Eureka Report

WEEKLY REVIEW

Number 198, January 28, 2010

Dear Investor

As you prepare for retirement, the simple but often forgotten question to ask is how much money you will need to be comfortable. Robert Gottliebsen shares his experiences and finds that $1 million might not be nearly enough to retire on, depending on your lifestyle choices and health. Readers were grateful for Robert's honest approach to the subject, so make sure you find out the answers for yourself in this week's lead feature.

As predicted, mergers and acquisitions are a hot topic in 2010. Tim Treadgold joins the debate, unveiling his pick for the most logical takeover target. Bruce Brammall looks at the leaks from the Henry tax review. Mike Hawkins of Evans & Partners asks if you're too exposed to fully priced gas stocks. Roger Montgomery reflects on one of Warren Buffett's core values. Ivor Ries says a 'fifth-pillar' in our banking system would solve a lot of problems. Jim Stening reports on what could be the last of the step-up hybrids, and Monique Wakelin provides a checklist for anyone considering buying a property interstate. All this and much, much more.

Your Eureka Report weekly review is ready to print. I hope you enjoy it.

Best wishes,
Alan Kohler

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Published in *Eureka Report* on January 22

Don't sell your retirement short

By Robert Gottliebsen

PORTFOLIO POINT: Retirement can cost more than you expect; I know – I've been there. Here's how to avoid being left short.

Today I want to share with you some of my "retirement experiences" and in particular look at how much money may be required for your retirement.

Back in 2006 during the Howard government there was a quirk of "legislative madness" that forced a series of people, including me, to go into a state of retirement. The "legislative madness" was rectified but enabled me to experience "retirement" briefly before being persudaded to start writing again by Eureka Report publisher Alan Kohler.

Last week I alerted subscribers to the long-term dangers on the horizon that I discovered on my overseas travels (see *A recession made in China*). At that time I did not know when those dangers would affect the market but I felt I should not delay my commentary. Today there is a lot more discussion about the dangers emerging in Europe and the US and it is beginning to affect the market. (Wall Street fell by more than 2% last night: its biggest fall since October 30).

It is clear these dangers could affect long-term rates of return and therefore be a factor in the amount of money required in your retirement. I want to emphasise that there is no simple set of rules for retirement and how much money you will need, but I hope my comments will help.

Mathematically there is a very simple equation that shows that if you retire with $1 million at age 65 you can draw down $60,000 a year plus inflation for 30 years – until you reach about 95. If you retire at 60 the money runs out at age 90. The figures were calculated by Doug Turek back in August 2008 (see *The trouble with wealth projections*). (Subsequently, Doug did some more work on this subject in November of that year – see *How much is enough?* – and said he thought it more prudent to plan on taking $45-$50,000).

Doug, the managing director of private wealth advisory firm Professional Wealth, writes on asset allocation and portfolio planning. He assumes returns of about 8% a year after fees from a portfolio mix of 60% equities and 40% bonds.

Others will come up with different sums because they calculate a slightly higher or lower rate of return but Doug's initial formula is a widely accepted sum. Actuaries say most of us are not going to make it to 95, but there is always the possibility that you will live longer than you expect. If we do live beyond 95, what a miserable experience we face in our final years if we start to run out of money.

Indeed, the alarm bells will start ringing by about age 85. If we live to 100, having only made provision for 30 years, 15 years of our lives will be spent under financial pressure. So in reality if you have a million-dollar retirement nest egg, you must base your income sums on a yearly distribution of less than $60,000 or build a bigger nest egg. (The $60,000 will be tax free if it comes out of superannuation.)

I want to emphasise that the figure of $60,000 a year is just an example, whether it is sufficient or insufficient will depend on the lifestyle that couples or individuals want to lead in their retirement. I found costs in retirement much higher than I had expected. You will look to travel. You may want to look after your children or your grandchildren (particularly with regard to education). In some cases you may also be caring for you own elderly parents. Other expenditures will arise that you didn't expect as you seek to maintain your lifestyle. The CPI figures that are reported greatly understate the inflation experienced by retirees.

So for the people who are used to incomes that are currently classified the upper-middle area, $1 million is a bare minimum and, frankly, for most in that bracket it will not be enough.

Many will require much greater sums: at least $2 million. Of course these calculations assume that you already have a dwelling, which may need to change during your retirement depending on your lifestyle and health. But do NOT assume you'll have less money tied up in your residence as the years go by, because the costs of accommodation can be very high in the final years.

Those that live in luxurious accommodation may have the option of downsizing but for the vast majority the old idea of cashing in a standard house and downsizing to fund your expenses is a very high-risk strategy should you or your spouse later require special care. Many seek to retire in a remote location, which may work well but in most cases those who do should expect to see less of their children and grandchildren.

Another aspect that is often not taken into consideration is timing. Imagine you retired in the second half of 2007 as the stockmarket peaked and you had 60% of your funds invested in equities. This is a standard strategy and would

have seen your investment decimated. Although there has been a recovery you would now have a totally different idea of what you will need. Conversely if you had retired late in 2008 or early 2009 and adopted the same investment strategy you would now be laughing.

These two hypothetical experiences underline that those smooth curves that financial planners are fond of putting before you are very different to what happens in real life. And again this emphasises the need for financial buffers so that you will not be tempted to panic in the bad times.

While there are obviously many factors that influence longevity, financial security is one of the forces that can extend your life expectation. At the moment the benefits of superannuation that deliver tax-free income to those over 65 are incalculable. The government is restricting how much money can go into superannuation so those nearing retirement should maximise contributions including contributions from after-tax income.

I must repeat that I don't think that having $1 million in superannuation is a large amount for a couple, especially if they are currently on a higher income. All this means that the old idea of retiring early with a lump sum of about $500,000 or less can be very dangerous to your lifestyle. There is no doubt that many of those who did retire on what now appear to be low sums have found retirement a difficult experience, both financially and personally.

For many couples, being around each other all the time takes some getting used to, and the absence of work in many lives requires a different approach to conversations with friends and acquaintances, particularly among men. So my bottom line is that unless you have substantial capital and believe you can handle the lifestyle of retirement, you should seriously consider working on after 65 but at a lower pressure and with fewer hours. The Henry tax review is likely to recommend tax incentives to extend your working life.

Changes in work practices and skils shortages in many areas mean that extending work beyond 65 is a real option for many older people. You can use this elongated work time to increase your superannuation and ease the adjustment to full-time retirement. Even for those with retirement sums substantially above $2 million, it will create other options including funding the needs of grandchildren.

My bottom line is that whatever sum you thought you needed for retirement, look hard at it and question whether it is enough for what lies ahead. Remember that we are headed into a period where the cost of funding companies is going to rise because governments are going to move into the capital-raising arena on an unprecedented scale.

That means that equity returns will be volatile and many people may choose to reduce the equity component of their portfolios. While overall investing returns may be good, it will require excellent timing to participate in bonanza returns. In reality, this scenario implies that you'll probably require more money.

I will be interested to hear your views, click here to let me know your thoughts. ◆

Footnote: Despite the challenges of retirement, it must be said that I am having a ball. Being able to spend more time with my family, travel and write for Eureka Report have all been enormously rewarding.

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Published in *Eureka Report* on January 27

Takeover target: Lihir Gold

By Tim Treadgold

PORTFOLIO POINT: The stock has been effectively put into play since the departure of its CEO.

Australia has two ranking gold stocks, Newcrest and Lihir. They both have a chequered history and either would have frustrated a long-term investor in recent years. For as long as I can remember the two stocks dwarf all rivals including relative juniors Kingsgate (more on that later), Avoca, Dominion or Silver Lake Resources.

But just one week ago everything changed with the departure of chief executive Arthur Hood, which has effectively put Lihir in play. The dynamic duo of stocks that have lorded it over the Australian gold sector for decades looks ready to be torn asunder. Make no mistake: Lihir is now the market's top takeover target.

Before going any further it must be said that tipping Lihir Gold as a worthwhile investment has made fools of stockbrokers – and journalists – for 15 years.

But this time should be different: Weak management, led by chairman of 13 years Ross Garnaut, and a poor use of shareholder's funds are the reasons why Lihir is effectively for sale, and there is little doubt that institutional investors would rush a bid priced at $3.50–4 a share, with the higher price being about 30% above Lihir's most recent sales, which have slipped beneath the $3 support level to around $2.94.

Patience with Lihir, and its never-ending list of excuses for failing to perform as promised, means that it's time for wholesale change, with the first whiff of that coming on January 18 with Hood's abrupt departure. The move suggests further management ructions at the group with no obvious CEO replacement plan – former chief financial officer Phil Baker has been temporarily installed in the position.

Significantly, and somewhat embarrassingly, Lihir's share price rose slightly after Hood walked out. The immediate message from the market was that change – any change – has to be for the good.

As Hood headed for the door his boss, and Lihir's chairman since the company floated in October 1995, Ross Garnaut, provided a second clue into Lihir's fate as a business for sale.

Garnaut used two magic words in his widely reported briefing of selected commentators. The next chief executive, he said, would focus on "maximising value" from its assets rather than just running the operations.

There are two ways to maximise shareholder value in a company: run the business better, which is a bit hard to accept in Lihir's case after 15 years of false starts; or sell it and bring in an expert team from a bigger mining company.

Whether a bid comes from one of the gold majors, such as Canada's Barrick, South Africa's AngloGold, Newmont of the US, or local gold sector leader Newcrest is hardly relevant: The point is that Lihir's share register is loaded with investors who are willing sellers having watched their company lurch from crisis to crisis despite being the owner of one of the world's great gold deposits on Lihir Island in Papua New Guinea.

Perhaps the greatest damage to Lihir's relationship with institutions can be traced back to a $US325 million fund raising in March last year, which saw new shares issued at $3 each.

Funds raised were earmarked for expanding operations on Lihir Island and in West Africa, where Lihir had expanded via the takeover of Equigold. Little mention was made at the time of the company's third business unit, Ballarat Goldfields.

However, a month after the capital raising, Lihir reported that the Ballarat mine was being "streamlined" after failing to perform as planned. By June, Lihir management announced plans to effectively write off the Ballarat investment for between $US250 million and $US350 million, roughly what was raised from shareholders three months earlier.

The 2007 Ballarat investment was an attempt by Lihir to invest in Australia, a move that would "derisk" the company with its heavy focus on PNG and Africa. It failed and the jury is out on whether the 2008 Equigold investment will be any better.

For investors, the question with Lihir is whether its current status as a business, which appears to looking for a new owner as well as a new chief executive, makes it – in terms of gold holdings – the best gold stock on the market.

Among Lihir's key rivals are:

- **Newcrest Mining**, which also offers exposure to copper as well as gold, with the potential for tungsten production in the future. Like Lihir, Newcrest has had its management moments but is now settling into a highly profitable pattern, which should see earnings rise from $248 million last year to as much as $900 million in 2012. Over the past 12 months, Newcrest's share price has risen from a low of $27.64 to recent trades around $33.30.
- **Kingsgate Consolidated**, a company dogged for more than a year by slow government approvals for a major

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mine expansion in Thailand, but now free to grow there and perhaps elsewhere as well. Production at its flagship mine will double over the next two years, and perhaps more thanks to ongoing exploration success. Management has also started talking about expansion outside Thailand, with Australia and South America the prime targets. Over the past 12 months, Kingsgate's share price has risen from a low of $3.42 to recent trades around $9.49.

Other gold stocks with solid production profiles and growth prospects included Avoca Resources, Dominion Mining and Silver Lake Resources. Each offers direct exposure to the gold price, strong management and the potential for exploration success.

Set against these rivals, Lihir is a company sitting on a staggeringly good gold deposit at Lihir Island with official reserves of 28 million ounces, enough for 28 years of production at the current target rate of one million ounces a year and total resources measured at 43 million ounces.

Production costs are running at $US454 an ounce, yielding a gross margin of more than $US500 an ounce, with profit in the current financial year tipped to come in at around $300 million.

The problem is that management has struggled from the day mining started to maximise value from its namesake mine, partly because of the difficulty working in the hot ground of an open pit mine in a dormant volcano and partly because the ore needed expensive processing.

