth on Tuesday**

Do you really need $1 million to retire? **Elizabeth Moran** does the numbers in **Wealth on Tuesday**

New opportunities shine in China

Australia is being left behind as the rest of the world dives in

STIRLING LARKIN
GLOBAL INVESTOR

Martin Luther King Jr once said that we don't have to see the entire staircase, all that we need to do to progress is to take the first step.

When it comes to investing directly into Chinese mainland bourses, Australian investors, retail and sophisticated alike, remain particularly reluctant to take such a step.

This is despite the fact that other foreign individual and institutional global investors are not only cleverly taking these steps but are now several paces up the staircase, well ahead of us.

The Australian global investor remains consciously indifferent to the recent stellar performances seen on Shanghai's CSI300 index, the successful listing of Alibaba on the NYSE and the fact that China remains an economy representing one fifth of the world's entire population still growing at "5 per cent plus" per annum.

Coffee shop banter along George and Collins streets may be filled with white-collar professionals chatting about all things Chinese but when these same "China acolytes" are asked whether they would be willing to make any investment, risky or conservative, directly into China, the answer always, ironically, appears to be a "no".

Even though the year is now 2015, most of these "pundits" remain more preoccupied with grumbling about why China is no longer buying our iron ore, that it no longer needs, at prices seen in economic times well past.

This hypocrisy, if played out in reverse, would see Chinese salesmen try to sell Australians' VHS video cassettes at a unit price fixed at 1985 pricing in the year 2015.

Clearly, that wouldn't make sense and defies the basic logic of commerce and trade, let alone reasonableness.

Professional fault finders would then rehash the old argument that China still harbours "shadow cities" where "irrational exuberance" led to overzealous regional officials building cities that were never needed.

But again, this diatribe has been discredited many years ago by those who appreciate that Chinese construct infrastructure for the decades ahead.

Many of these touted "shadow cities" are now, in fact, being populated and prospering.

Visiting several of these myself, such as the new cities of Central Shanxi Province, there's nothing "shadowy" about them.

Further still, according to a new OECD report and as the graph illustrates, the UN had itself, until very recently, significantly underestimated the size and capacity of growth in China's megacities, defined as those with more than 10 million people.

But what makes this story particularly interesting is not the foreigners' misconceptions, the Chinese whispers or even the classic economics in play but, rather, the formidable gravity of the Chinese Communist Party's pull as a central markets puppeteer.

Much is written about the scientific aspects of markets within China but at this point in time, such science becomes irrelevant when contextualised against the politics.

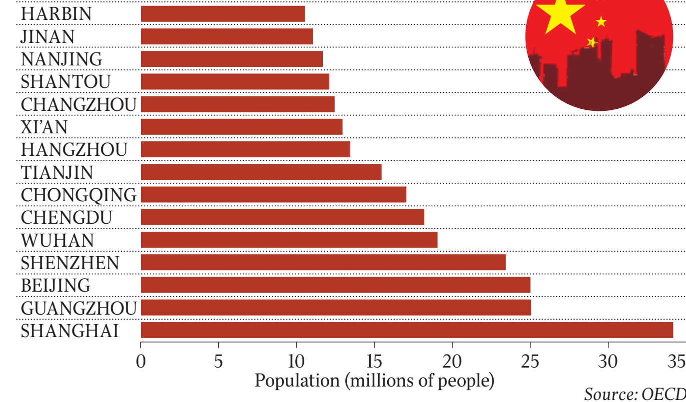
Conceptualised differently, understanding why the Chinese stockmarkets are rallying has little to do with market fundamentals and far more to do with political puppetry.

There is no conspiracy at hand — all that is transpiring is that the Communist Party's political apparatus is demonstrating how its authoritarian style of market architecture will now work and presumably continue into the foreseeable future.

On this, the forward-looking global investor is very interested to know what further architectural amendments will be announced by the politburo at the upcoming fifth plenary session of the 18th National Communist Party Congress in the Chinese autumn (October) of 2015.

AFP

The recent rally in Chinese stockmarkets has more to do with political puppetry than market fundamentals



China's megacities

OECD says there are 15, more than double UN estimates

Source: OECD

Perceptive ultra high net worth (UHNW) overseas global investors have already identified this upcoming watershed moment and are tactically taking positions in anticipation.

To fathom why many Australian global investors continue to misread the situation, it is important to quickly understand where our misconception began.

In short, Western capitalism's understanding of markets is deeply rooted in the original theories of the first recognised major economist, Adam Smith.

Smith argued individuals seek their own economic self-interests, which, by their very nature, allow an "invisible hand" to best allocate capital with resources, labour and investment.

By contrast, the CCP's authoritarian approach to markets flies in the face of this premise, because, the state represented by the CCP in China, directs the metaphorical hands. Whether this is philosophically right or wrong is a debate for another day.

But what it means for Australian investors is that they need to rapidly awaken to how other markets function, particularly in light of the fact that China's markets will indubitably dominate our side of the Pacific, both in scale and velocity, in the coming decades.

