“All my time in investing tells me the pendulum always swings back and sometimes violently.”
ROGER MONTGOMERY

Don’t count on rates staying lower for longer

ROGER MONTGOMERY

Perhaps unwittingly, one of our clients wrote to me on the subject of what is now accepted as “the new normal” — a long period ahead of very low returns. He asked: “If I have to accept very low returns for a very long time, why bother taking the risk?”

It’s a reasonable point and if his stance were widely adopted a correction in asset prices would be a given.

What, then, do we make of famed investor Howard Marks’ former colleague and founder of the $US100 billion DoubleLine Capital, Jeffrey Gundlach, who a week or two ago said: “Sell everything. Nothing here looks good”?

What do we make of bond king Bill Gross, who said in July: “I don’t like bonds; I don’t like most stocks; I don’t like private equity … the obvious answer is to reduce risk”?

I remember the tech boom. I was at Merrill Lynch at the time, and the average first-day listing gain of an IPO was 90 per cent on the Nasdaq. Anything with a “dotcom” in its name soared and Warren Buffett was deemed a “has-been” — his value investing mantra and reinvestment into boring manufacturing businesses evidence of a washed-up strategy that was no longer relevant.

Of course, we all know what happened.

Today it’s the “same same but different”. What’s the same? Rational, experienced and intelligent investors have broadly adopted another theme. Back in the late 1990s, the theme was: “Pay almost any price for a company with dotcom because it will change the world”.

Today it is: “The world has changed (and interest rates are zero), you can pay any price”.

Back then, investors stampeded into stocks with massive growth aspirations and high levels of retained earnings (or reinvested for no earnings at all) and they migrated out of stocks that paid dividends.

In my book *Value.able,* I describe a company called Professional Recovery Systems trading at 50c that changed its name to NetBanx.com, had US $989 in assets and noted in its SEC filing that, “The company does not presently engage in any substantial activity of any description and has no plans to engage in any such activity in the foreseeable future.”

At the peak of the internet bubble, Netbanx shares traded at $8 each!

Today investors are stampeding into stocks that pay big dividends and retain little or nothing for growth.

Back in 1999, it was unbridled optimism that fuelled new highs in stockmarkets, particularly in the US.

Today it is the precise opposite — unmitigated pessimism — that is doing exactly the same thing.

The logic goes like this: earnings are weak, the economy is doing poorly, central banks will therefore keep interest rates low … buy stocks!

Mark Twain once observed that when you find yourself on the side of the majority, it’s time to pause and reflect.

But who is the majority?

The majority is not represented by the rising chorus of commentators and fund managers warning you to be careful.

Rather, the majority is reflected in the prices of assets like Auckland International Airport and Sydney Airport, which for some reason, unbeknown to your author, are the two most expensive listed airports in the world.

The majority is paying very high prices for assets believing they are justified by discounting future cash flows back to today using ultra low rates. But ultra-low rates aren’t normal.

All my time in investing tells me the pendulum always swings back and sometimes violently.

Back in 2000, the tech boomers were proved wrong when the dotcom revenues and profits didn’t eventuate.

This time, the advocates of “lower-for-longer” will be wrong, too.

We look back on the tech boom and the willingness of investors to pay extraordinary multiples for businesses with no earnings with astonishment.

We will also look back on this period, with more than 30 per cent of global bonds paying negative yields, and 80 per cent offering returns of less than 1 per cent, with equal astonishment.

Some things just never change.

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

LICs investors pay a price for the ‘free options’ carrot

TIM BOREHAM

The notion that nothing in life is free applies to the dozen or so new listed investment companies (LICs) that have graced the ASX boards in the last two years.

From the record $394 million WAM Leaders raising to the tiny $15m Henry Morgan offering, the common feature of these IPOs is that investors received a “free” option for every share they subscribed to.

But investors beware: the professional investors play games ahead of the expiry date of these options and the value of the head stock is affected.

Options are deemed a necessary incentive for a LIC initial public offer, because the cost of listing typically equals 2 per cent of the funds raised.

In theory, a $1 share should list at 98c, the value of the net tangible assets (NTA, the wad of uninvested cash just raised).

The options carrot means the IPO investors can double their holding at the original subscription price when the options become exercisable, typically in tranches starting from one year after listing. Otherwise, who would pay $1 for a share worth 98c?

If the share price does OK, investors stand to pick up stock at a discount. But it’s Catch 22 because the market doesn’t know how many of the options will be exercised and thus the degree of asset dilution.

As a result, the LICs trade poorly until the options are dealt with, even if the managers prove to be gun investors.

“The very thing that an LIC requires to get their IPO away is the same thing that hangs over their heads and hold their share price back after listing,” says Boyd Peters, who promotes LICs to Australian investors.

“Too few of them neuters an IPO and its size, while too generous holds back the share price.”

Peters says investors are often advised to sell the head stock below the issue price and recognise a tax loss, while retaining the options so they can re-enter the stock when they like.