As if difficulties in the pit, and in the processing plant, were not enough to keep management fully occupied, Lihir's board decided to expand via acquisition, including the loss-making takeover of Ballarat Goldfields and the far-from-convincing merger with West African specialist, Equigold.

The move on Ballarat was supposed to lower the risk profile of Lihir. The move on Equigold was supposed to diversify gold production. Neither initiative has yet succeeded although that is not to say any, or all, of these difficulties could not be overcome by a new owner.

Curiously, despite the layers of bad news currently washing over the stock, Lihir is persevering with its attempts to impress mining analysts by organising a tour of mining facilities in the coming days, a move certain to increase attention on the assets of the company.

A sum of the parts calculation, with the treasure trove on Lihir Island and the potential of Equigold's Bonikro mine and exploration tenements, could easily produce a valuation greater than Lihir's current market value of $7.2 billion, less than half the value of Newcrest's $16 billion.

If ever there was a mining company looking for someone to show it how to perform as a business it is Lihir – which is perhaps why Garnaut said the future was all about "maximising value" for shareholders. ◆

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Your guide to the Henry tax review leaks

By Bruce Brammall

PORTFOLIO POINT: Is super headed towards becoming a de facto age pension system, designed to encourage only the lower-paid to put away for themselves?

SMSF trustees have lived in fear of the three government inquiries that have been running over the past two years. The biggest and most important, the Henry tax review, has been handed to the government, which has promised to release the review in “early 2010”.

In the same way the good news from all federal and state budgets is leaked each year – to maximise publicity, control the news flow and make sure the “good” messages aren’t lost amongst the bad in the headlines – a sizeable portion of the Henry tax report has already found its way into the media.

So what has Henry recommended and what does it mean?

Let’s start with a declaration: I haven’t seen the report, so the following comments are based only on media reports (and assume that they’re accurate).

Of what has been leaked so far, there seem to be six broad recommendations that will have an impact on your super:

Stopping the “wealthy” from getting higher tax benefits from contributing to super

Henry postulates that it’s unfair that someone earning in excess of $180,000 a year gets a larger benefit from contributing to super than a worker earning less than $34,000.

If someone earning $200,000 a year took the final $20,000 as salary, they would pay 46.5% in income tax on that amount. If they put it into super they would pay just 15%. Those earning between $6000 and $34,000 would only pay either 15% or 16.5% (including the Medicare levy) for salary taken in that range. If they contributed money to super, they would still lose 15%.

Henry believes this is unfair and wants to square the ledger. One way this has been done in the past is through the government co-contribution, whereby lower-paid workers who had contributed $1000 to super were given $1500 by government, an automatic tax-free return of 150%, which Labor has temporarily cut to 100%.

Possible compulsory lifetime annuities – run by the government

I looked at this proposal from funds manager Challenger last year (click here). The most interesting of Challenger’s points was that it would guarantee a higher income than the full pension for life, even if it was only $20–50 a week more. Henry recommends that the government step in and offer lifetime annuities (probably not what Challenger was proposing). But the theory behind making the switch from a defined lump sum to an ongoing annuity stream makes sense.

The problem with lifetime annuities has been that so few providers still offer them, because a vicious circle was operating: only those people who expected to live long were taking them out, which forced providers to reduce the returns available, which meant that even fewer people were prepared to buy them.

Whether or not this is a good idea comes down to the detail. Will the government force Australians to take a particular portion of their superannuation balance at retirement as a lifetime annuity? If so, what percentage? Should it be a minimum, across-the-board, percentage, such as 30–50%? Or should those who have a lower super balance be forced to have a higher percentage paid from their super into the lifetime annuity (to ensure a higher proportional lifetime payment)?

Having the government provide a base service, perhaps against which private enterprise could compete, also seems sensible.

Delaying access to your super

In last year’s federal budget, the government announced that access to the government age pension would be slowly pushed back. Those changes will be phased in between mid-2017 and mid-2023. It means that anyone born after July 1, 1956, won’t be able to access super until they turn 67.

Henry has suggested the same idea should apply to superannuation, to keep Australians working and paying taxes longer. Effectively this is an issue about when you stop paying taxes, which is what Henry’s interested in, rather than when you get access to super.

Thankfully, the government has not responded warmly to this idea. There is little doubt that the age at which Australians can access their super will be pushed back at some stage; it’s just not going to happen now.

Closing the tax gap on different types of savings

Full taxes are paid on salaries and any sort of other payments

included in assessable income, such as interest, dividends or rent. However, if you make a capital gain on the sale of an asset that you've held for longer than a year, you only pay tax on half the gain.

Henry argues that bias towards capital gains in favour of other types of savings is wrong and needs to be changed. Any change here would impact on the relative values of investing inside or outside super. We just don't have enough detail on this yet.

Cut income taxes for older working Australians

There has been a suggestion that people should be given the incentive to stay in the workforce longer by cutting taxes beyond retirement age. Not enough detail has been leaked so far, but again, any change here would impact on the relative attractiveness of super.

Increase the 9% super guarantee contribution

Henry is not going to recommend an increase in the mandatory 9% super contribution for employees, claiming that those who have been in the Superannuation Guarantee system for their entire working lives (that is, those who started work in 1992) will have enough from this to retire on.

He also claims that it would have a more direct and immediate impact on lower-paid workers' current take home salaries.

Many, many people would disagree with Henry on this, and push for a rise in the levy. As do I. A reasonable body of opinion believes it should be raised to either 12% or 15%.

The Henry report is reportedly 10 centimetres thick, so there will be plenty that hasn't yet been leaked. Henry may not have covered some things. Or he may be saving all the really bad news for the day the report is released.

Two important questions that have not yet been answered are whether tax-free super pensions are to be scrapped and whether funds in pension mode will keep their tax-free status. Changes here could devastate investment plans.

The government seems intent on a serious shakeup. But we won't get to see the biggest portions of their shakeup – Jeremy Cooper's review – until much later this year.

Henry's recommendations will get many people wondering whether committing too much money to super is really a wise idea. Should they instead invest in property and shares directly?

Is that too drastic? I'm not convinced it is. Superannuation under Labor is looking more and more as though it will become something designed to become a de facto age pension system. That is, it will become a system that will help lower-paid Australians put away for their future, with so many restrictions being placed to make it of marginal benefit for the average to well-off.

It's laughable that where the Henry report considers itself a long-term thinking document by talking about "longevity risk", it completely fails to understand the myopia it engenders by further considerable changes to the law. ◆

Bruce Brammall is director of Castellan Financial Consulting and author of Debt Man Walking.

Superannuation Q&A

By Andrew Quinn

This week:

- SMSFs and warrants
- Calculating pensions.
- Defining an 'eligible person'.
- Concessional limits.

Warrants your attention

I keep hearing about how I can use my SMSF to invest in property through warrants. Are these the same kind of warrants that are available in equity markets or something entirely different? Is it an off-the-shelf product or something that is tailor-made for each individual investor?

An instalment warrant is an agreement that enables you to purchase an asset over time. Under the agreement, the buyer makes an initial payment and then pays one or more instalments plus interest in the future to fund the asset. According to the tax office, warrants are very much like a loan, which has been a problem for super funds because they are not supposed to borrow.

To make the rules consistent across all asset classes, the government amended the Superannuation Industry Supervision Act in September 2007 to allow super funds to invest in warrant-style arrangements as long as certain conditions were met.

In particular:

- The borrowed funds must be used to purchase an asset (such as real estate) that is held in trust for the SMSF
- The fund must have the right to acquire legal ownership of the asset by making payments.
- The lender can only have recourse against the underlying asset, not other assets of the SMSF.

This means that the door is now open to a range of SMSF borrowing strategies as long as they have the features of a warrant. There are many banks and lending institutions that will set up SMSF loans that are tailor-made to your situation and will allow you to qualify under the new rules. You can also provide the funding yourself if you have appropriate legal documentation and trust arrangements in place.

If you are interested in exploring these options, you should get professional advice because there are lots of boxes to tick.

DIY dilemma

My husband and I have been advised to set up a DIY fund and then pay ourselves an allocated pension. We are currently transferring cash and assets, including shares into a fund. I am little confused about how the pension amount is calculated. Also, especially at the start, if there is not enough cash in the account, how is a pension paid out?

Superannuation pensions are fairly straightforward to set up and can provide some excellent tax outcomes but the rules regarding payments can sometimes be tricky to grasp. The amount of pension that you can, or must, take will primarily depend on your age, employment status and the type of pension you are taking.

If you are still working, your account-based (allocated) pension will be a transition-to-retirement income stream and you will need to draw a minimum pension based on the percentages set out below. Pensions commenced during the year should be pro-rated unless they were started in June.

For these pensions, a maximum limit of 10% of the account balance will apply until you retire or reach age 65.

Minimum pension drawdowns

Age	% of account balance for 2009-10	% of account balance for 2010-11 onwards
Under 65	2.00%	4%
65-74	2.50%	5%
75-79	3.00%	6%
80-84	3.50%	7%
85-89	4.50%	9%
90-94	5.50%	11%
95 or more	7.00%	14%

The rules on pension payments are very flexible. The key is to make at least one payment per annum and to ensure that you have kept within the pension limits. If there is not enough cash in your SMSF to start a pension immediately, you can delay the payment until later in the relevant financial year if you wish or wait until you have sufficient cash available. I'm sure your accountant or financial adviser can assist you with these details.

The definition of eligible

I have been receiving WorkCover payments for the past 10 years, having been incapacitated by an accident at work. My accountant tells me that changes in the definition of income mean I can no longer obtain a deduction for contributions to my SMSF as I am not an "eligible person". This is because "I received or was entitled to receive superannuation benefits in respect of eligible employment for the year of income". While I have no problem accepting that the income from WorkCover is taxable, I do not believe I received any "superannuation benefits" to render me ineligible. Do you have a better explanation for this?

Generally speaking, a taxpayer is an "eligible person" as long as their assessable income, exempt income and reportable fringe benefits from the employment are less than 10% of their total assessable income and reportable fringe benefits for the year.

For the purposes of the 10% rule, it has been found that if an employee receives periodic workers compensation payments from an insurer as a result of an injury suffered while engaging in eligible employment, and the payments are included in the employee's assessable income, those payments are "attributable to" that eligible employment.

Without more details about your situation, it is difficult to say whether your compensation payments are still "attributable to" your employment of a decade earlier. Your eligibility to contribute and claim a deduction will also depend on your age and whether you are engaged in any of the other eligible activities described in s290 –160 of the Income Tax Assessment Act. ◆

Andrew Quinn is a director of Wren Investment Advisers.

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Is all the good news priced in?

By Rudi Filapek-Vandyck

PORTFOLIO POINT: The market may have risen, but many top stocks are still below long-term valuations.

It may be less apparent to those who only look at financial markets with a short-term (trading) horizon, but intrinsic valuation will come to the fore at some point – especially because most experts seem to think that excess global liquidity will be reined in this year, implying the weight of money will increasingly play a lesser role as the year matures.

To put it very simply: higher economic growth in key regions should translate into higher corporate profits and into higher demand for energy and base materials. Thus prices for companies and for commodities should move higher. But what if these price rises have already occurred?

In the US, the main discussion among investment experts seems to be whether market leaders such as Apple, IBM and Microsoft still represent value beyond their present upward momentum. Short-term traders might decided they'll play the stock as long as it moves, but for investors with a longer-term focus the question is not that easy. For them, if all the upside, or nearly all of it, has already been accounted for, then these stocks should no longer be bought at present levels.

Now that we're mentioning it, I wouldn't necessarily be afraid to have a higher than usual proportion of my investment portfolio in cash. It beats owning shares that seem stretched from a valuation point of view, but it also allows one to jump on any opportunities that might come along as we move through 2010.

Much has been said about the market's potential on the basis of expectations for 2010-11, and I have been a firm advocate for using 2010-11 projections to gauge where today's true market value is located. But most companies in Australia will only report their full 2009-10 numbers in August, which is still more than seven months away. In the meantime, a lot of 2010-11's upside potential is already being priced in.