Perceptive foreign UHNW investors understood that the first step the Communist Party took was to allow Chinese domestic individuals to speculate on real estate assets.

Appreciating that the Chinese banking system was originally built to predominantly assist state owned enterprises (SOEs) and not domestic consumers (as seen in the West), these UHNWs respected why what we refer to as "shadow banking" investment solutions — banking solutions provided by non-banks — were allowed to proliferate in the way that they did.

It was a purposely permitted buffer for the excesses that were accumulating in the overly invested domestic real estate market.

Today, these same perceptive global investors understand that the CCP's redirection of allowable domestic investment from real estate and "shadow banking" investments towards Chinese stockmarkets is both a part of the CCP's grander plans and also its current tacit objective.

The Australian's China correspondent, Scott Murdoch, correctly reported in his April 25 story the oddities being seen by the Chinese government who were both concerned and yet at the same time stoking domestic Chinese investors to pile into their own bullish stockmarkets.

Maybe when considering Martin Luther King Jr's advice, the first step Australian global investors should take is to accept that not all staircases lead us to the same destinations.

Larkin Group is a wholesale wealth adviser focusing on high yielding global investments. www.larkingroup.com.au

Use with care: the crude truth about P/E ratios

ROGER MONTGOMERY

Has the market's enthusiasm eroded all the safety out of buying stocks? I am leaning towards thinking so. In fact, for a few weeks now I have been saying that there are very few quality stocks that are cheap.

Meanwhile, outside the share market, an apartment from the latest series of the Nine Network's *The Block* sold for $2.23 million, $835,000 above reserve, and a Lin Onus painting sold for $512,400, with buyer's premium, above the $150,000 estimate.

We appear to be in a good old-fashioned asset boom.

I cannot see how it will all end nor when but experience tells me that it is time for cautious optimism at best and nervous caution at worst.

The poor underlying earnings growth does not justify the rich prices attributed to stocks in Australia, and highly priced US stocks are equally precarious after a seven-year economic expansion that appears to now have the wobbles despite trillions of dollars spent in stimulus activity.

Many analysts are using the high price to earnings (P/E) ratios to justify their arguments that the market is expensive. But if you don't already know, I have no use for P/E ratios.

P/Es can't tell you very much about whether stocks are cheap or expensive other than in the most crude and rudimentary way. Here's why:

Suppose three companies each have $10 of equity per share, each returns 20 per cent on that equity, and each is trading on a P/E of 10, which equates to $20 (ie $2 of earnings multiplied by 10).

The only difference is that the first company is paying out 100 per cent of its earnings as a dividend, the second is paying out 50 per cent and the third is paying no dividends.

If you were to assume that you could buy and sell the shares at the same P/E of 10 times, the first company would return 10 per cent a year over any number of years, the second would return 15 per cent and third will return 20 per cent a year.

The third is clearly the cheapest and yet all three had the same P/E of 10.

Nonetheless, there are times when P/Es are at such extremes that they provide support to my preferred analysis of the spread between price and value. Now may or may not be one of those times.

In October 2009 it was suggested by many economists that the US economy was emerging from recession. September 2009 was the last month of the recession and the trailing P/E was 27 times.

This seemed extreme at the time and out of nine recessions since 1954, it represented the highest trailing P/E at the last month of a recession, with the exception of November 2001. Despite those expensive "valuations" the US S&P 500 has more than doubled over the period in question.

Many of you will correctly point out that it makes no sense to use trailing P/Es when emerging from a recession because the trailing "E" is unusually low. In such situations, analysts focus on forward P/Es. (Of course you know my view: if P/Es are nonsense, then forward P/Es, sector average P/Es and the like are simply nonsense cubed!).

Whether emerging from a recession, such as in the US in 2009 or perhaps falling back into one today, the P/E ratio must be used with care as a guide to whether stocks are cheap or expensive.

I believe the one year forward P/E in Australia excluding energy and resource stocks is close to 19 times. That's the highest it has been since 1990 with the exception of the booms before the recession we had to have and the tech wreck of 2001-2003.

But while it seems that multiples have surged from historic lows to near all-time highs, and while conventional wisdom would suggest that P/Es are at levels normally reserved for the late stages of a bull market, there is a counter argument; at market peaks, such as October 2007, analysts are unusually bullish about the future, while after a recession analysts will be overly cautious about their forecasts. The result is relatively low forward P/Es at peaks. And yet, today, there is precious little optimism about Australian corporate earnings. Indeed, on my analysis, while the Australian stock market price has rallied only a meagre 24 per cent in total over five years, earnings growth has been far worse, growing just 5.47 per cent in aggregate over the same period.

P/E ratios are a function of price and prices are freely available

In other words, most of the stock market's growth has simply come from a willingness on the part of investors to pay more. No wonder there is little optimism.

P/E ratios are a function of price and prices are freely available. Perhaps their only use then is to track sentiment — in effect the willingness to pay more.

