John Abernethy - Why bank stocks will lift from here in WEALTH on TUESDAY

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How do you pick a bargain in shares? It's important to spot dumb prices first

ROGER MONTGOMERY

Throw this question out at your next dinner party: what's any asset worth? More than likely the answer proffered will be: what someone's willing to give you for it!

And though agreement is invariably uniform on this answer ... in fact it is 100 per cent wrong. What someone else will give you for something is the price. If you don't agree, consider the following example.

In mid-1999 in the US there was a company previously known as Professional Recovery Systems that became NetBanx.com and was trading at less than 50c. Around the same time a Securities and Exchange Commission filing read: "The company is not currently engaged in any substantial business activity of any description and has no plans to engage in any such activity in the foreseeable future ... (and) it has no day-to-day operations at the present time. Its officers and directors devote only insubstantial time and attention to the affairs of this issuer at the present time, for the reason that only such attention is presently required."

The company had no principal products or services, no patents, trademarks, licences, franchises, concessions, royalty agreements or labour contracts and no employees. It had assets of less than one thousand dollars. That's right ... assets were just $US989.

At the peak of the internet bubble in March of 2000, the share price would have brought tears of joy. In March 2000, the shares traded at over $US8 and near enough to $US9!

The shares subsequently declined, along with everything else that ended in ".com", and eventually the shares were delisted. True to label, the company never conducted any business activity of any description.

But here's the point. If an asset is worth what someone else will give you for it, someone was willing to give you more than $US8 for a share of this company. Was NetBanx.com — a company that did nothing and wasn't planning on doing anything — ever worth $US8 or more? The answer is clearly no. The price was $US8, but the intrinsic value was zero.

Price is what you pay for something, but value is what you will receive and the value will ultimately determine your return. Your job as an investor then, is to own shares that are worth more than you paid for them. What it is really worth — its value — is something else entirely.

With so-called blue-chip shares such as ANZ, CBA, NAB, Westpac, Telstra, BHP and Woolworths tanking in recent months, now is a reasonable time to ask if anything is cheap. The short answer is no. Bargains are not abundant at the moment, but how an investor arrives at that conclusion is perhaps more important than the conclusion itself. It's helpful to know if others are paying irrational prices. That knowledge gives you the power to protect your wealth.

So how do you know when a share is cheap? Well with blue-chip shares collapsing, it's tempting to believe that a decline of 70 per cent, or 50 per cent, or 30 per cent, or a decline by some other number renders a stock cheap.

Are a company's shares cheap when the price-earnings (P/E) ratio is below 10, or the dividend yield rises to 8 per cent? Isn't a low price-earnings ratio or a high dividend yield a sign that the shares are cheap? When your measure of value is derived from the price, you are mixing raisins with turds and, as Charlie Munger once observed, you can mix raisins with turds but they are still turds.

The first step is to value the business independently of its price. Even if a low price-earnings ratio coincides with a high dividend yield, the shares may still not be a bargain-price investment — as many retirees who purchased high-yielding shares after the interest on their term deposits fell have recently discovered!

Suppose I have a hypothetical bank account in the name of Roger's Valuations, in which $10 million has been deposited. This bank account earns an after-tax return of 20 per cent per annum, fixed for 30 years. The interest cannot be reinvested. Given current interest rates on bank accounts of 2.5 per cent (and that's pre-tax), my $10m account looks very desirable. I bet there would be a few people willing to buy it.

Now suppose that I offer the account "for sale" and auction it off.

What should you be prepared to pay for it? If the money in the account represents my "equity" or "book value", then the intrinsic value of this account is higher than that equity or book value. Warren Buffett said it took him a while to let go of his ways inherited from mentor Benjamin Graham and work this out, and his purchase of See's Candy at three times book value showed he had succeeded.

How much higher than the equity is the true value of the bank account? At an auction I would discover what people are prepared to pay. But people can get pretty silly in an auction environment — just as they do frequently in the stockmarket — and someone could pay a really dumb price.

What would a dumb price be? Interest rates offered by some bank term deposits might be 2.5 per cent and they offer the benefit of reinvestment and thus compounding. I'd argue that someone would be paying a "dumb" price for the Roger's Valuations account if the interest coming off it is less than 5 per cent. That's not to say it wouldn't or couldn't happen; it's just that if it did, the buyer might be irrational and you'd be tempted to let them have it.

