Buying overseas property with a DIY super fund? **Monica Rule** investigates in **WEALTH on TUESDAY**

The hidden price of divesting from ' sin stocks' read **Andrew Main** in **WEALTH on TUESDAY**

China plans new path to prosperity

The Party's plenary sessions are worthy of close attention

STIRLING LARKIN
GLOBAL INVESTOR

Halloween has special meaning for the Chinese this weekend as they remember the haunted year that has spooked both themselves and global markets.

Given heightened global attention surrounding those events, and the emerging correlations between developments in China and the world economy, it becomes ever more timely to take pause and assess how China's fifth plenary session of the 18th Communist Party Central Committee, which met this week, really went.

These communist caucuses matter and ultra high net worth (UHNW) investors take them particularly seriously.

That's because this community, more often than not, not only invests its "fungible" wealth into mainland Chinese markets but also operates businesses or joint ventures that are directly affected by these communist five-year forward-looking manifestos.

Unlike US Federal Reserve FOMC meetings, which are all deemed "live and active" monthly roundtables, solely representing the monetary arm of the US government, China's plenary sessions, generally speaking, consist of seven sessions held during the five-year tenure of central committee members.

They also represent both the fiscal and monetary arms of the Chinese regime.

Importantly, the global investor needs to respect the ritual that has been continued since these sessions began in 1953, as unlike Western equivalents, each plenary session focuses on a certain predetermined agenda.

AFP

China president Xi Jinping here with British Prime Minister David Cameron

For instance, the first plenary session is for the arrangement of personnel, when central committee members elect members of the Political Bureau and other committees. The last was held in November 2012.

Decisions concerning major national development and economic issues are usually passed at the third plenary, while the fourth typically discusses party-building issues, as was last seen in October 2014.

Traditionally the fifth plenary reviews the national economic development plan with the aim to map out strategies for overall economic and social development, setting growth targets and defining development policies. Given the extremely volatile northern summer Chinese markets experienced and the uncertainties linked to the accuracy of official GDP statistics, a plenary centred on national Chinese economic development under the leadership of president Xi Jinping will have visible market impact.

More than merely a "tea leaves" reading exercise, the communiques coming out of these caucuses matters tremendously, not only for those focused on Asia but also those deciphering US Fed Chairwoman Janet Yellen's next steps.

Yellen and the FOMC this week explicitly acknowledged "recent global economic and financial developments highlight the risk that a slowdown in foreign growth might restrain US economic activity somewhat further."

As the graph shows, China is succeeding in attempts to transition the groundings of its economic model.

But the question now for the global investor, following these meetings, is what happens to markets given the linkages between financial gearing and China's real economy?

From an economic perspective, the most important topic of the plenum will be the 13th five-year plan, the blueprint for development between 2016 and 2020.

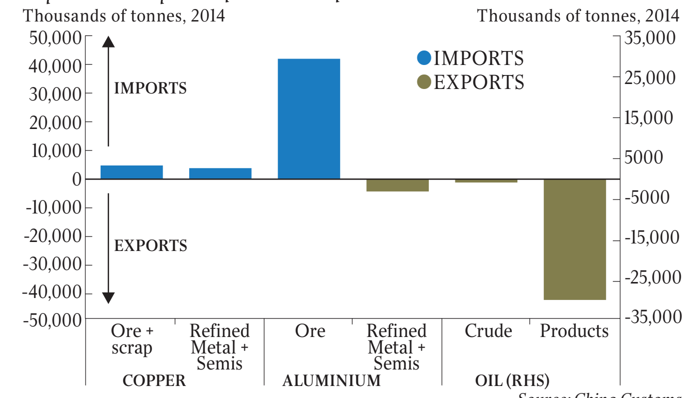
Within this plan, analysts have zeroed in on two possibilities: 7 per cent or 6.5 per cent GDP growth targets.

The two possible targets will have very different implications on policy outlook.

Analysts believe that if the target is set at 7 per cent, the government will have to maintain its loose policy stance and execute more easing.

As a result, the leverage of the Chinese economy will continue to rise and such easings will immediately and directly affect Australian

China is well integrated across the commodity value chain
Imports and exports of raw and refined commodities



Source: China Customs

ASX and bond market valuations. On the other hand, if the plenary's growth target is set at 6.5 per cent, it means the government will tolerate slower growth to allow more space for structural adjustments, and in this case it is thought there will be fewer stimuli by the government.

For global UHNW investors, who not only approach mainland Chinese investing via listed equity bourses, but also via private equity channels, this matters greatly as well.

