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In **WEALTH on Tuesday**

Tony Negline discovers your SMSF is not immune from personal legal problems in **WEALTH on Tuesday**

China market's moment is now

It's time to pay close attention to China's share market indices

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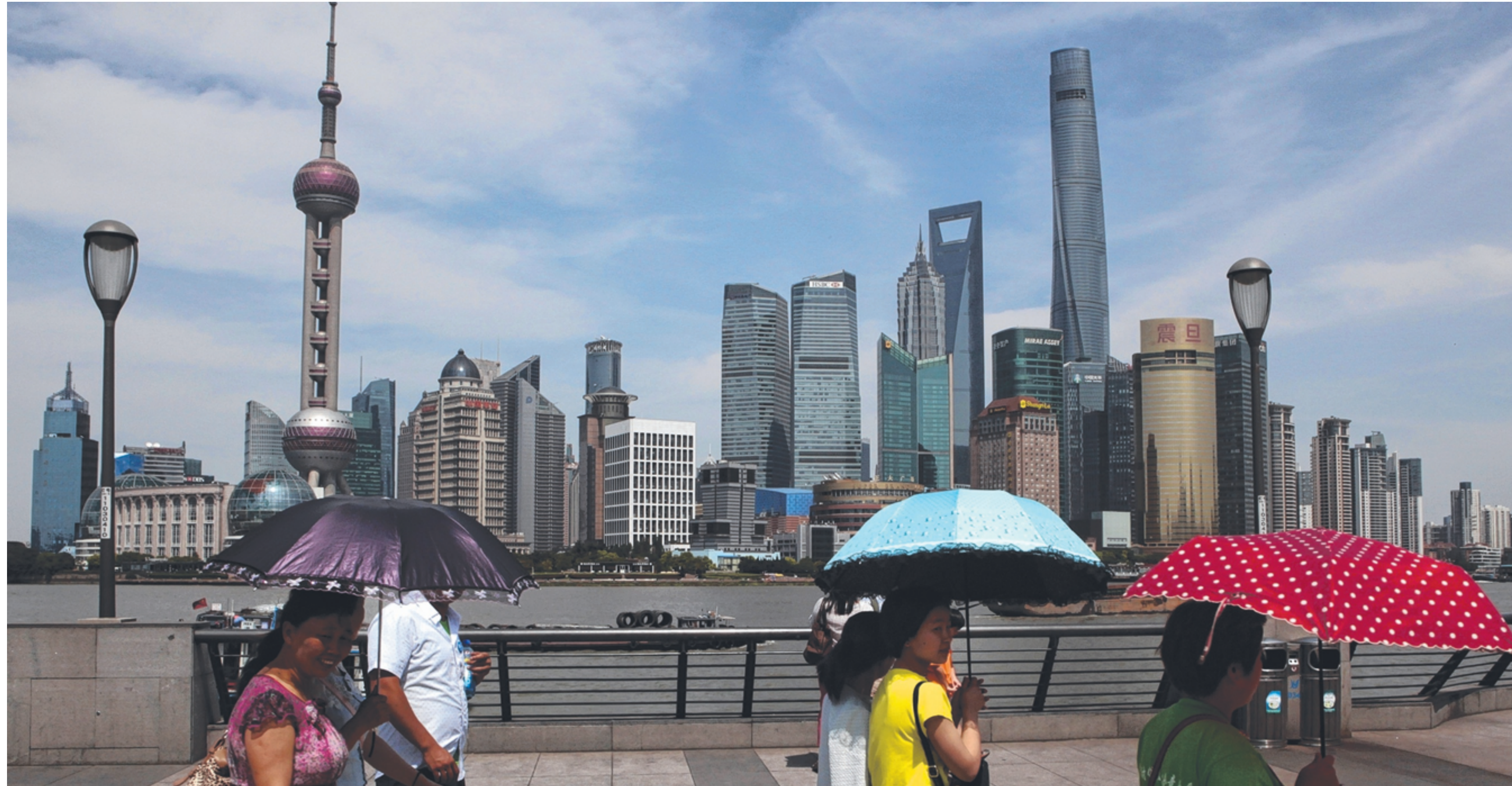


China's shift towards global economic integration will give astute investors a once-in-a-quarter-century opportunity

AP

The Chinese CSI 300 — the nation's leading share market index that is a composite of the Shanghai and Shenzen exchanges — has the real possibility of tripling or even quadrupling from current market valuations by or near 2020.