To calculate this dumb price, we simply divide the after-tax return being paid by the bank account (20 per cent) by the return the investor would be content with — the dumb return (5 per cent) adjusted for tax — say, about 3.5 per cent after tax. We then multiply this amount by the equity — the balance of the bank account. In the above example, this would look something like: 20 per cent ÷ 3.5 per cent x $10m = $57m. If someone paid $57m for this bank account it would be very high and very dumb, because the return would be a low, non-cumulative 3.5 per cent after tax.

Knowing when dumb prices are being paid in the market is perhaps one of the most powerful pieces of knowledge, if your goal is to protect your wealth. It gives you the time to wait for "bank accounts" to be available at bargain prices. If that doesn't happen today or this week or this month, so be it. An opportunity will eventually present itself. It always has and it always will.

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US, China first for investors

STERLING LARKIN
GLOBAL INVESTOR

What do we do as investors if we see the global economy slowing and Australia appears to be leading the charge among the vanguard?

The golden rule has always been to take a step back from the noise of markets and look to the underlying economic fundamentals, to determine for ourselves who's doing business and who is being dragged along for the ride.

There is no question that leading global stockmarkets are "expensive".

However, expensive markets can reflect a macro-environment that has growth, low inflation and supports valuations.

The premise of "expensive", similar to that of "inflation", can actually present as welcome signs for markets that may have crystallised the view that growth is imminently ahead.

It is too often forgotten that inflation often accompanies economic expansion, which is the desirable outcome we all seek.

But most importantly, as the narrative for developed markets, such as the US, has not materially changed this year, it is imperative to recognise that it has significantly shifted for emerging markets and in this context that means China.

With both major markets and underlying economic blocs showing signs of tepidness, the questions then are: what impacts Australia more in 2016?

Where will growth and investment opportunity be found?

And, how do we identify and support the ultimate winners?

With the US Federal Reserve, most likely, but not certainly, raising interest rates on December 15 to begin their path to monetary policy normalisation — which will see sequential rates rises moving forward — Goldman Sachs, which is arguably one of the paramount equity market thought-leaders, this week shared the view that the US S&P 500 will end 2016 at "2100", which would see us almost unchanged from current levels.

They shared the view that "Fed hikes will begin in December and continue steadily for several years. When investors realise tightening will be more sustained than most expect, the P/E multiple will contract and offset the positive impact of higher EPS."

As Australian ultra high net worth investors always seek out areas of particular value within international equity markets, two important facts then become material when understanding why the S&P 500 has become "expensive" in this way.

1. Technology companies have accounted f or 50 per cent of the overall S&P 500 expansion during the past five years and within this, Apple (AAPL: US) alone is directly responsible for 20 per cent of this lift.

2. US large and mid-cap firms that have returned cash to shareholders via buybacks and dividends have outperformed for 25 years on the S&P 500.

That pattern was repeated this year and the trend may very likely continue in 2016.

Remembering the golden rule that market noise does not necessarily represent underlying economic success, the attached table then perfectly frames where our thinking needs to focus.

Since 2001, when China joined the World Trade Organisation, it is no secret that the global trade picture dramatically altered.

Recognising that companies such as Apple drove the S&P 500's market performance since that time, determining who contributed, and ultimately profited, from these economic success stories then becomes the science within the art of savvy investing.

Knowing that the conventional measures of headline trade data are misleading because they suggest that China today accounts for 27 per cent of global aggregate imports, allows us then to identify who in truth is in fact re-exporting "finished goods" and where are they being exported.

Apple, Foxconn (2354: Taiwan) and Lenovo (992: Hong Kong) for instance, all import computer "CPU's" into China but then export approximately 92 per cent of these finished goods to Europe, North America and Asia-Pacific, which includes Australia.

However, what Australian equity investors, who are attempting to invest in these blocs, have learnt is that at the end of a commodity super-cycle, volumes do not always translate into investment market success.

On this, Peter Nathan, chief executive of a2 Milk Company (A2M) believes that "Australian capital markets are just waking up to the reality that the sweet commercial outcomes in the vast China food export opportunity are actually about the power of premium differentiated brands and not about food commodities, which is in fact, very competitive and gross margin challenging".

For a2, the primary driver behind their reported 300 per cent sales increase for the first four months of this year were predominantly found within their baby formula campaigns within China.

Nathan believes that "it is clear that Chinese consumers are highly engaged with premium aspirational brands such as A2 Platinum, as opposed to Chinese label brands that maybe sourced from Australia or New Zealand but are not perceived as being aspirational like brands that are actually used by Australian consumers."

For Australian global investors, identifying underrated "brand" value also means recognising higher level trading patterns between China, the US and other economies.

And as the table astutely shows us, today the US only accounts for more exports from Japan, Vietnam and Cambodia, as compared to China, which has clearly become the dominant trading partner for New Zealand, Laos, Singapore, Taiwan and Australian businesses.