I have observed, for instance, that the total number of downgrades from stockbrokers is now outnumbering the number of upgrades for the second week in a row. That's two out of two so far this year, as the first week saw hardly any research released. One downgrade in particular caught my attention: following the release of a production report that was much better than market expectations last week, analysts at Citi nevertheless downgraded Rio Tinto (RIO) shares to neutral.

Their reasoning? Most of the good news is now priced in. As a token of their conviction, Citi analysts stated that in case of any meaningful rally in the shares, they would have no doubt and become sellers of the stock. Now that is conviction!

Most stockbrokers currently have a price target for Rio Tinto shares between $80 and $90. Citi's is $83. FNArena's average price target stands at $82.64.

On a pure price/earnings (P/E) consideration, Citi analysts seem a bit harsh in their assessment. After all, Rio Tinto shares are only trading on 11.3 times consensus forecasts for 2011, which is far from excessive. Consider, for instance, that BHP Billiton (BHP) is on a multiple of 12.7, Asciano (AIO) is on 19.4 and even Woolworths (WOW) and CSL (CSL) are on 15.2.

However, Rio Tinto has yet to report its full 2009 results as its fiscal year runs to December. As such, the 2011 financial year for Rio Tinto is six months further off today than it is for most Australian companies. In addition, the above-mentioned 2011 P/E is on the basis of the average Australian dollar value over the past 12 months. At the present exchange rate of US92¢ the implied P/E for 2011 instantly jumps to 13.3.

Regarded from a positive perspective, this still leaves further room for share price appreciation, especially with iron ore prices likely to surprise this year and with most metals trading above consensus price projections. But let's not forget the start of Rio's 2011 financial year is still nearly 12 months away. On 2010 numbers, and taking into account the present value of the Australian dollar, the P/E jumps to 16.

Add the fact that Rio's P/E has hardly ever been as high as 14.5 (let alone 16) during the period 2005 to 2007 and one is inclined to have more sympathy for Citi's view. This becomes even more the case given the growing army of experts who are questioning whether prices for the likes of crude oil, copper and gold have moved too high too quickly between December and early January.

I have already indicated in the opening paragraphs where I stand in this matter.

For BHP Billiton, whose fiscal year concludes six months sooner than Rio's, the 2010-11 P/E currently stands at 12.7 (on average foreign exchange values for the past 12 months). However, if we take guidance from today's exchange rate, the P/E jumps to 14.5.

On a positive note, if we apply the Australian stockmarket's longer-term average forward-looking P/E of 14.5, then both BHP and Rio seem fully priced, but not

excessively so. This, of course, on the understanding that normally the longer term P/E applies to the year immediately ahead, which in this case is 2010, not to 18 months into the future (2011).

One important factor for investors to watch during the upcoming reporting season is what'll happen to earnings and dividend expectations for 2010-11. Some experts believe there is simply not much room left for projections to rise further, which seems a reasonable assumption given most growth expectations for the year are between 20% and 40%.

Here are a few random examples, of consensus growth expectations for FY11:

- Emeco (EHL), 50%.
- National Australia Bank (NAB), 30.7%.
- Qantas (QAN), 74%.
- AJ Lucas Group (AJL), 84%.
- OneSteel (OST), 89.5%.
- Ten Network (TEN), 36.9%.

The obvious question from all these figures is: does further confirmation of global economic recovery still have the potential to further increase growth projections for 2010-11, or have analysts already accounted for as much in their present projections?

Another way of looking at the Australian stockmarket is that a little over half of all ASX 200 companies are trading on at least 14.5 times' projected 2010-11 earnings. This automatically implies that nearly half are not.

Some of these companies come with exceptionally low multiples, such as Boart Longyear (BLY) and Sunland Group (SDG), for example, with 2010-11 P/Es of 1.65 and 2.89 respectively. But there are many others with less exceptional P/Es (and thus likely less risks). These include the following random picks (with 2010-11 P/Es):

- Hastie Group (HST), 8.32.
- Telstra (TLS), 9.62.
- OZ Minerals (OZL), 9.95.
- Elders (ELD), 10.54.
- QBE (QBE), 12.37.

Special mention: all banks still seem to represent good value on 2010-11 metrics. Only CommBank (CBA), which traditionally commands a sector premium, seems relatively fully priced on a multiple of 13.3.

Another group worth mentioning are healthcare stocks and other defensives. On a pure multiple basis, these stocks are mostly trading on above-market multiples (see previously mentioned examples of Woolworths and CSL) but compared with historical multiples most of these defensive stocks are valued below the P/Es they usually enjoyed prior to 2009.

One factor to keep in mind is that healthcare stocks in Australia come with lots of US dollar exposure.

The reason I end on a relative value note is because I have noticed professional investors are increasingly looking into alternative value propositions ("alternative" as in "outside the usual movers and shakers that pushed the market in 2009"). It may well be that, as the usual suspects start running into valuation headwinds (Rio, BHP, CommBank), the market might make a switch into lesser valued stocks, which could keep the rally going for longer.

Having said this, the ASX 200 index undertook an attempt at conquering the 5000-point technical resistance level earlier this month, a move that was bluntly rejected by Mr Market. The market now appears to be waiting for direction in between support at 4850 and resistance at 5000.

With regard to Rio Tinto, technical resistance lies at $80, while for BHP Billiton it is at $44–44.50. All these resistance levels are near, but they still leave further room to move upwards.

More worrying is the fact that the S&P500 has historically found resistance at 1150. After closing right on 1150 on Tuesday evening the US benchmark has shed about 3%, which means little has changed. ◆

Rudi Filapek-Vandyck is editor of FN Arena, an online news and analysis service.

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Published in *Eureka Report* on January 27

ValueLine: Step 3 – recognising fair value

By Roger Montgomery

PORTFOLIO POINT: Once you have identified and valued a great business, it's time to wait for an opportunity to present. It inevitably will.

In the first of three steps from speculating to investing, we learnt that the market is full of people who treat it like a casino, betting not on black or red but on "up" and "down". Step two involved a crash course in the economics of a terrible business, such that you can give them a wide berth when presented to you.

Today we are going to value a business, using a formula outlined by Warren Buffett in his 1981 letter to Berkshire Hathaway shareholders. It applies to companies that pay 100% of their earnings as a dividend.

Suppose I reveal to you that I have a bank account in the name of Roger Pty Limited, into which $10 million has been deposited. This imaginary bank account earns an after-tax return of 20% per annum, fixed for 40 years. The interest cannot be reinvested. Given current interest rates on bank accounts of 5% (and that's pre-tax!), my $10 million account looks very attractive.

Now suppose that I offer this account "for sale". What should you be prepared to pay for it?

At an auction I would discover what people are prepared to pay. But people can also get pretty silly in an auction environment. If I pitched the auction with some marketing teasers such as "last account of its type in the world" or "never to repeated" I may generate a bit of interest and someone could pay a really "dumb" price. But the price achieved at auction is not necessarily what the account is worth.

So what is a dumb price?

With interest rates in a standard bank account at the time of writing of about 5%, with the benefit of reinvestment and thus compounding, I would argue that if someone paid such an amount for the Roger Pty Limited account that the interest coming off it amounted to less than 5% – that would be a dumb price.

To approximate this dumb price, we simply divide the after-tax return being paid by the bank account (20%) by the "dumb" return (5%) adjusted for tax – say, about 3.5% 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% divided by 3.5% x $10 million = $57.1 million

If someone paid $57.1 million for this bank account it would be very high and pretty dumb, because the return they would receive over 40 years would be a low, non-cumulative 3.5% after tax.

Using the same formula through which the dumb (high) price is derived, we can also arrive at the bargain (low) price.

If you were to pay $10 million – the amount of equity actually in the bank account – this would be a bargain price (let's leave inflation out of the discussion for the moment) because you would end up receiving a 20% annual return.

Applying the formula produces:

20% divided by 20% x $10 million = $10 million

So what might be a reasonable price to pay? When rates of interest elsewhere are very low, it is probably unrealistic to adopt them as your own "required" return. Eventually interest rates go back up. There is also inflation to think about. In such a situation you should use a rate that better reflects a return that will compensate you for inflation and for the possibility that interest rates might rise. And if there is a risk that the bank paying the high rate of interest could default or fail, you would require some compensation for that too.

Investing through a family company, my after-tax required return is 10%. The risk in the stockmarket is simply too high to accept a lower rate. If rates elsewhere start climbing above this rate, a higher rate is required.

Using this 10% required return we can establish that you should be willing to pay no more than 20% divided by 10% x $10 million = $20 million.

Again, you may find that at an auction someone is willing to pay a lot more than this. As an investor, you should be willing to say "good luck to them". You are now in the business of finding bargains, and if a bargain cannot be obtained today, the market will open again tomorrow and offer you a new opportunity at a new price.

Your job – now that you know how to identify great businesses, and once you understand how to value them – is simply to ignore periods when dumb prices are being paid and wait for top quality "bank accounts" to be available at bargain prices. If that doesn't happen, so be it. An opportunity will eventually present itself. It always has and it always will. ◆

Roger Montgomery is an independent analyst and managing director at rogermontgomery.com.

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Research Watch

By Luke McKenna

PORTFOLIO POINT: This is a sampling of the week's best research notes. In a world of too much information, we hope our selection helps you spot the market's key signals.

As the global focus shifts to stricter bank lending rules in China, Research Watch looks at the link between Chinese loans and metals prices, and asks whether the new restrictions will be enough to scare away inflationary speculators. We also examine the recent performance of two US leaders: Barack Obama, who has delivered the second-best first-year market returns of any US President; and Warren Buffett, who could stand to make big gains if Berkshire Hathaway is included in the S&P 500. Looking ahead, the price of gold is said to be facing a steep correction as oversupply looms, and history suggests equities still have a way to climb. On video, though, Marc Faber offers a word of caution on stocks for 2010 and – if it all gets too much – instructs on how to get drunk "economically".

Commodities to come under pressure as China tightens bank lending … "Remember how China was importing every commodity under the sun last year – quite inexplicably, considering exports were lagging throughout most of the period? Sean Corrigan at Diapason Commodities has a theory to explain the phenomenon … 'Further to the suspicion that much in the way of Chinese metals imports are related to schemes to game the cheap money there by circumventing capital controls – whether in order to bet on Yuan appreciation or commodity price rises, or both – note that the relative prices of copper, aluminium, and zinc in Shanghai vis-à-vis that on the LME bear more than a passing resemblance to the volume of new loans concurrently granted by Chinese banks' … He goes on: "If – as seems increasingly likely – a genuine crackdown on lending is indeed in train … a good part of the rationale for such speculative holdings would be removed, with potentially significant consequences for prices of base metals (and possibly other commodities)'." *(FT Alphaville, January 19)*

Jim Rogers sticks up for China but has concerns about inflation … "Jim Rogers has debunked contrarian investor James S Chanos' suggestions that China's investment bubble may lead to a Dubai-style implosion … 'It is absurd to say China is in a bubble when the stock market is 50–60% below its all-time high. If you have a bubble you have things going through the roof. You have everybody screaming fire every day.' … Chanos, a hedge fund investor who predicted the collapse of Enron, said speculation in China's real estate sector was a thousand times worse than Dubai … 'His remarks show a lack of understanding about Dubai and of China. Dubai's economy is built on real estate speculation, whereas China's is not. It is just part of the Chinese economy,' said Rogers. He warns, however, that the world could be heading again for 1970s-style inflation. He said while concerted government efforts to bail out economies may have averted a depression, it would eventually lead to spiralling price increases. 'I am sure inflation is going to go to levels seen in the 1970s, if not higher. It is not necessarily going to happen this year, but certainly over the next few years'." *(China Daily, January 19)*

While Roubini thinks that inflation could lead to sovereign defaults in the US … "Rating-agency downgrades, a widening of sovereign spreads, and failed public-debt auctions in countries like the United Kingdom, Greece, Ireland, and Spain provided a stark reminder last year that unless advanced economies begin to put their fiscal houses in order, investors, bond-market vigilantes, and rating agencies may turn from friend to foe … The US might be among the last to face the wrath … The US is a net debtor with an ageing population, unfunded entitlement spending on social security and health care, an anemic economic recovery, and risks of continued monetisation of the fiscal deficit … It also faces political constraints to fiscal consolidation: Americans are deluding themselves that they can enjoy European-style social spending while maintaining low tax rates, as under President Ronald Reagan … If America's Democrats lose in the mid-term elections this November, there is a risk of persistent fiscal deficits as Republicans veto tax increases while Democrats veto spending cuts. Monetising the fiscal deficits would then become the path of least resistance: running the printing presses is much easier than politically painful deficit reduction. But if the US does use the inflation tax as a way to reduce the real value of its public debt, the risk of a disorderly collapse of the US dollar would rise significantly. America's foreign creditors would not accept a sharp reduction in their dollar assets' real value that debasement of the dollar via inflation and devaluation would entail. A disorderly rush to the exit could lead to a dollar collapse, a spike in long-term interest rates, and a severe double-dip recession." *(Nouriel Roubini in Project Syndicate, January 20)*

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Obama: the best President for stocks since FDR … "When Obama came into office, there was all sorts of hand-wringing about how his liberal policies would exacerbate the economic weakness, freak out investors, and tank the market. For the first few months it was dicey, but then things turned around. Big time. Bespoke tabulates the first-year returns of the last several presidents, and finds that Obama had the second best first-year return of the bunch. First place: FDR. And we all know how the economy did for years after that."