And what about the question of whether the market is expensive or cheap? My analysis suggests the market is overpriced by about 10 per cent.

But before you conclude the market is due for an imminent correction, keep in mind that it has been much more expensive in the past and periods of overpricing have lasted much longer than the current phase.

Roger Montgomery is founder and CIO of the Montgomery Fund.

It's monkey v gorillas in the midst of a mighty software stocks battle

RICHARD HEMMING
UNDER THE RADAR

You would think that investors would avoid accounting software maker Reckon in the wake of the listing next week of its much bigger competitor MYOB, which will be the biggest initial public offering this year.

Instead, Reckon's shares have rallied 12.5 per cent in the past two weeks.

MYOB, which has about 60 per cent market share of small business accounting software in Australia, will list having raised at least $830 million, giving it an initial market cap of close to $2.3 billion.

In the lead-up to its listing, MYOB has been in a much publicised brawl with Xero over which has the fastest online membership growth. Xero's market cap is $2.7bn.

As well, Reckon's former software supplier, Intuit, the dominant player in the US, is still a force to be reckoned with as it muscles back into the Australasian market place. With a market cap of $US28bn ($35.1bn), what else would you expect? Given Xero's ambitions in the US, it's possible that Intuit feels the need to have a go on Xero's home turf.

With a market cap of $230m or so, Reckon is like a monkey dwarfed by the three gorillas in an (Australasian) cage fight. So why do I think Reckon will survive, and not only that, be profitable?

Maybe their thinking is like my own, which has a game theory edge to it: the gorillas will attack each other, leaving the monkey to its own profitable devices.

As it stands, Reckon is going pretty well: its turnover was just over $100m last year, which delivered a net profit after tax of $17m and dividends of 9c a share. On our numbers, it's trading on a prospective price-earnings ratio of 13.5 times and a dividend yield of 4.5 per cent. Where else could you get a software stock so cheap?

Xero could claim to be profitable if it turned off the marketing tap but it needs that spend to fulfil its ambitions to attack the big US market.

As for MYOB, its capital raising isn't to finance future growth but to pay down the company's debts. That's because it has been through two sets of private equity hands. In fact it delisted only back in 2009, so don't expect any cost savings to boost its prospectus forecasts, which puts it on a prospective P/E of about 20-plus times.

In common with Reckon, MYOB has been slow to take up the cloud computing business model where the software is held on its own servers and customers have access via the web for a monthly fee.

This is Xero's model and it has been a success because small businesses can afford to take up this more standardised and cheaper software.

Reckon is also expanding its cloud-based product Reckon One into Britain and New Zealand, which I expect it wouldn't be doing if it weren't performing well.

Both Reckon and MYOB have a competitive edge over Xero with a customer base of accountants as well as small businesses. In Reckon's case it has 300,000 active customers, which won't simply change for the sake of it. It also has complementary and highly profitable niches such as providing documentation to accountants for services such as self-managed super funds and trust structures, so that they don't have to worry about the legals and have ready-made templates to fill in and offer to clients.

It will be very hard for the gorillas to increase profits by enough to satisfy the market. Based on its much lower valuation, all Reckon has to do is carry on supplying to its business and accounting products and hold on to customers slightly better than the market expects.

Richard Hemming is an independent analyst who edits www.undertheradarreport.com.au

Global perfomance ²

Performance 31 March 2015 Net of all fees*	6 months %	1 year %	3 years % p.a	5 years % p.a	Since Inception % p.a
K2 Global High Alpha Fund	18.5	25.9	25.8	25.6	25.5
K2 Asian Fund	17.5	25.3	18.6	8.6	11.8
K2 Select International Fund	20.5	23.3	17.2	11.4	12.4

Since inception, the K2 international funds have achieved positive returns.

Investors looking for global equities exposure should consider these funds as our active fund managers constantly seek out international opportunities and are forever vigilant.

Our consistent performances clearly demonstrate that **vigilance rewards.**

Find out more at: **www.k2am.com** or telephone **61 3 9691 6111**

Vigilance Rewards

Past performance is not a reliable indicator of future performance and should not be the sole factor considered when selecting a financial product. Fund returns are annualised compound rates, net of all fees, exclude individual taxes, assume dividends are reinvested, and consist of income and capital return. K2 Asset Management Ltd ABN 95 085 445 094 AFSL 244 393 ("K2") is the issuer of the K2 Global High Alpha Fund ARSN 139 669 293 (inception 1/12/09), K2 Asian Fund ARSN 106 882 384 (inception date 1/9/99) and K2 Select International Fund ARSN 112 222 465 (inception date 1/1/05). You should read K2's product disclosure statements (available from K2), and consider whether these products are appropriate for you, before deciding to acquire or continue to hold an interest in any K2 fund. K2 and its related parties do not guarantee the repayment of capital or the performance of any K2 fund. A cooling off period is available to some clients. The K2 funds' portfolios can diverge significantly from underlying market indices.

KAM31024_AUST_04/15