On May 9, the Morgan Stanley Composite Index (MSCI), arguably the world's most important global shares benchmark, announced "China's A-shares (are) on track for inclusion".

The announcement was greeted by many commentators as a negative.

It is, in fact, a positive, as it presents another huge and particularly timely opportunity for Australian investors to tactically position into a market with huge potential.

The delay of China's A-shares inclusion into specifically the MSCI Emerging Market, China and World Indices provides Australian wholesale investors another chance to astutely front-run the predictable eventuality that the Shanghai-Shenzhen CSI 300 will be represented throughout these important global benchmarks one day very soon.

MSCI indices matter — a lot.

This is because, as of June 30, 2014, they have $US9.5 trillion ($12.3 trillion) in known assets benchmarked against them.

Australian ultra high net worth global investors have been advised — at least by us — that this is the moment to take action and do so with conviction.

More than simply ringing the bell, this is a once-in-a-quarter-century opportunity that won't be repeated, at least not during this contributor's professional lifetime.

Stripping out the geopolitics and stereotypical noise surrounding China's ascent, such a step-change is plausible and makes a lot of sense when explained in the following light. The Chinese Communist Party's state-led model allowed its population to invest in real estate so China could continue its progression from developing to developed economic status over the past 15 years.

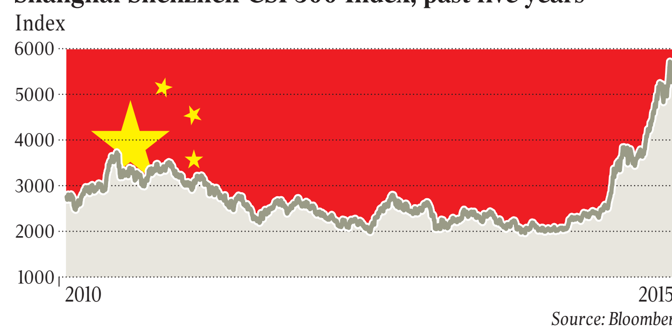
The excesses seen within what we refer to as shadow banking — off-balance sheet non-bank lending — were permitted, primarily because this allowed a circuit breaker when domestic Chinese real estate investment overheated.

The CCP has now consciously opened a new gate for its citizenry to invest more easily — contrary to their own rhetoric — into the CSI 300 and other Chinese sharemarkets for two primary reasons.

The first is that China now wants advanced capital market architectures, just like we have in the OECD; and second — and more interestingly — it purposely wants to inflate its bourses, with very specific outcomes in mind for 2017, 2018 and beyond.

These forethought outcomes involve China's CSI 300, in the near future, joining the MSCI World indices, where, as discussed, they are not currently represented.

Shanghai Shenzhen CSI 300 Index, past five years



Source: Bloomberg

Until very recently, piercing the walls of these "iron curtain" capital controls has been near impossible — or at least not legal.

While the May 9 announcement explicitly said MSCI and the China Securities Regulatory Commission would form a working group to resolve "a few important remaining issues related to market accessibility", it is likely the CSRC, on direct instructions from the CCP, and more importantly President Xi Jinping, will not budge on these iron curtain controls until the following occurs.

What the CCP wants is an inflation of its sharemarkets' valuations. Only when this has happened, it would be fair to predict, would they then have plans to loosen these capital controls and progressively allow more foreign institutional investors to enter the mainland bourses. When this happens, CSI 300 prices will be far higher than they are now and these foreign institutional investors will be purchasing Chinese shares with fresh foreign capital, namely US dollars.

This is why now is a crucially important time for Australian global investors to pay particular attention to China and global affairs.