Presidential first years and the Dow Jones

President	Party	First Day in Office	1st Year
William McKinley	R	3/4/1897	11.66
Theodore Roosevelt	R	9/14/1901	-1.41
William Taft	R	3/4/1909	13.50
Woodrow Wilson	D	3/4/1913	1.83
Warren Harding	R	3/4/1921	14.38
Calvin Coolidge	R	8/2/1923	16.66
Herbert Hoover	R	3/4/1929	-12.86
Franklin Roosevelt	D	3/4/1933	96.06
Harry Truman	D	4/12/1945	30.59
Dwight Eisenhower	R	1/20/1953	0.40
John Kennedy	D	1/20/1961	10.46
Lyndon Johnson	D	11/22/1963	25.19
Richard Nixon	R	1/20/1969	-16.47
Gerald Ford	R	8/9/1974	5.20
Jimmy Carter	D	1/20/1977	-18.99
Ronald Reagan	R	1/20/1981	-11.02
George Bush	R	1/20/1989	19.80
Bill Clinton	D	1/20/1993	20.05
Geaorge Bush II	R	1/20/2001	-7.70
Barack Obama	D	1/20/2009	33.14
	Median Republican		0.40
	Median Democrat		22.62

(Joe Weisenthal, Business Insider, January 20)

Is Buffett gaming Berkshire's stock price with a share split? … "By splitting Berkshire's class B shares 50-for-1, the price of the conglomerate's cheapest class of stock will fall from about $US3247 each to about $US65. Class A shares – never split since Buffett began building Berkshire Hathaway 40 years ago – will still trade at about $US97,500 … Berkshire needs low-priced shares for its $US44 billion acquisition of railroad Burlington Northern, whose shares are priced at a more typical $US100. By lowering Berkshire's share price, even the railroad's smaller shareholders can receive a comparable amount of Berkshire stock as payment … The split could also make Berkshire eligible for membership in the S&P 500-stock index, which would force index funds to pump billions of dollars into the stock … Because so many investor dollars are held in index funds that track the S&P 500, [it is] estimated that those funds as a group need to buy up 11% of a company's shares when it is included in the index. (In Berkshire's case, that would represent $US16.6 billion in A and B shares.) And that doesn't include the impact of buying by other investors who unofficially track the S&P 500, or by traders trying to piggyback on the market trend." *(Ben Steverman, Business Week, January 18)*

While a gold glut could send prices crashing … "Analysts at Credit Suisse have calculated there will be an excess of 420 tons of gold hitting the market in 2010 if buying by exchange traded funds (ETFs) goes back to levels prior to the credit crises last year. They estimate that gold prices would have to drop to $US722 an ounce – a fall of about 36% from current levels north of $US1100 – before supply and demand were in sync again. While the analysts 'can see signs of institutional investor divestment in ETFs, smaller investors have been rushing into gold leading to shortages of gold coins', for example and 'institutional sales have been offset by non-institutional purchases', propping up prices thus far. But the big players on Wall Street are now expecting an economic recovery to take shape … and demand for gold ETFs … is likely to turn down as a result … Credit Suisse notes that last year's run up in gold prices had an 'accelerating and reinforcing effect on market sentiment and the safe haven status of gold' and that things could turn quickly in the other direction … investors are growing increasingly concerned about the prospect of sovereign debt crises. Any likely panic would likely lead to a pile-on into the dollar and sharp selling of gold much as it did when concerns recently surfaced about Dubai … If gold's volatile history is any guide, the considerable oversupply already expected could quickly turn into a glut as investors race for the door." *(Daily Finance, January 20)*

Here's another reason to never go on holiday, especially if you are defrauding the company … "Former Morgan Stanley vice president Richard Garaventa Jr was sentenced to as much as six years in prison for stealing $US2.5 million from the firm in a seven-year period. Garaventa, who pleaded guilty to grand larceny and falsifying business records in July, wrote 50 cheques drawn on an in-house account between 2001 and 2008 ranging from $US3000 to $50,000, all made out to a company he created … he used the stolen money on luxury cars, landscaping, jewelry and travel, including a $US49,000 engagement ring, $US24,000 for landscaping and $US52,000 on pools … As part of his sentence, Garaventa forfeited his

Goldman outlines its top 280 game changing energy projects

… "We define legacy assets as those which represent a material profit centre for the industry with potential for expansion and provision of long-term reserve and production growth. We believe that the top 280 projects are true legacy assets for the oil and gas industry in terms of materiality, size of investment and profitability, and offer material opportunities for future growth." (For the full-size image, click here).

(Goldman Sachs, via Financial Times, January 15)

house, vehicles worth $US60,000 and two bank accounts. A 3.42 carat diamond ring he had given his wife was also forfeited. The alleged scheme was discovered while Garaventa was on 'a vacation paid for with stolen money', prosecutors said." *(Bloomberg, January 19)*

Meanwhile, history suggests the market has a lot more bull left in it … "On Tuesday, when [Wall Street] hit a new 52-week high, no fewer than 316 NYSE-listed issues also hit new yearly highs. These are impressive numbers, suggesting to at least some analysts that the final top of the current bull market is, at a minimum, several weeks or months into the future. Consider first an analysis of the last 13 bull-market tops recently conducted by Ned Davis Research … On average, the firm found, just 13.2% of NYSE-listed issues were hitting new weekly 52-week highs at those bull market peaks … Last week, according to the firm, 25.1% of NYSE listed issues hit new 52-week highs. But there typically is a long lag time between when the percentage of stocks hitting new weekly highs reaches its peak and when the bull market finally tops out … according to Davis' calculations, the average lag at the last 13 bull-market tops was 33.6 weeks … And on none of those occasions did the bull market top out before the percentage of weekly new highs. This adds up to good news, because the peak so far in the weekly percentage of stocks hitting new 52-week highs came the week before last … when the percentage rose to 26.7%. Even if that … marks the highest level to which this percentage rises during this bull market, these historical parallels would suggest … the stockmarket itself might not peak until the end of this coming [US] summer." *(Mark Hulbert in Market Watch, January 20)*

Video of the week: Marc Faber warns equities could end the year lower than they started, but talks up the benefits of precious metals and cheap alcohol. *(LOLFed, January 18)*

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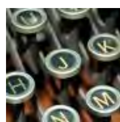
Letters of the Week



By Eureka Report subscribers

Inflation figures a bad joke

Robert Gottliebsen's article *Don't sell your retirement short* is excellent. On inflation, as a former financial planner, I advised my older clients when doing the figures to make allowance for annual inflation of at least 5%. The government CPI figures are a joke and have little bearing on reality. Healthcare appreciates at least 6% per annum, while food and energy seem to increase in double digits every year. This doesn't leave a lot if your returns are 6–8% per annum, even if you can enjoy the tax-free benefits of super.

– C Smith

Don't blame Jennifer Hawkins

Poor Jen! While Alan's weekend comments about the dangers of floats are instructive, I really wish people would stop imputing the success of the Myer float ("con") to the influence of Jennifer Hawkins. Ms Hawkins is not some ephemeral "eye candy" dredged up by some opportunistic marketing company to entice the unsuspecting public into participating in the float. Rather, she is an integral part of the Myer brand. Her absence from the campaign would have been ridiculous, suspicious even. Comments that seem to liken her to a human "Venus Fly Trap", as implied by Alan last weekend and earlier Tom Elliott (*Nine tests of an IPO*), are vaguely insulting. I almost feel sorry for her, but I am too busy feeling sorry for myself having stumped up the crinkle for the float. Anyway, this is so "short-termist" of us all! As a long-term investor and a visionary, I am confident that I will have the last laugh on the Myer issue.

– L Bain

Stress-free returns

In Scott Francis' article Peaking ahead, he defends the performance of the ASX since early 2005 by suggesting that an investor with a $100,000 static portfolio would by 2009 have an asset worth $149,000. Big deal. If we assume they pay no tax, reinvest all dividends, and avoid a heart attack in 2008 and 2009, that may well be so. But equally so, if the same investor had plonked $100,000 in a fixed deposit at 8%, they would have had $146,900 on the same date with far less risk to their health.

– D King

To read this week's letters, click here.

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Published in *Eureka Report* on January 22

Too good to be true for the big four

By Ivor Ries

PORTFOLIO POINT: Merging regionals to create a fifth big bank would get a vote from investors and government, and it would keep the big four on their toes.

Investors who have not owned the big four banks over the past 12 months have suffered miserably. Those who were significantly underweight the banks have underperformed the market by a country mile as the banks gained momentum.

The interim profit upgrade from Commonwealth Bank underlined just how much money they are making. But there is a turning point approaching here: we're in an election year and it just won't do for banks to be reporting super-sized profits as we go to the polls.

Australia's big four banks are under enormous pressure to minimise the rate at which their profits increase but it is going to get harder and harder for them to sweep it under the carpet. Last year there was about $18–19 billion in impaired assets. They took a big hit on that and the government stepped in with the guarantee introduced in late 2008.

This time around bad and doubtful debts have been much smaller than expected. The non-bank lenders have gone and the big four account for more than 80% of retail banking profits.

They are going to be reporting profit growth of 20–30% and – although average funding costs have risen gradually in recent months – over time funding costs will begin coming down as well. In my view this is going to place a great deal of pressure on the government to remove the guarantee.

CommBank and Westpac have been extremely active with it in offshore markets, raising capital mostly without the specific government guarantee but with the general perception offshore that the Rudd government is standing behind the Australian banks. While the guarantee is rarely used today, the perception of government backing is real. If I were the treasurer at a major bank, I would be issuing as much paper as I could because one day in the not too distant future the guarantee will be removed.

The problem for the investor is that there is nowhere to go. No, they're not cheap. Yes, the news flow will remain negative for a while. But while the banks have the upper hand you can't really afford not to be there.

But what might be an interesting proposition, to both investors and the government, is if there was an alternative for the big four: a new player with enough scale to keep them on their toes.

What I'm thinking about is a tie up between any of the three regional banks: Bendigo & Adelaide Bank, Bank of Queensland and Suncorp, a merger that could create some real pricing pressure.

The combination that would create the most muscle is probably Bendigo & Adelaide and Suncorp, although Bendigo would probably not be the initiator of any merger as its board and management are committed to remaining independent. Merging the three would create a bank as big as St George but geographically diversified over Queensland, Victoria and South Australia instead of being concentrated in NSW.

It's the kind of merger that could solve the government a whole lot of problems in one swoop, as it would at least put the perception into the public's mind that there was a real alternative to the big four, even though the new mega-regional would still be paying a premium for its funds and initially at least would struggle to compete on pricing.

If they were able to smooth the waters and Kevin Rudd was able to use his Queensland connections to persuade the board of Suncorp to have a swing at Bendigo, he could stand back and say, "Look at this. A vibrant and competitive banking industry. Fancy that."