A typical scenario sees the client buying at $1 a share, selling at 98c a share but holding an option worth 5c a share.

“They are effectively 3c ahead and of course the broker has earned a nice commission for putting them in the IPO,” Peters says.

If a LIC does well and the NTA (and share price) increases, investors are usually better off buying the options on market and converting at the $1 issue price.

More likely, a LIC with big wads of unexercised options will trade at a substantial NTA discount.

Even when a LIC overcomes the options headwind and trades at a decent premium to the IPO price, the brokers who put their clients into the stock suddenly become averse to these investors exercising their options.

Why? The brokers would prefer to participate in the ensuing options shortfall placement on the original terms, but pocket a fee of up to 3 per cent for taking on the risk.

The fortunes of a LIC can improve dramatically after the options overhang has been dealt with. Take the tech-oriented Bailador Technology Investments, which issued 62 million options at $1 apiece in 2014.

Created by former Fairfax Media chief executive and Trade Me chairman David Kirk, Bailador shares struggled to maintain the $1 level, despite the fund’s NTA at $1.26 a share on the March 31 options expiry date.

An options shortfall placement saw the NTA reduce to a diluted $1.18. But the stock hit $1.30 within eight weeks of the options expiring.

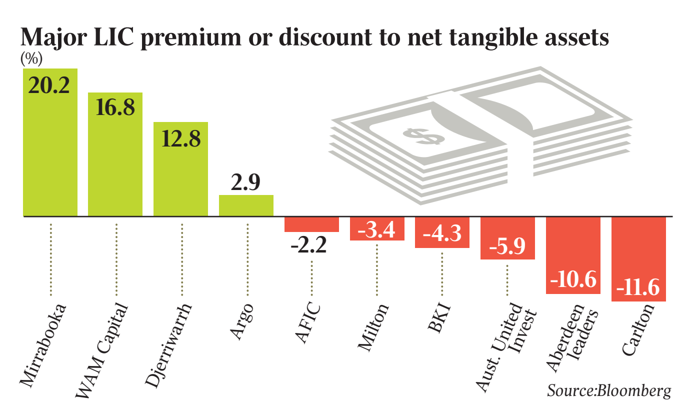
“It would appear investors and shareholders were simply waiting for the options to get out of the way in this company,” he says.

Barrack Street Investments faces a similar test. Founded by high-profile stock picker Manny Pohl in 2014, the LIC has traded under its $1 issue price and NTA of $1.21. A swag of Barrack options expired on Wednesday.

“The company has recently given guidance that it will pay a minimum of 1.5c per share dividend by October, which may be a hook for investors to acquire shares,” Peters says.

Glennon Capital has entered a shortfall placement agreement with Taylor Collison and Morgans Corporate after options in its Glennon Small Companies expired on Thursday.

The fortunes of LICs can improve dramatically after the options expire



Still they come

In the meantime, the trickle of LIC initial public offerings continues.

Antipodes Partners is doing the rounds for Antipodes Global Investment Company, eyeing a $300m raising and an October 14 listing.

India Equities, which was trying for a more modest $50m, has extended the close date from yesterday to next Monday.

The backers cite clients of financial planners “ who have indicated significant interest in the offer, but require more time to get their application paperwork in order”.

Tapping investor appetite, every self-respecting fundie has launched an LIC in recent times to increase the volume of assets on which they can charge a management fee. These include Acorn Capital, Perpetual Investments, Perennial Value Management, Investors Mutual and Thorney Investments.

Golden oldies

But is the best value still in the old LIC names?

Baillieu Holst data shows the established “big two” LICS are trading at a lower premium to NTA than the historic norm.

The biggest, Australian Foundation Investment Company, trades at half a per cent above the inherent value of its $6.5 billion of investments, compared with the three year average of 3.8 per cent.

Argo Investments trades at a 2.3 per cent premium compared with the 3.4 per cent run rate over three years.

Shares in Australian United Investment, the distant third-biggest LIC, can be picked up at a 6.1 per cent discount compared with the historic minus-5.7 per cent differential.

A case of money for nothing, (dividend) cheques for free.

The Weekend Australian accepts no responsibility for stock recommendations. Readers should contact a licensed financial adviser. The author does not own shares in the stocks mentioned.

THE COACH

Should I participate in the Telstra buyback? I am 73 and retired. All my income is generated from my Allocated Pension plus a small amount in share dividends. I own 1000 Telstra shares in my own name. Should I sell them on market or participate in the buyback? If so at what discount?

Telstra recently announced it would buy back from shareholders up to $1.25 billion of shares in an off-market buyback. Shareholders can tender their shares at a discount of 6-14 per cent of the five-day average market price to September 30 or accept the final buyback tender price.

The buyback will have a capital component of $1.78 a share and the remainder being declared as a fully franked dividend.