Remembering that these Chinese bourses aren't yet in MSCI World indices, when they achieve IMF "Special Drawing Rights" status sometime soon — which they will — it will further allow the convertibility of yuan to US dollars, even more foreign institutional capital will, by forced mandate, be directed towards the CSI 300.

The logic for this is simple. When China's bourses are then included in the MSCI World Index or any similar benchmark, then a plethora of global institutional passive investment managers, by mandate, must then purchase CSI 300 exposures, solely to satisfy their prescriptive portfolio guidelines.

The CCP knows this and is making every effort now to stoke bourses such as the CSI 300 to much higher levels.

Put simply, the delays will dissipate when the CCP and Xi believe the CSI 300 is at valuation levels they are comfortable with.

Coincidentally, it is the CCP itself, which as a significant stakeholder in a majority of state-owned enterprises stands to benefit when such new price levels are reached.

This is not a conspiracy, this is capitalism in practice — the US invented shadow banking and spent the past six years inflating their own bourses. Then the British, Swiss, Japanese and now the eurozone have followed suit.

Clearly short-term trading on the CSI 300 is like riding a wild tiger and at Larkin Group we have people watching this Chinese market on a full-time basis.

This is a truly exciting time for Australian UHNW investors, and rather than licking our wounds about former iron ore export levels, let us look forward towards 2020 and what could very likely be a golden, not iron, opportunity.

Separately, Australian SMSF investors should consider passive five-year "Rip Van Winkle" opportunities.

Waking up in 2020 to a CSI 300 index exposure priced quite differently than it is at present, could be a shrewder alternative than doubling down on currently rudderless ASX investments.

Larkin Group is a wholesale wealth adviser focusing on high-yielding global investments.

www.larkingroup.com.au

The dividend trap can leave you out of pocket

ROGER MONTGOMERY

Chasing yield and ignoring growing income is a mistake — and in the long run it will prove costly for its adherents.

Take a business with $10 of equity a share and earning 20 per cent returns on that equity (ROE).

In the first year, the earnings will be $2. If the directors acquiesce to shareholder demands and pay all the earnings out as a dividend, the dividend will also be $2 a share.

Now, if we assume the popularity of the shares never changes and they trade at 10 times earnings, they will be priced at $20 in the first year.

You will note the dividend yield is 10 per cent.

It all seems very attractive in the context of the present miserable returns on cash and term deposits.

If we then assume in the second year the company begins with the same equity it had at the end of the first year — $20 — and it earns another 20 per cent return, then the earnings will also be $2. You will note there's no growth, but as the popularity of Telstra shares has shown, you don't need growth in earnings or dividends to keep a share supported.

The reason there is no growth in earnings is because we are assuming the ROE stays constant. It is also a fact the company pays its entire earnings out as a dividend, so there is no capital retained to grow the equity base. All this is rather academic until you get to the return you are going to make.

If we assume the company's shares trade at 10 times earnings when you buy them and also at 10 times earnings when you sell, then provided the above pattern of returns and dividend payments continues year after year, your return will just be 10 per cent a year.

Now here's where it gets really interesting.

Suppose the company paid no dividends, instead retaining all the profits so the equity grew each year, and the company continued to earn 20 per cent returns on the increasing equity.

If you bought and sold this company's shares on a price-earnings ratio of 10 times, you would end up with an annual return of 20 per cent and double the return compared with taking the dividends.

In other words, by demanding a dividend equivalent to 100 per cent of the earnings, the opportunity cost is as much as double. The rubber really hits the road with an example.

In 2005, you could have bought $100 of Telstra shares at $4.69 on a 5.97 per cent yield — paying $5.97 on your $100. Alternatively you could have purchased shares in another, much smaller telco, M2 Telecommunications. Unfortunately the M2 dividend yield wasn't as attractive as Telstra's at 3.91 per cent, so your income on a $100 investment was just $3.91.

You'd be forgiven for opting for the higher-yielding Telstra shares, but as we demonstrated a moment ago, the returns are higher when a company can retain profits and continue to generate high returns.