But there are other possibilities. AMP looks to have missed out on AXA-Asia Pacific. Maybe it could take out Bendigo and combine that with its banking business.

What the government really wants is competition at the retail level and I think if Suncorp or AMP wanted to take over Bendigo the government would be very receptive.

Regardless of which combination we are talking about, merging the balance sheets of any of these entities would create a stronger business with considerable cost savings, almost certainly in excess of $100 million a year by year three.

It would create a more profitable bank, ignite the kind of fierce competition that the sector has been lacking and remove any suggestion that the banks are getting a free ride. That's a lot of boxes being ticked.

Bad and doubtful debts at all the banks are going to start dropping. In the meantime though, the regionals are going to deliver some pretty ordinary results where they bear the brunt

of mistakes that they made in the past, as Bendigo has with its involvement in managed investment schemes. Boards will want to make sure that there has been an adequate level of provisioning.

That means that after this reporting season there will be a window where someone is going to be able to buy a regional bank without paying crazy prices. After that, the regionals will start being rerated pretty quickly and we've already seen that with Bendigo, which has risen 10–15% in the past couple of weeks.

The tussle over AXA is not going to be the end of consolidation in the finance sector; there are still a few more moves to be made.

If that doesn't happen organically then the government will try and push some levers to make it does because the overseas banks are not about to come back and set up shop for another three or four years. The solution is going to have to come from inside our own borders. ◆

Ivor Ries is head of research at EL&C Baillieu Stockbroking. He may have interests in any of the stocks mentioned.

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Gas stocks may lose steam

By Mike Hawkins

PORTFOLIO POINT: Good news might continue until March, but investors should consider switching to term deposits.

The pipeline of (relatively) good news is still delivering. I have doubts, however, that this can continue much past March. This is not to say that the news flow will suddenly turn negative, just that the easy gains have been made.

Equity markets should continue to be well supported by a rising earnings base, but the reality of a still challenged world will be felt via lower price/earnings (P/E) multiples.

If the "good news" does continue to drive markets and valuation multiples higher over the next month or two – as we expect – it may be a signal to consider the benefits of a 12 month, 6.2% term deposit.

In particular, we are becoming increasingly uneasy about the material valuation premium Australian energy stocks are enjoying over their global peers.

Although the relatively narrow energy exposure available on the Australian market means we are not strictly comparing like with like, the headline P/E of the local sector (an average of about 26 for 2010-11, see table below) clearly implies that expectations are very high.

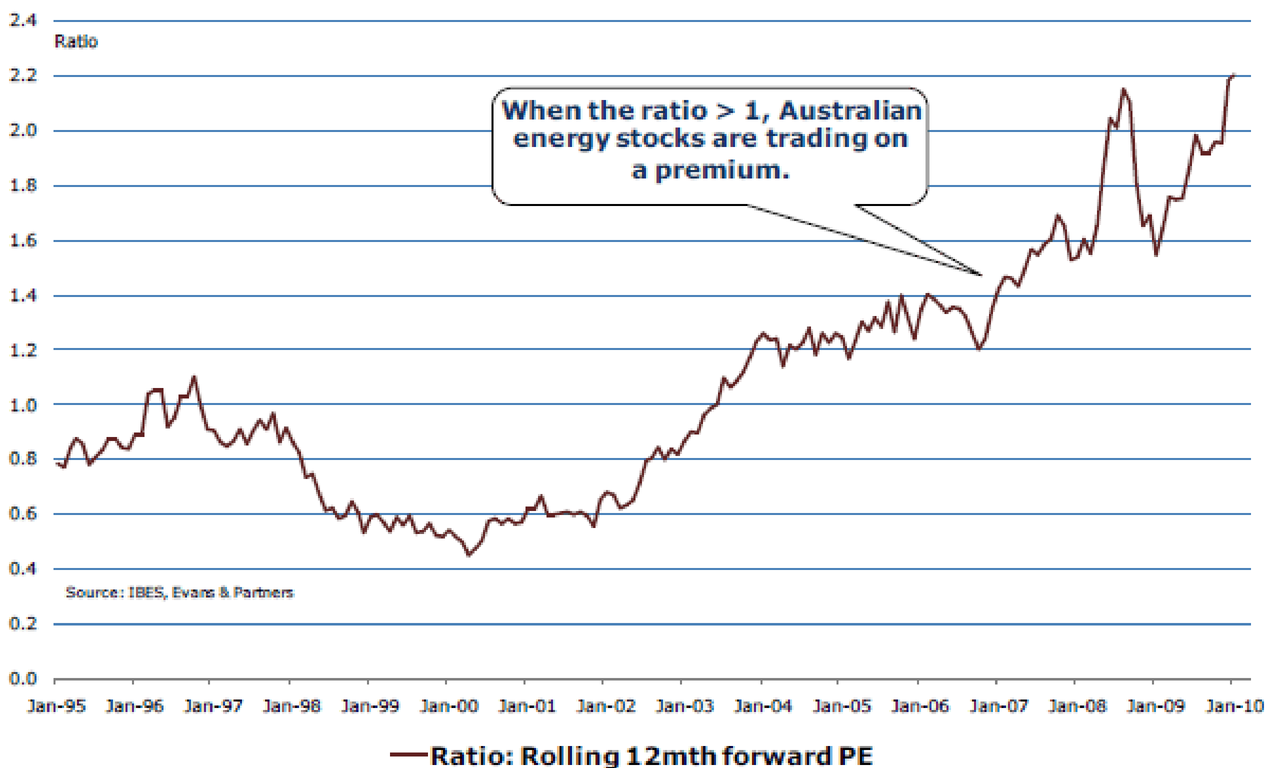
Over the past two years the market has been comfortable to reward the significant expansion plans of the LNG sector (through the North-West Shelf, Papua New Guinea and coal seam gas projects in Queensland) which will only begin to come on stream from early 2011 (via Woodside's Pluto expansion).

There is little risk that these projects will not proceed (although rationalisation of the five coal seam gas projects in Queensland seems inevitable), but we believe that there is a growing risk that investors will begin to question the returns they will receive from these material investments. As such, the sector's premium over the market, and its global peers, is at risk.

When questioning the potential project returns, the market's unease will be based more on price than volume. The uncertainty around price relates to both the ultimate size of the investment – given the mounting risk of cost inflation – and the ultimate price received for the product.

There is no doubt that global gas demand, particularly from Asia, will be significant over coming decades. (The International Energy Agency forecasts global primary gas

Energy: MSCI World vs MSCI Australia



demand will rise from 3 trillion cubic metres (tcm) in 2007 to 4.3 trillion in 2030). It is from the supply side that the risk to pricing assumptions will emerge, as the world's gas reserves remain largely untouched. We highlighted this issue back in November when discussing the International Energy Agency's annual energy outlook.

The key observations from the IEA were:

"The world's remaining resources of natural gas are easily large enough to cover any conceivable rate of demand increase through to 2030 and well beyond, though the cost of developing new resources is set to rise over the long term. The long-term global recoverable gas resource base is estimated at more than 850tcm, of which 45% is unconventional gas (shale gas, tight gas and coal bed methane). To date, only 66tcm of gas has been produced, equal to less than 8% of total recoverable resources.

"In the US, new technology, especially horizontal-well drilling combined with hydraulic fracturing, has increased productivity per well from unconventional sources – notably shale gas – and cut production costs. When combined with cyclical demand weakness, this supply surge has depressed US gas prices. While drilling activity has slowed as a result, production has held up remarkably well, indicating that marginal production costs have fallen steeply.

"The unexpected boom in US unconventional gas production, together with the depressive impact of the recession on demand, is expected to contribute to an acute glut of gas supply in the next few years. The under-utilisation of pipeline capacity between the main regions and global LNG liquefaction capacity combined is expected to rise from around 60 billion cubic metres in 2007 to close to 200bcm in the period 2012- 2015, as a number of new projects come on stream. Gas suppliers to Europe and Asia-Pacific will come under increasing pressure to modify their pricing terms and cut prices to stimulate demand."

As the year unfolds, we suspect that the market will become more sensitive to this latter risk; certainly it is beginning to get more attention in research commentary.

A critical test for the various gas expansions in Australia will come as the developers continue to pursue sales contracts with Asian buyers. If marginal buyers sense that prices will be lower in the future, it will be in their best interests to delay.

Although it is unlikely to undermine valuations overnight, the emerging supply glut in the global gas market is likely to become an ongoing drag on the energy sector's premium valuation.

It remains highly unlikely that this drag will be offset in the next year or two by a surging oil price, as oil demand will be capped by the weak global recovery and ongoing material improvements in energy efficiency. In addition, a stronger US dollar and the mounting efforts of global regulators to quell speculation in energy markets will temper price gains in 2010.

Finally, following the recent cyclical hit to oil demand (global oil demand in 2009 will be about 2.5% below 2007), OPEC is sitting on ample excess capacity, which will have to absorbed before oil prices can test the 2007-08 highs (refer Chart 6). "Energy" remains an attractive long-term investment theme and we are not suggesting investors desert the sector. Nonetheless, given prevailing valuations, the risk/return dynamics are now more evenly balanced.

There is a strong case emerging for investors to review their exposure to the sector, particularly where the aggregate holding exceeds 5% of your portfolio.

Origin Energy remains the only energy exposure recommended by Evans & Partners. While there is little in the share price for its coal seam LNG joint venture in Queensland, we still feel it will be vulnerable if sentiment towards the gas sector deteriorates. Even allowing for market-plus earnings growth between now and 2011-12 and a strong balance sheet, the valuation is now full with the share price recently benefiting from favourable exploration news. ◆

Mike Hawkins is the chief investment officer at Evans & Partners.

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Published in *Eureka Report* on January 22

Beware of going platinum

By Tim Treadgold

PORTFOLIO POINT: Platinum and its sister metal palladium have been pushed up by fast money, which could move on just as quickly.

Financial bubbles can be an investor's dream, just before they become the worst nightmare; exciting when expanding, but devastating when popped – which is why it is worth learning from the first bubble of the year, platinum … and the bust to come.

Platinum and its sister metal palladium are prime examples of what happens when hot money finds a new game. Sharp rallies in ASX-listed platinum miners such as Platinum Australia, Nkwe Platinum and Aquarius Platinum are further evidence of speculation.

Fast profits can be made early but the crash will come when the same hot money moves on to the next fad in the hunt for a return that beats low interest rates, and the flat global economic outlook tipped for 2010.

Platinum and palladium might be the first bubbles of the year, but will not be the last, thanks to the appetite of US investors for greater risk in an attempt to break free of their near 0% interest rate environment.

Aiding the hunt for higher returns, and with near-perfect launch-timing, are two new US-focused exchange-traded funds (ETFs) specialising in platinum and palladium, metals that find their greatest use as auto catalysts, cleaning the exhaust fumes of petrol and diesel engines.

However, the ETFS Platinum Trust and the ETFS Palladium Trust are not interested in the trading of metals. They are financial players, soaking up platinum and palladium, warehousing it and waiting for the price to rise while management peels off a fee.

There is some logic behind the funds. Platinum and palladium are "supply constrained" commodities. Most of the world's platinum comes from South Africa. Russia dominates palladium production, and there are no economically viable alternatives to their primary industrial use: cleaning car exhausts.

That's why the entry of the new ETFs, which took eight months to win US regulatory approval, has disturbed what had been a fairly predictable market based on industrial consumption, with minimal stockpiling. Until now, the most active platinum funds were based in London and Zurich.

However, from late last year, when the new US funds started buying in preparation for a January 8 launch date, the price of platinum and palladium has been rising strongly, outperforming the best-known of the precious metals, gold.

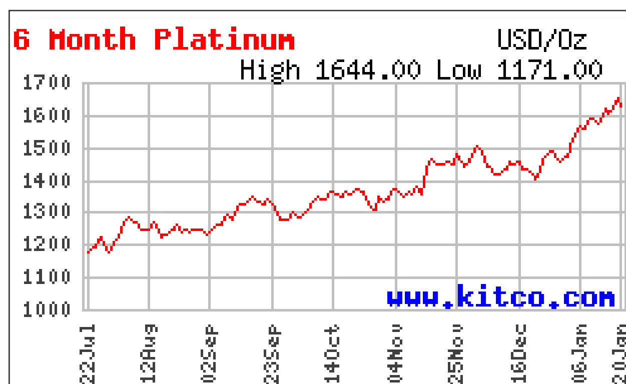
On the London metal market, platinum has risen by 23% since mid-October, from $US1315 to $US1621 an ounce. Palladium has risen 42%, from $US325 to $US462 an ounce.