According to Stone Shi, senior partner of China's largest domestic law firm, Allbright, and a Larkin Group Advisory Board member, "China is still an attractive place for private equity investment, but Australian UHNWs make up a very small portion of the foreign PE base".

Dr Shi says "the legal entry channel for foreign PE investors, the QFLP (Qualified Foreign Limited Partners) mechanism, is still a valid and effective way, which is a permit system by selective Chinese municipal governments for foreign private equity funds."

Dr Shi notes most of these foreign PE QFLP permit requests now come from European and North American domiciled family office and wholesale trusts, with few originating from Australia.

For other Australian investment communities, which look more to China's listed markets — where onshore and offshore equities have rebounded 13 and 15 per cent respectively from their September lows — the question has become, what visible catalysts are required to see a complete retracement back to pre-haunted levels?

Some believe the upcoming potential inclusion of China ADRs to the MSCI universe fits the bill and this may happen in the May 2016 semi-annual MSCI Index Review.

With 14 China ADRs potentially eligible for inclusion, the recent price volatility and changes in liquidity profile, as well as potential privatisation deals that may happen before the MSCI inclusion date, it becomes a "tea leaves" reading exercise for the active global investor wishing to purchase these names before the uptick seen from a MSCI index inclusion.

The three largest constituents — Alibaba (BABA), Baidu (BIDS), and JD.com (JD), are very likely to be included in any scenario as they collectively represent 74 per cent of the US quoted Chinese ADR universe.

Of course, what might spook markets next is a China back on the rise.

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

'Discounted' Challenger offers investors a solid growth opportunity

ROGER MONTGOMERY

Challenger dominates the annuities market in Australia. It is one of the few businesses I can find that is not only high quality and with bright prospects, but remains at a discount to our estimate of its value. At about 4 per cent of our portfolios, it is one of our largest holdings.

Generally markets are efficient and stocks are priced about right.

As a result, value investors such as ourselves sometimes have to wait for temporary adverse events to befall a company or the shares — and for those events to be treated as permanently damaging by the rest of the investment community — before we can pick up a high-quality bargain. Challenger has been cheap for a relatively long time, and the reason is twofold.

- The company's history has left a sour taste in the mouths of investors and there seems to be an aspect of the business that is misunderstood. But if a great business remains undiscovered for a long time, it simply means we can purchase more of the shares at attractive prices as our funds grow in size.
- Challenger distributes retirement annuity income products, and sales have been booming — even before the looming legion of retiring baby boomers begins to think about retirement income needs. At Challenger's half-year result, the company noted retail annuity sales had continued to grow strongly despite being only four years into the 20-year retirement phase of Australia's more the four million boomers.

(An annuity is a product that offers a specified income payable in the future).

Boomers are the wealthiest population cohort in history, and assets in retirement will quadruple in this decade. As a result, they have a lot to lose.

But more importantly, as more individuals and couples retire, the level of assets that Challenger services is expected to quadruple.

Think about the company's growth opportunity this way. The number of baby boomers retiring will grow significantly.

Within this cohort more money will be transitioning at a faster rate from accumulation to dissaving (when you spend rather than save).

Indeed, the amount of dissaving is now forecast at $66 billion annually, and according to industry forecasts, this trend will exceed $200bn annually in the next decade.

And finally within this "dissaving" class, the annuity products Challenger distributes amount to less than 4 per cent of portfolios.

On this last point, the government's response to David Murray's Financial System Inquiry report, which supported the development of the annuity market, is likely to enshrine annuity income products into superannuation portfolios

That's growth on growth on growth, and there aren't many sectors of the economy demonstrating such a long and steady growth profile opportunity. There are even fewer where the dominant and established player in that sector trades at a price lower than its intrinsic value.

Until the government's response to the FSI, the objectives of superannuation were ill-defined, designed to provide "retirement benefits". Super now has serious direction for legislators with the announcement it is designed to provide retirement income.

According to Credit Suisse research, assuming annuities' share of flows into retirement income increases to between 5 and 30 per cent, the total market could increase by as much as 400 per cent over a three-year period, and Challenger's annuity book could experience growth of between 40 and 150 per cent. The only issue with these estimates is they may understate the growth potential.

If Australia experiences what more mature markets elsewhere are already witnessing, annuities' share of retirement portfolios could triple. If that happens, Challenger's retirement book could grow by a factor of these estimates.

Perhaps most importantly, a recent Investment Trends survey said: "Among financial planners who recommended income guaranteed products in the last 12 months, the vast majority, 86 per cent, used a Challenger product."