And that's what M2 did.

Your $100 investment in Telstra in 2005 is now worth $132. Importantly the dividends have been steady and you are now earning $6.40 a year in dividends.

Contrast this with M2. Because M2 has been able to grow its equity by retaining profits — and admittedly other techniques such as capital railings — and employ the additional capital at high rates of return, the growth in the value of the business has been much greater than Telstra's.

A $100 investment in M2 has now grown to $3453 as the share price surged from 32c 10 years ago to more than $11 at present.

More importantly you should recall you didn't buy M2 shares because you needed the higher income Telstra was offering in 2005. That's a pity because the income on the shares you originally purchased for $100 is now $93.75. In other words, going for growing income rather than yield has delivered more income and more wealth — it's the best outcome.

Roger Montgomery is founder and CIO of The Montgomery Fund.

Tax wise: year-end donations are fine, but charitable trusts the way to go for a lasting legacy

TABITHA LOVETT

In the coming weeks many people will be thinking of giving to charity: it's a way to reduce your tax bill for the year to June 30. What most people don't realise is that you can commence a philanthropic foundation with significant long-term tax advantages for as little as $20,000.

While it's easy to respond to those appeal letters that find their way into mailboxes at this time of the year, this isn't really the best way to support charities.

It is easier to establish a perpetual charitable trust than most people think, and it does not need to be expensive or complicated. However, the misconceptions about establishment, operation and flexibility of such trusts, often deters people. There is also a perception that charitable trusts are just for the very wealthy, which just isn't the case.

Ultimately, a perpetual charitable trust can help to better fulfil a donor's intentions in a much more appropriate and lasting manner and will ensure a greater impact on their chosen charity or cause rather than ad hoc donations.

Typically, there are two options for establishing a charitable trust or fund: private ancillary funds (PAFs) and charitable accounts or sub-funds. PAFs are often used for family foundations and are suitable for those who can donate at least $300,000 in investible assets.

Charitable accounts or sub-funds are individual funds set up under the umbrella of these public ancillary fund (PuAF). PuAFs are recommended for those who want to start small but nevertheless wish to have some direction over which charities or causes they support. Sub-funds are a particularly good option for people who don't want to be involved with investment decisions.

A sub-fund is quick and simple to establish. Using the Equity Trustees Charitable Foundation as an example, the minimum establishment amount is $20,000. You can name your account yourself, within certain Australian Taxation Office guidelines, and all beneficiaries must be eligible Australian charities with Deductible Gift Recipient status.

Once established, the trustee, which might be a well established foundation or an independent trustee company, will manage the investment, governance and administration of your account. You notify the trustee which organisations or projects you wish to support with the income generated from your account.

Additional contributions can be made to your account over time to build up the capital base. There are no restrictions on the frequency of subsequent donations. You can also direct a bequest to your account in your will and your account can receive donations from the public.

The trustee will advise the amount available for you to grant each year based on investment performance and minimum distribution requirements and the trustee will issue grants on your behalf. Grants can be made in your account's name or be anonymous.

You can involve family members as grant-making advisers, making recommendations to the trustee. In this role they have no legal responsibility or liability.

Donations to sub-funds attract the same tax deductions and considerations as making a donation directly to a charity. For those on a high income, there can be significant tax advantages in this approach as donations are tax deductible and the deductions to the donor's income can be upfront or spread across five years. The income generated from the charitable account or sub-fund is distributed year after year to charitable organisations.

Among the financial advantages of setting up a PuAF sub-fund, the initial start-up capital is tax deductible; the income from the fund's investments is generated in a tax-free environment; and further donations to the fund can be tax deductible.

In the past 10 years many new philanthropic trusts have been established. The primary reason for setting up a foundation is to create a lasting legacy. Family foundations can strengthen families and bring them together with a common altruistic goal. It can be a great way for parents and children to get together to discuss family financial matters, inheritance arrangements and identify how they can support charities.

Tabitha Lovett is general manager Philanthropy at Equity Trustees.

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