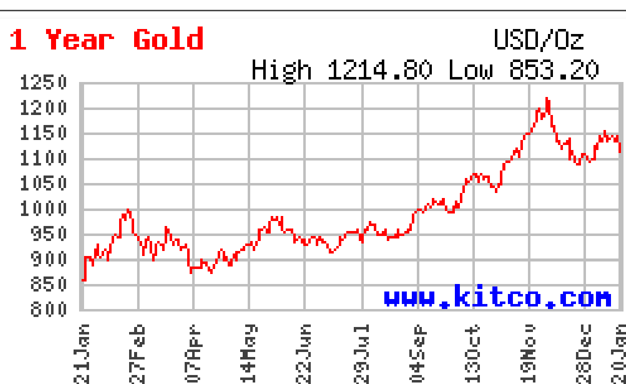
Gold, over the same time, has risen 8%, from $US1031 to $US1113 an ounce. There seems little doubt that the hot money has been taken out of gold and reassigned to the newest game in town: platinum and palladium.

It's not often that you can pinpoint the precise time when a bubble was born, but you can with platinum and palladium because January 8 is the date when these two new ETFs were listed on a branch of the New York Stock Exchange.

The easily traded funds are being marketed as providing pure exposure to metals not available over the counter in the same easy way gold can be acquired. Cash invested in ETFs is matched precisely with platinum or palladium in a warehouse, and not invested in futures contracts or any other paper instrument.

How platinum has outshone gold





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Since being formed the funds have soaked up an estimated 170,000 ounces of both metals (an outlay of about $US200 million) effectively creating an entirely new market for the metals – but one which can slide into reverse just as easily when funds are withdrawn and metal is sold to meet redemptions.

A metals trader in the London office of Commerzbank, Rory McVeigh, told Reuters earlier this week that the absence of a solid recovery in the world automobile market meant that once investment demand for platinum and palladium was saturated both metals could head for a sharp correction.

"When it's investment-driven, the exit could be harsher than the rise," McVeigh said.

The challenge is picking the turning point. McVeigh reckons the platinum price could continue to rise, hitting $US1800 before investor appetite is satisfied. After that, and the market for both metals will return to its traditional focus of hoping that car and truck sales rise, an event that depends on how the global economy handles the end of government stimulus programs

The Australian stockmarket has few platinum entry points, largely because the metal is not mined here, except as a by-product of nickel production. However, the handful of locally listed platinum stocks have reacted positively to higher metal prices.

- Platinum Australia, which is mining in South Africa, has risen from a low last year of 52¢ to recent trades around $1.20, with 16¢ of that rise coming since the start of 2010.
- Nkwe Platinum, another Australian that plans to start mining in South Africa soon, is up from a 2009 low of 11¢ to recent trades around 58¢, including a 6¢ rise since early January.
- Aquarius Platinum, the first Australian miner to develop assets in South Africa, is up from $3.17 to $7.21, and hit a 12-month high of $7.95 on January 11.

Interesting as those share price moves are, the real lesson in platinum is that what you're seeing today is likely to be repeated in other asset classes as speculators search for the next best thing, and they don't really care what that thing is.

In platinum and palladium, they have found metals that have been supply constrained for decades and look like staying that way. There are very few new platinum mines on the drawing board, and most are in Africa.

Don't forget that the production of platinum rises and falls with automobile demand. In 2006 total world production was 6.83 million ounces, falling to 6 million ounces in 2009 as car production declined, but is tipped to rise back over 6.3 million ounces in 2010.

Consumption totalled 6.5 million ounces in 2006 (leaving a 330,000 ounce surplus of metal), and fell to 5.9 million ounces last year (a 400,000 ounce surplus year).

This year, demand is expected to outstrip supply, possibly by as much as 500,000 ounces as the new ETFs soak up platinum and car production recovers. In theory, that makes platinum a metal worth following on its fundamentals.

The problem is guessing which way global car production will trend, a factor affected by the oil price and many other influences, including the strength of the world economy and the warehousing efforts of the ETFs.

For most investors this makes platinum a very tricky commodity to follow.

Recent events in the platinum market illustrate how just quickly a bubble can form when there are speculators willing to place bets on anything that looks better than a 0% return on a bank deposit.

The best advice is to use the platinum bubble as a learning experience, trade if you must, but be prepared for a sharp correction; and if the ETFs started selling the metal they hold to meet redemption demands, be prepared for a sharp retreat. ◆

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Published in *Eureka Report* on January 22

Bendigo hybrid's special attraction

By Jim Stening

PORTFOLIO POINT: The end of step-up clauses add to the attraction of the last two issues from Bendigo Bank.

A recent announcement from the Australian Prudential Regulation Authority has prompted some confusion over the future of bank hybrids in Australia. Claims they may mark the end of hybrid issuance are misguided: APRA was simply clarifying what has been standard practice for some time.

Even where the minor tweak to the proper treatment of convertible preference shares at redemption represents a new development, its impact would be minimal.

The real news is the upcoming regulatory change, which will spell the death of future bank-issued step-up securities. Contrary to what has been reported, convertible preference shares should comply with the new requirements.

In December, the global banking supervision committee released its proposals for strengthening the banking sector. These reforms touch on almost all areas of prudential regulation, including spelling out new requirements for hybrid instruments.

The most relevant proposed changes for hybrids are:

- A requirement that there can be no incentive for issuers to redeem.
- That while they can be callable after five years, they must be replaced with capital of the same or better quality.
- That they can no longer be issued by special purpose vehicles (SPV).

This first requirement is specifically targeted at ending the issuance of hybrids with step-up clauses, which regulators see as having eroded the quality of Tier 1 capital.

Don't expect to see structures such as Westpac Trusts and the CBA PERLS 3 in the future. On the other hand, these reforms lend themselves perfectly to convertible preference shares. They don't have a step-up, they aren't issued by an SPV, and as they convert to ordinary shares they satisfy the requirement that they must be replaced with equal or better quality capital.

Accordingly, it looks as though issues similar to PERLS 5 and ANZ CPS 2 are the way of the future.

Before these changes can be implemented, there are several hoops to jump through. The global committee still needs to fine-tune the proposals, and then APRA needs to consult with Australian industry.

As Australian banks already appear to have shifted towards issuing convertible preference shares securities over step-ups, we cannot see either of these processes influencing the hybrid proposals. While they won't technically be enforced until year-end 2011, in practice they will simply reinforce a change that has already been observed.

Moving forward, hybrids will still fill a key part of banks capital requirements, but only in forms such as convertible preference shares, and no longer with innovative features such as step-ups.

Bendigo and Adelaide Bank has had a tumultuous past two years with its exposure to the Great Southern Plantations collapse and its reliance on maligned securitisation for funding its loan book. However, if it weren't for these problems, it's unlikely that two of the bank's hybrids would now be available at such attractive prices.

The bank actually has four hybrids listed on the ASX but it is the two step-up securities, the BENPB and the BENPC, that are currently offering the most attractive returns. At current prices of about $83 and $86, both securities are trading on margins of more than 5.5% above the 90-day bank bill swap rate (BBSW) when priced to their respective step-up dates of June 15, 2015, and October 10, 2014.

BBSW is currently about 4.15%, meaning that these securities should yield close to 10% if this figure was to stay constant until they are redeemed. However, interest rates, and thus BBSW, are still likely to increase substantially from current levels and we would expect the total returns from these hybrids to easily exceed 10%.

In fact, based on swap rates (which are a proxy for translating returns on floating rate to fixed rate securities), both these securities are expected to yield well above 11% to their step-up dates.

As previously mentioned, the bank has had its difficulties over the past couple of years. We wouldn't be surprised if the Great Southern situation deteriorates further and there are more bad debts from this exposure. Overall, however, we believe the worst has passed and Bendigo is sufficiently profitable and capitalised. This should ensure that distributions on these hybrids will continue and the probability of a capital loss is low.

We also think it is highly likely that Bendigo will call these hybrids on their respective step-up dates, resulting in investors receiving the $100 face value of these securities back.

Like the major banks, Bendigo and the other Australian regionals have called their debt securities at the first opportunity to maintain their reputation in financial markets even in the midst of the global crisis. With markets stabilising we think it's highly unlikely they will change their stance now.

There are risks associated with owning the BENPB and BENPC but potential double-digit returns from regional bank hybrids (or spreads or more than 5.5% over BBSW) more than compensate. Both these securities are currently rated a buy. ◆

Jim Stening is managing director of FIIG Securities.

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Published in *Eureka Report* on January 27

The Speculator

By David Haselhurst

PORTFOLIO POINT: We lift our holding in Golden Gate Petroleum as production testing begins on its oil and gas play in Louisiana.

Golden Gate Petroleum (GGP) is a likely candidate for some speculative attention as it begins testing this week on its recently completed Fausse Point well in Louisiana.

On January 11 the company announced completion of the well at a final depth of 8475 feet, with three separate gas and oil formations encountered below a depth of 7000 feet. On January 18 it added that testing would begin in about 10 days on the lowest formation, which extends over 300 feet.

Golden Gate reported that the lowest formation had been recently logged and included several zones of interest, with some showing good permeability, porosity and oil/condensate in the sample cores.

Golden Gate is the operator of the project and retains a 20% working interest, with the other members of the consortium being the Australian-listed Verus Investments Ltd (VIL) with 50% and US-based Pass Petroleum LLC (30%).

The Fausse Point project, contained with a leased area of 281 acres, was targeted as a low-risk, low-cost oil and gas prospect on a producing salt dome field with a P50 (or 50:50 chance) reserve estimate of 7.4 million barrels of oil and 24.2 billion cubic ft of gas. (For a 9000 foot well, Golden Gate's share of a dry hole cost was estimated at $US250,000.)

The entire Fausse field, first discovered in 1926, has so far yielded cumulative production of 44 million barrels of oil, 2.1 billion cubic feet of condensate and 141.1 billion cubic feet of gas. The consortium this month confirmed another 80 acres of prospective ground had been added to its project area.

We first added Golden Gate to our portfolio late last August with the purchase of 100,000 shares at 4.4¢ – after the stock had tumbled from a 12-month high in 2008 of 45¢ to what was then its year's low. A week later the stock surged after the company announced a new capital raising and we quit 60,000 shares at 6.5¢. We then took up our entitlement on the remaining 40,000 shares to a one-for-three issue at 3.5¢ a share plus an attaching one-for-two free option exercisable at 8¢ before August 31, 2012.

The rights issue, plus an institutional placement on the same terms, injected $5.4 million into the company. Issued capital now stands at 589 million shares which, at 4¢ when they traded down on Monday, gives the company a market capitalisation of $23.56 million, with remaining cash of about $3.5 million. GGP's present net revenue from its share of other gas and oil production in the US is estimated at around $350,000 a month.

I've taken a punt on 100,000 shares at 4¢ in the hope

The Speculator portfolio, as at January 25, 2010

Company	ASX	No of shares	Bought	Purchase price	Current price	Current value
Cortona Resources op ex. 20¢ by 31/01/2012	CRCO	5,000	31/12/09*	Free	$0.070	$350
A1 Minerals	AAM	20,000	31/12/09*	$0.370	$0.355	$7,100
Image Resources	IMA	8,000	31/12/09*	$0.830	$1.080	$8,640
Golden Gate Petroleum op ex. 8c by 31/8/2012	GGPO	6,665	31/12/09*	$0.017	$0.016	$107
Viralytics	VLA	50,000	31/12/09*	$0.037	$0.081	$4,050
Trafford Resources	TRF	20,000	31/12/09*	$0.760	$0.990	$19,800
OBJ Limited	OBJ	100,000	31/12/09*	$0.029	$0.056	$5,600
OBJ Limited	OBJ	22,222	21/01/10	$0.023	$0.056	$1,244
OBJ options ex. 1c by 31/12/2010	OBJO	11,111	21/01/10	Free	$0.045	$500
Beacon Minerals	BCN	200,000	13/01/10	$0.024	$0.029	$5,800
Quickstep Holdings	QHL	20,000	14/01/10	$0.520	$0.485	$9,700
Golden Gate Petroleum	GGP	100,000	25/01/10	$0.040	$0.041	$4,100
Total value of portfolio						**$66,991**
Owe the bank						–$13,854
Total						**$53,137**
Portfolio change since January 4, 2010 (started with $40,000)						+32.84%
All ordinaries change since January 4, 2010 (then 4889.8)						–3.00%

* Shares held from last year. They are carried at their December 31, 2009, closing price.