If the average share price of Telstra over the five days is $5.40 and a shareholder tendered their shares at the full 14 per cent discount, they would be tendering the shares at $4.64. From this, $1.78 would be received as a capital payment, $2.86 would be a fully franked dividend and the dividend would attract a franking credit of $1.23 a share. This means assessable income of $4.09 a share plus the capital payment of $1.78. So between franking credit, capital payment and dividend, you would receive a total benefit of $5.87 a share. That is an additional 47c a share compared to selling on market without the costs of brokerage.

If you are in a no or low-rate tax environment, the offer is attractive as you will be able to claim the franking credits back. For those owning shares either in a super fund paying 15 per cent tax or your taxable income is over $18,200, the case isn’t compelling if you apply the full 14 per cent discount to market price. If you pay tax at 15 per cent or higher, you would need to tender your shares with a much lower discount to be better off.

The price you originally paid for Telstra should also have a bearing on your decision. The higher the price you paid, the greater the capital loss that you will be able to use to offset gains on other investment assets in your portfolio, either now or into the future. If you make a capital loss, it can only be offset against capital gains.

The final buyback price will be the lowest price Telstra can buy back the amount of capital for.

To be eligible for the buyback you need to be a resident of Australia or New Zealand, and be a shareholder on August 19.

The offer documents to shareholders are expected to be available at www.telstra.com/buyback on Wednesday.

There are two key tax considerations; your income and capital gains tax position. But not all decision should be driven by tax; you need to form a view on the future prospects of Telstra and whether you want to own the shares into the longer term.

If you are in a low or no tax environment and are happy to part with the shares with no brokerage costs, you should consider the offer. In all instances, seek advice to determine what will work best for you.

Visit the Wealth section at www.theaustralian.com.au to send your questions to Andrew Heaven, an AMP financial planner at WealthPartners Financial Solutions.

May the forces be with you: can a shot at Defence Housing win war on returns?

JAMES GERRARD

They are widely advertised, they would appear to be very dependable — after all, it is the army, but what is for sale here really and is it necessarily better or safer than standard investment property?

Defence Housing Australia was established in 1988 to provide housing to Australian Defence Force members and their families. Today there are 18,000 homes in their network worth about $8 billion in total.

Rather than tie up significant public funds to house troops, DHA decided to give everyday investors the opportunity to purchase newly constructed properties and rent them back to the federal government on long-term leases with guaranteed rent. The term of the leases are generally nine or 10 years and the rent is set and adjusted each year by an independent licensed valuer at the market rate. The property can also be sold throughout the lease period using a real estate agent of the investor’s choice, so people are not locked in to holding the property until the lease term expires.

Wayne Dive, lending specialist at Smartline, says normal bank lending criteria apply to DHA property and no special conditions or considerations need to be given from a lending perspective relative to a traditional property investment. So what’s the catch?

The usual concern voiced from accountants and financial planners are around the high ongoing management fees.

While DHA charges 13 per cent management fees for apartments and an eye-watering 16.5 per cent for houses, attention needs to be given to what you get for the fee to compare apples with apples. The DHA management fee covers day-to-day maintenance of the property, most non-structural repairs and end-of-lease restoration, which can include painting and carpeting.

To dispel the common misconception that DHA properties achieve below-market rental yield due to their management fees, DHA engaged business research and forecasting firm BIS Shrapnel to compare the running costs of DHA investment properties versus traditional investment properties managed by a real estate agent. They found that, under every scenario varying from low rent to high rent and low costs and high costs, the running costs of DHA properties was lower. BIS Shrapnel attributed this to factors such as no vacancies and no reletting fees on DHA properties, and the inclusion of most repair and maintenance charges inclusive in the DHA management fee.

Before you crown DHA as the holy grail of property investments, give consideration to some of the limitations. Available stock of property is limited. You can generally buy in a handful of suburbs in each capital city and some regional cities across the country. So if you are an investor who wants to target a particular suburb, let alone a particular street, you will find this difficult to do with DHA properties.

Another drawback is for property bargain hunters. DHA properties are sold via a ballot process at a fixed price. So for those wanting to scoop up a bargain, you will be disappointed and have to pay the going market price.

The final consideration is the limitation to add value to the property during the DHA fixed-lease term. You will not be able to subdivide, build a granny flat or renovate to name a few strategies investors employ to boost the capital value of their investments.

DHA acting managing director Jan Mason says a DHA investment “may be suited to any type of investor including SMSF investments. Our investors are typically looking for long-term, hassle-free investments.

“Because DHA properties are located in most capital cities and many major regional areas, investors looking for geographic diversity for their portfolio can achieve this with a DHA investment”.

The guaranteed annually reviewed rental income, security around the quality of tenant, coverage of repairs and maintenance in the fixed management fee and depreciation benefits may appeal to a range of people including conservative, long-term property investors or people starting out with their first property investment. However, DHA property may not appeal to some property investors who wish to have control over the purchasing, improvement and developments aspects of property investment.

The purchase price is fixed and there is no scope to improve or develop the property while under the DHA lease period. But you can’t really ask for a better tenant than the federal government.

James Gerrard is the principal and director of independently owned Sydney financial planning firm FinancialAdvisor.com.au