Interestingly, due to the rising demand for milk powder from China, exports by New Zealand to China in 2014 were roughly the same quantity as those exported to Japan, Europe and the US combined. Recognising that the global economy is slowing and that existing developed market stockmarkets, on a whole, are expensive, the astute global investor needs to remain focused on economic fundamentals.

This also involves accepting that as US monetary policy begins to normalise, well-known valuation distortions will also dissipate and the winners that will remain will be those who continue to trade with the world's two largest economies.

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

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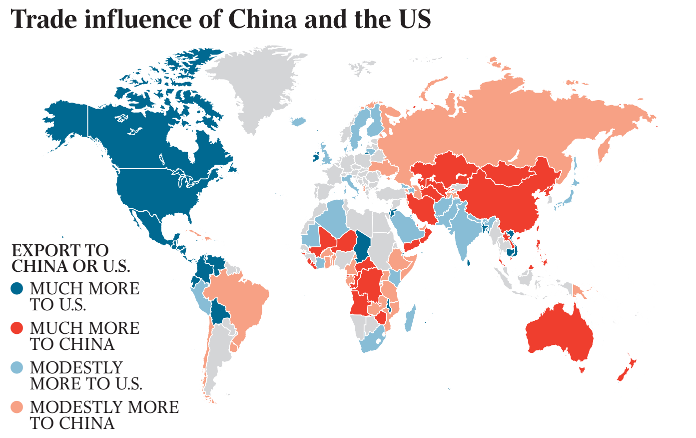
New Zealand's dairy exports to China last year matched its exports to the US, Japan and Europe combined

Trade influence of China and the US



Source: China customs, IMF, UN comtrade

Insurers finally move to rewarding healthy

MIRANDA MAXWELL

Annual health and life insurance cover are among the biggest bills in many homes: now leading insurers are finally shifting towards rewarding the healthy for their efforts.

Two of Australia's largest corporations — Qantas and MLC — this week launched insurance products that make full use of technology to reward individual behaviour.

Qantas announced a new health insurance joint venture, with health insurer NIB that offers incentives to people monitored by digital fitness devices. Qantas Assure will be offered to the airline's 11 million frequent flyers next year. A wellness app will log the number of steps taken in a day and then deposit points into their frequent-flyer account.

This introduction of tailored financial bonuses is part of an growing worldwide trend among insurers to reward, and change, customer behaviour.

Australia's $19 billion private health insurance market is an obvious fit, as any behaviour that will improve the wellbeing of the customer is likely to directly lower their likelihood of claims, and benefit the policy provider as well.

Health insurers are far from alone, though. Incentives for desirable behaviour are flooding the industry across a broad range of products and sectors.

As Qantas and NIB were announcing their venture on Monday, NAB's MLC was launching what it promises is a "game-changer" in life insurance.

Using its product "MLC On Track", Australians will be able to save on their life insurance premium by exercising and living a healthier lifestyle in this Australian-first initiative, MLC says.

Customers can measure daily physical activity and health data using an Intel Basis Peak fitness and sleep tracker, offered exclusively in Australia via MLC and Big Cloud Analytics. The tracker costs about $US350, but will be offered at a discount of about $285, and participation is voluntary.

"The insurance industry has assessed risk in the same way for a long time but smartwatches offer new and improved ways of assessing and pricing insurance risk," says MLC executive general manager insurance, David Hackett.

To date, new policyholders were asked to complete a lengthy questionnaire and were only really given "an opportunity to tell of bad things that have happened", adds Fiona Guscott, chief underwriter at MLC. MLC On Track allows the customer to "demonstrate how healthy they can be".

But the real value for MLC is in the relationship with customers, the firm says. NAB's wealth business has almost 15 million customers, with $1.795 billion of premiums in force.

The car insurer, Progressive Australia, uses telematics to provide a usage-based insurance product in more than 30 US states, based on braking speed, distance travelled and the amount of night-time driving.

These in-car telematics devices capture information on when and how people drive, their speed and braking patterns, giving rise to usage-based insurance, or UBI.

In Britain, one insurer that offers telematics-based insurance solely for young drivers gives discounts based on cornering, swerving, braking, speed and acceleration.

Another charges a low premium, but imposes a £100 penalty if you drive after 11pm on a Friday night.

In Britain, telematics has been estimated to reduce accidents involving young motorists by up to 40 per cent, at an average premium saving over £600 a year.

This is likely to be a fertile area for new insurance innovation in Australia, where about 15,000 people still die in a decade on the road, and about 300,000 are hospitalised.