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that some happy news emerges in the coming weeks from production testing of the multiple zone of interest in the first Fausse Point well. Early estimates from the company suggest that there may be room for between six and 12 wells in the tenement area, each with potential to produce up to one million barrels at a flow rate of 1000 barrels a day. Let's hope they're right.

Skin-patch drug delivery company is well covered

As foreshadowed, we took up our rights to OBJ Ltd's share issue due on January 21 aimed at the early commercialisation of its unique magnetic drug delivery skin patches in association with 3M Corporation of the US.

On Monday this week, the company confirmed that the issue received "overwhelming support" with great demand for the shortfall resulting from the non-renounceable one-for-nine issue at 2.3¢ a share plus an attaching free option for every two shares applied for. That augurs well for the company in the stockmarket.

The total number of shares taken up in the entitlement issue was 74,047,027 ($1.7 million), leaving a shortfall of 33,072,967 ($760,678). Total applications received, however, were for 248 million shares ($5.710 million).

The shortfall has been directed to the underwriter, Novus Capital, which in consultation with the company will allocate the shares. ◆

This week
Bought
100,000 Golden Gate Petroleum (GGP) at 4¢ = $4020 (inc brokerage)

David Haselhurst writes a monthly column for Money *magazine.*

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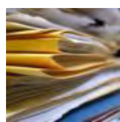
Published in *Eureka Report* on January 27

Collected Wisdom



By Alex Liddington-Cox

PORTFOLIO POINT: This is an edited summary of Australia's best-known investment newsletters and major daily newspapers. The recommendations offered represent the views published in other publications and may not represent those of Eureka Report.

BHP Billiton (BHP). The mining giant's fourth-quarter production numbers were largely in line with expectations. But, while one newsletter said the difference was marginal, another described the report as "a ripper". Half-year production records for iron ore and petroleum helped offset weaker-than-expected output from copper and alumina, while record output results for nickel and zinc helped complete the picture.

Much of the commentary about BHP has centred on China's revised liquidity requirements for banks. Granted, it will have a slowing effect on orders, but one newsletter says the economy needs to cool a little to prevent the emergence of bubbles. If investors require more reassurance, another newsletter points to the nascent US recovery as reason to start tapping the major miners.

With its low-cost operations and a conservative balance sheet, BHP's healthy production report confirms its position as Australia's premier mining company. Speculation about the next big acquisition is becoming routine. Talk of BHP returning to its share buyback program is emerging, which was suspended due to the massive Rio Tinto bid, and kept off the agenda by the global financial crisis.

With BHP sitting on billions of dollars, the newsletters say proceeding with caution has merit. Governments worldwide are beginning to wind back stimulus programs and monetary policy is expected to tighten around the globe in 2010. So the newsletters acknowledge that there is some uncertainty going forward, but emphasise that BHP is mitigating the risks where possible. The prevailing consensus is for an optimistic outlook with limited downside risks.

- *Investors are advised to buy BHP shares at current levels.*

Commonwealth Bank of Australia (CBA). The recovery for financial stocks continues, with CommBank's profit upgrade the latest reminder that Australian banks are in much better condition than most of their global peers. The bank lifted its first-half cash earnings guidance from $2.7 billion to $2.9 billion, catching at least one newsletter by surprise.

The newsletter says income growth across CommBank's operations is solid, while operating costs are tipped to ease and impairment charges are subsiding gradually. Another newsletter flags the bank's low exposure to commercial and SME lending as further reason for confidence, while another expects the bank to stay away from these areas until the economy appears more stable.

With residential mortgage volumes swelling and a possible small improvement in interest rate margins, one newsletter says the only substantial road bump for CommBank is a potential regulatory shakeup.

The Basel Committee for Banking Supervision and national regulators around the world are running their eyes over current capital requirements. One newsletter says CommBank's dividends could be pegged back slightly in 2010 if regulators decide to raise the amount of cash banks need on their balance sheets. However, CommBank's capital ratios are at historically high levels and the newsletter says the lender is likely to maintain them, making share buybacks unlikely.

- *Investors are advised to hold Commonwealth Bank shares at current levels.*

Foster's Group (FGL). Following a nine-month review of its operations, Foster's decided to tackle its struggling wine business by culling 37 wine brands and auctioning 31 vineyards. One newsletter says the beverage maker's restructure is progressing, but it's slow going. The latest saga for its wine business is a $90 million first-half profit downgrade, but to make matters more complicated, unfavourable foreign exchange rates played a big part as well.

It's been widely acknowledged that the wine business isn't doing Foster's any favours at the moment, but the foreign exchange problem just gives investors another reason to go sour on the stock.

The main attraction at Foster's is its beer business, one of a duopoly in the Australian market. Another newsletter reminds investors of this, adding that there are benefits to be gained if Foster's can lift the margins in its wine business and ultimately turn the ship around.

But with currency rates weighing on the company and the wine glut hurting the wine industry worldwide, one publication thinks it's time for investors to get out, saying the upcoming first-half results present a very real chance of disappointing. Another publication says the latest profit downgrade simply confirms Foster's status as a serial underperformer.

- *Investors are advised to sell Foster's shares.*

Recent directors' trades worth more than $200,000

Date	Company	ASX	Director	Volume	Price	Value	Action
18/01/10	Magnetic Res	MAU	George Sakalidis	589,812	0.4	$233,703	Buy
06/01/10	Magnetic Res	MAU	George Sakalidis	1,017,604	0.23	$233,951	Buy
31/12/09	Bow Energy	BOW	Howard Stack	300,000	1.35	$404,980	Buy
24/12/09	Paladin Energy	PDN	Rick Crabb	200,000	4.022	$804,400	Buy
22/12/09	Hutchison Telecom	HTA	Canning Fok Nin Ning	500,000	50.203	$HK25,101,500	Buy
18/12/09	Atlas South Sea Pearl	ATP	Stephen Birkbeck	10,000,000	0.11	$1,100,000	Buy
14/12/09	BKI Investment	BKI	Robert Millner	200,000	1.26	$252,873	Buy
10/12/09	APN News & Media	APN	Brendan Hopkins	89,769	2.25	$201,980	Buy
10/12/09	CMI Limited	CMI	Raymond Catelan	2,069,636	0.475	$983,077	Buy
10/12/09	Hyperion Flagship	HIP	Patrick Corrigan AM	800,000	1.38	$1,104,000	Buy
07/12/09	Trinity Group	TCQ	Steven Leigh	2,000,000	0.115	$230,759	Buy
02/12/09	NSX Limited	NSX	Thomas Price	1,024,018	0.199	$204,184	Buy

Source: The Inside Trader

Macarthur Coal (MCC). One newsletter is taking a second look at Australia's largest coal producer after it announced a series of proposed acquisitions to alleviate infrastructure problems. It says Macarthur has struggled with port and rail bottlenecks for some time, and recent signs of margin improvement could be eroded by competitors.

In four separate deals announced in December, Macarthur put $1.2 billion on the table for Gloucester, owned by Hong Kong's Noble Group, as well as stakes in Australian assets owned by Macarthur shareholder CITIC Pacific and other Noble assets.

Another newsletter says coal is becoming a lucrative game for the majors. These deals win Macarthur plenty of volume, which could give it a larger slice of the government funds earmarked for infrastructure. Another newsletter says Macarthur's balance sheet is solid and is sitting on a modest amount of cash.

Macarthur was once a popular stock among traders and investors alike, but at the moment the consensus is that there is a great deal riding on the acquisitions. One newsletter stressed how sharply the coal company's share price rose in the wake of the announcement, hinting at a drop if the deals fall through.

- *Investors are advised to hold Macarthur Coal shares, pending the outcome of the acquisitions.*

Ramsay Health Care (RHC). An ageing population presents one of Australia's most difficult domestic problems, but this hospital operator is exporting its expertise overseas in an effort to make a buck. Ramsay has spent €87 million ($A136.4 million) for 57% of France's Proclif. Credit Agricole subsidiary Predica is partnering with the remaining 43%.

One newsletter likes the move for several reasons, saying France is ideal destination for growth because its population is ageing, wealthy and well insured. Also in Ramsay's favour is the majority of the market is made up of smaller players ripe for bolt-on acquisitions, especially for a cashed up player like Ramsay.

On the downside, the market is well catered for and waiting lists are non-existent. Still, one newsletter says the time Ramsay took to make this relatively modest investment shows a degree of caution, while the experience of Predica will substantially reduce any operational risks for the hospital operator.

Another newsletter points out that Ramsay's revenue has swelled three-fold to $3.2 billion over the past five years, while its sales and net earnings have continued to trend higher, which vindicates Ramsay's growth strategy. The conclusion offered is that Ramsay's growth prospects are not reflected in its current price/earnings multiple of about 15 times.

- *Investors are advised to buy Ramsay shares around $11.89.*

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Published in *Eureka Report* on January 27

The interstate property buyer's checklist

By Monique Wakelin

PORTFOLIO POINT: Diversifying into other states can be rewarding, but means treading carefully. Our checklist will help.

It was just a short advertisement spied by an associate of mine, relaxing on a well-deserved Queensland holiday. "Come to Perth," it said, "and invest in the fastest-growing real estate market in the country."

What a difference a year makes! Twelve months ago, anyone plunking serious money into Perth property would have attracted concern from friends and family. But at the start of 2010, it seems the fly-in fly-out property investment phenomenon is about to return: another sign of a healthy property market marching forward with confidence and the genuine short supply of good opportunities.

If you're flying interstate to attend a "property investment seminar" run by spruikers and salespeople, it's likely you're walking straight into an investment disaster. But buying outside of your home town makes sense for some investors. Different markets show different propensities for growth. Diversification can help manage the risks associated with varying economic and market factors at different points of the cycle, provided the process is undertaken correctly and cautiously.

For interstate investing, here's my list of do's and don'ts.

Monique's Fly-in Property Investor's Checklist

Take the test: Are you a fly-in investor? Buying interstate makes sense for investors who:

■ Live in a low growth area or city

■ Want to diversify their portfolio of multiple properties in their home market.

■ Want to acquire assets in a larger city with a broader economic base.

Your reasons for investing interstate must have a solid, long term foundation. Trying to catch a price-growth burst is likely to end in tears as many east coast and Perth investors in small mining towns have found in the past two years.

■ **Diversify while you identify.** Check the five major markets in Australia and identify the cities most likely to grow over the next five years, particularly if they're growing for reasons different to your home market. Pick a city with the best drivers and broadest growth prospects.

■ **Get online before you get onboard.** Research, research, research. You will need to understand as much about your investment destination as possible. Start with geography and then determine which suburbs have the most comprehensive infrastructure and services.

■ **Read like a local.** Start reading the newspaper of your destination city. You'll find within a couple of weeks you'll get a sense of the city, how sales results are progressing, which areas are vibrant, which are falling out of favour and which perform consistently because they are in perennial demand. Local journalists reflect local perceptions and you'll uncover the "lay of the land" by "reading local".

■ **Determine your entry point.** By this stage, your research will have found the same names popping up as proven investment locations. Pick three prominent and consistently performing suburbs and track sales in these areas for at least two months. Whatever you do, don't try to outsmart a market you're not familiar with. Only opt for the seasoned, proven investment localities.