Having established the growth opportunity, which is something that should be widely known by market participants, why is the stock trading at a discount to what we believe the company is worth?

We believe the opportunity exists because the market misunderstands the risks associated with Challenger's assets and the funding associated with meeting its obligations (liabilities) to annuity income recipients.

When Challenger writes an annuity, it accepts a premium from the retiree, adds some of its own capital — this is an important point missed by many — and then invests this in a portfolio of assets that fund the future annuity payments to the retiree.

The quality of these assets and the mix is critical. Investors should remember the company rode through the global financial crisis and the more recent collapse in the energy-related, high-yield securities market without incident. In the latter case, Challenger's exposure to high-yield credits was immaterial.

Of course, even in the highly rated securities markets credit losses can be incurred, particularly if some European sovereign bonds or some US municipal bonds have their principal repayments written down.

Fortunately, Challenger's life business is not exposed to any of these types of securities.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund. www.montinvest.com

Six investment lessons from a life in the market

CHRIS CUFFE

I have worked in financial markets for more than 25 years, including as chief executive of Colonial First State and Challenger's Wealth Management business, and more recently as founder and portfolio manager of the Third Link Growth Fund.

I have distilled this experience into a number of lessons on how markets actually work. Here are six observations that every investor should consider.

Past performance is the best guide to future success

Every offer document in the country says something like: "Past performance is no guide to future performance."

That is exactly the opposite of what I think. It's the best guide to knowing what a manager is really like over a long period. Past performance is extremely important and a great guide to the future.

Only long-term results are relevant. The managers I use are selected for the long term. I have no interest in their short-term results. If it looks like a manager is struggling — which I would only conclude after rolling three-year periods — I would only exit after, say, a poor rolling five-year result.

Never buy a bad stock because the price is low

I don't like "deep value" investing, whereby a manager is willing to buy a poor quality stock because the price is so cheap. I don't like people saying a bad stock priced cheap is low risk. I would hate to see any of the stocks held by my managers fall over. Managers need to buy quality stocks. Adding that to a good track record and a high tracking error (deviation from the index) should mean my fund will do well in falling markets (which it does), which is a sign of a good portfolio.

Blending styles is a waste of effort

In my view, professionals blend managers in multi-manager funds in exactly the way that produces a mediocre result.

Typically, they will blend value managers, growth managers, large managers and small managers, and then wonder why they achieve the index, less their fee? The results of these blended funds have never been great.

Watch the level of funds under management

I look at total funds under management in a manager and the types of stocks the manager buys. A small cap manager in Australia with more than $1 billion concerns me.

And I am cautious about investing with a larger cap manager in Australia with more than say $6bn under management. At that level, I need more convincing. Size can get in the way of performance. It's no coincidence most of my managers have performance fees, which enable them to remain smaller while making it economically viable to run their business.

Most managers talk about staying below capacity and refusing to take in more money, but in my experience most don't do that — especially when there's an institutional owner. It's compelling to take more money. Boutiques are best at watching capacity, as they can make a lot of money from performance fees if they're good.

Don't be afraid of performance fees

I believe managers deserve their high fees based on performance. In my own personal investment portfolio, I don't mind paying a 20 per cent performance fee (as long as the right hurdle exists) if I'm getting 80 per cent.

It's a great part of the Third Link structure that the managers kindly refund all performance fees, as well as management fees. It's the sizzle in the fund.

For most professionals who provide a fund-of-fund product, the underlying fee of each manager is so crucial for their own economics that they can't pay performance fees.

> I'm agnostic on fees, so I just look for the best managers

But I'm agnostic on fees, so I just look for the best managers.

Index or not?

The active versus passive debate is not a "one size fits all". It should be considered in the context of the asset class.

In Australian equities, I'd never invest in a passive fund. You have to look at the index before you go passive. Why would you buy an index that is 30 per cent in banks (mainly four stocks) and 15 per cent in resources (mainly two companies)? Talk about a risky portfolio. It amazes me people would start with that.

But internationally — say, the MSCI World Index — index investing has merit. In Aussie small caps, you could invest in an index fund, but there is no upside in having small resources because of their boom and bust track record. And the active managers of small cap industrials generally do better than the industrials index because they can find small under-researched stocks.

But there's nothing wrong with indexing in parts of the fixed-interest asset class.

I hope some of the roboadvice models use active management, especially in Australian equities, but I suspect they are unlikely to do so, due to the cost.

Chris Cuffe is the portfolio manager of the Third Link Growth Fund (www.thirdlink.com.au) where the fund managers selected by him provide their services for free, enabling the fund to give more than $100,000 a month to charities. It is open to the public.

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