■ **Key players.** Identify two or three prominent local real estate agents in each of your locations and talk to them by phone. Then call two or three independent, experienced and qualified property advisers in that city. Talk to them about the types of property and locations you're looking at. Listen carefully to their feedback and observations and be willing to modify your views if necessary.

Now it's time to see your investment destination for yourself, armed with detailed market information, market intelligence and valuable local contacts. Just like George Clooney, Brad Pitt and Matt Damon in *Ocean's Eleven* (why do I like that movie so much?) you've picked a target, assembled a team and devised a plan … only yours is above-board. Time to fly in and make the kill.

■ **Before you leave home, leave your ego in your wardrobe.** Just because you've made millions in Sydney doesn't mean Perth can't humble you. Your instinct in Adelaide may be uncanny yet Brisbane could confound everything you thought you knew. Buying investment-grade property is both a systemic process and a nuanced business, and no matter how good you think your instincts are, never approach a new city impulsively. Investing in property is not like buying lipstick or a tennis racquet. If you buy impulsively, you're asking for trouble.

■ **Fly in, touch down, stick around.** Plan to fly in on a Thursday and stay for four or five days so you can observe

market dynamics over the weekend. Hire a car and drive around the areas you've identified, as well as neighbouring locations. Go to as many relevant open-for-inspections as you can. Go to auctions, talk to agents and keep your ears and eyes wide open.

■ **Meet and greet.** Make appointments to see the real estate agents and the independent property advisers you've spoken to. Get them to show you properties that meet your criteria and have some detailed, serious discussions about what you've looked at.

■ **Stop!** Of course, at this point, it's tempting to make an offer on a property you've seen and settle the whole deal. After all, isn't this why you spent money on your ticket and hotel room? No, it isn't. Now is the time to ensure you don't jump the gun and make a mistake.

■ **Get your property adviser to assess your selections.** How highly do they rate your selections? If they fail, it's time to go back and revisit your observations and calculations. Listen to the reasoning and advice your adviser is giving and correct your thinking. If your adviser rates your selections highly, move forward and keep your adviser as part of your "team".

■ **Go back within a month.** If your selections rated well the first time, take a few weeks to think things over and then make a return visit. This time the plan is in full operation; if you find the right property, check with your adviser and if they approve, buy it.

Buying an investment property is a meticulous business at the best of times; buying without a plan in an unfamiliar city is tantamount to gambling. Take your time, do plenty of research and get advice and you're likely to add a great property to your investment portfolio.

Property Q&A

This week:

■ Investing on the Sunshine Coast.
■ Perth or Sri Lanka?
■ Melbourne's inner-west.
■ Do I need landlord's insurance?

Sunshine Coast

I have been looking into buying an investment property on the Sunshine Coast, just five kilometres north of Caloundra and a couple of hundred metres from the water. What advice do you have for Sunshine Coast investors?

Can I ask why you are looking at this property in particular? If it's for investment, your focus should be on maximising capital growth with a property with all the right attributes for growth. And while the Sunshine Coast is one of Australia's more picturesque coastlines, recent history demonstrates that when the property market confidence tide goes out, it recedes a long way in coastal destinations like five kilometres north of Caloundra

If you're determined to buy a property in this neck of the woods, then I would concentrate on a two- or three-bedroom home as close to the traditional Queensland style as possible. Look for a house in good structural condition, well positioned in a quiet street, close to bus services and within walking distance of a good high school, and no more than a five-minute drive to a major shopping centre that includes a business hub.

As an investor, I would be inclined to suggest a residential property in an inner or middle-ring suburb of Brisbane is more likely to benefit from an upturn in the Queensland economy than the Sunshine Coast. I would start by looking at period two- or three-bedroom period-style houses in inner-Brisbane, in quiet residential streets no more than 10 minutes walk from a major transport route. These property types will have a more consistent growth profile than tourist-dominated coastal regions, which tend to suffer sudden reversals of fortune if the economy falters or if a sudden burst of development ensues.

Perth or Sri Lanka?

I have $600,000 to $700,000 to spend on a Perth investment property and am finding a well located, low maintenance, green title three- or four-bedroom house within 10 kilometres of the CBD is a bit difficult. I have started looking at southern Sri Lanka for portfolio diversity and long-term profits. With the civil war over, the area looks promising for tourism and economic growth, especially with growth engine – India – only 20 kilometres away. I am looking at short-term, semi-luxury accommodation. Any tips or thoughts are welcome.

Yes, the war in Sri Lanka is over, thank goodness for that. Often after such events a small stream of Western investors flocks in, looking to capitalise on a depleted market. Although some do manage to buy properties that turn out to be a great investments, they generally have to wait 10–20 years for above-average returns. Societies recovering from wars tend to have two or three episodes of fighting breaking out in the years following the cessation of war, driven by unresolved tension between former combatants. On top of this, wars are so destructive to economies that unemployment and inflation remain stubborn problems for up to a decade. And while India

may only be 20 kilometres away from Sri Lanka's northern tip, it's much further from the southern economic heart of the country. In short, I would advise you not to invest in Sri Lankan property unless you know the country really well and have a decade's worth of patience and financial resources.

I also don't understand why you think you're priced out of the Perth market. With your budget, you should be able to find a well-positioned investment property in many inner suburbs and some middle-ring beachside suburbs. You could start by looking at two-bedroom strata properties in areas with high rental demand that are close to but not in the city centre of Perth – areas such as Subiaco, Booragoon, South Perth or Ardross. In terms of medium and long-term investment potential, I would rate these property types in the right location as a better investment than a four-bedroom house further out. Just concentrate on finding a property in an architecturally consistent and appealing area with great access to transport, education and employment and with this budget you should secure an excellent investment.

Melbourne's inner-west

I am currently looking for my first investment property and considering a unit in the Footscray area of Melbourne's inner-west. There are a number of multi-storey developments with units selling in the $400,000–500,000 range. I am getting a lot of mixed signals about the future capital growth of this area and would value your comments.

For investors, mixed signals are the first and often reliable sign that the investment you are contemplating incorporates more risk than you should be taking on.

Melbourne's inner-west is a demanding place for property investors, as they need to be both highly selective and very skilled in selecting or rejecting specific precincts. There are outstanding properties located in this area and over the long term we should see improvements to transport and other infrastructure. But there are problems with investing here. First, the de-industrialisation process is not complete and there are still many factories, chemical storage sites and a refinery in adjacent areas. Second, although access to the CBD has improved in the past 10 years, access to the rest of the metropolitan area by public transport or road is still problematic.

With your budget, I would suggest that you stay away from these new developments and look towards the inner-northwestern suburbs instead. With your budget, you should be able to find a two-bedroom apartment in a low-rise complex. If you can find a unit in one of these complexes located in a quiet residential street within walking distance of shops, public transport, parks and recreation facilities then you should gain better capital growth.

Landlord's insurance

The local real estate agent told me I need to take out landlord's insurance for a rental property I have bought. If the building and public liability is covered by the body corporate, is this insurance necessary?

Yes, it's actually a cover all investors should have. The cost of this protection is very little compared with the potential losses.

Landlord's insurance will cover eventualities not insured by the body corporate's insurance or a standard home and contents policy. This includes rental default, accidental or malicious damage by tenants, damage to properties through natural disasters and legal claims by tenants against you. Landlord's contents insurance should also cover the internal fixtures and fittings, which may need replacing such as carpets, curtains, kitchens, appliances and cupboards.

Investors in a freestanding house need to insure their building, while the owners of a strata title unit should have structural damage covered by the body corporate's policy; in fact, it's required by legislation in most states. ◆

Monique Wakelin is co-founder of Wakelin Property Advisory, a Melbourne-based independent property acquisition and advisory company, and co-author of Streets Ahead: How to Make Money from Residential Property.

Note: We make every attempt to provide answers to readers' questions, however, answers are of a general nature only. Subscribers should seek independent professional advice for more in-depth information that is specific to their situation.

Do you have a question for Monique Wakelin? Send an email to monique@eurekareport.com.au.

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Week in View

By Alan Kohler

Latest markets

- Dow Jones – down 1.3% (for the week, down 3.2%)
- S&P 500 – down 1.4% (for the week, down 2.4%
- Nasdaq – down 1.3% (for the week, down 2%)
- All Ords – down 1.6% (for the week, down 3.2%)
- Oil – down 2%
- Gold – down 0.5%
- LME metals – down 1.2%

Obama's Wall Street Whack

US financial stocks were down again this morning after President Obama's "Wall Street Whack" on Thursday. Nobody knows what it all means but the proprietary traders and hedge funds are selling their bank stocks anyway, just in case other prop traders and hedgies do it before them. They don't want to be left behind.

What I mean is that the Wall Street action of the past couple of days, which has dragged down our market as well, has nothing to do with considered decisions by investors about the impact of US financial regulation. They're not involved: it looks like hedge funds and prop traders playing the odds based on political spin out of Washington that no one understands.

Will other countries do the same, or will it only affect US banks? Will the Obama plan apply to US banks' foreign subsidiaries? Will it even get through Congress? How will the law distinguish between trading for clients and trading for the bank? No one knows.

The Europeans are now wondering what happened to the G20 financial reform process that was set up so painstakingly last year. Barack Obama has simply ignored it and done his own thing.

Does it matter? After all the so-called G20 process was just an exercise in grandstanding and spin; now Obama is doing his own grandstanding and spin.

It might matter in Australia. I made a few phone calls yesterday and found that local investment banks and stockbrokers are in a frenzy of perplexity about what it all means to them.

Specifically, half of the top 10 investment banks in Australia are owned by US banks and all of them prop-trade their heads off, day in, day out. One broker told me that about 30% of Australia's ASX volume is proprietary trading.

Nobody knows whether Citi, Merrill Lynch, JP Morgan, Morgan Stanley and Goldman Sachs will soon be out of that game – thus providing a bonanza for Macquarie, UBS and the other Europeans, and dramatically shrinking the volume of trading in our market – or whether the US laws will only apply within the US.

If it does apply only in the US, the Americans will be shooting themselves in the foot: all their banks will simply move their prop trading desks somewhere else. And if it does apply to the global operations of Wall Street banks, they'll be shooting themselves in both feet.

That's because if it had been in place in 2008, it would not have prevented the GFC anyway, because Lehman Brothers, Bear Stearns and AIG would not have been affected.

The reason I'm talking about all this today is that these are the sort of dips you should buy.

Yesterday's 1.6% fall on the Australian market was based on nothing and is unlikely to last, although it's true big corrections can sometimes be triggered by the beating of a butterfly's wings in Brazil.

Also, the fact that all Wall Street sectors are down, including basic materials, suggests that this pullback is as much to do with the monetary tightening in China and the fact the market was overbought, as Obama's Wall Street Whack.

The US market rose 24% last year (65% from the March low) even as the US economy lost four million jobs. There is no sign of any job creation in America; in fact, non-farm payrolls fell in December.

Retail sales and manufacturing production are both falling, housing starts dropped 4% in December, the trade deficit widened and house prices are starting to fall again.

There are now two million homes in America that are vacant with "For Sale" signs out front, and another 3.5 million occupied houses for sale. There's also 3.4 million homes that are vacant but for some reason not for sale.

That's a housing overhang in the United States of nine million homes. In Australia we have a housing shortage. The difference is staggering, and can't be emphasised too much.

It means US house prices are going to be dragged down for years to come. And with Government debt running into many trillions of dollars, I think predictions of a powerful

recovery in the US economy are fanciful: the headwinds are too great.

Come to think of it, maybe you shouldn't buy this dip after all.

The Myer float

Let me explain how you were ripped off if you bought shares in the Myer float, perhaps enticed by the siren marketing of Jennifer Hawkins.

Myer floated at $4.10 on October 30, and since then it has been nowhere near that price. Yesterday it fell 3¢ to $3.47.

When I was with the *Financial Review* in the 1980s and 1990s, floats were always priced at a discount of 10–15% below the true value of the business, so that investors would make a nice little stag profit and would be more likely to come back next time. Brokers liked keeping their clients happy with stag profits from floats, because it meant the clients had to stay in good with them.

Those days are all gone now. These days it's all about short-term fees. The investment banks that run the IPOs have now abandoned the time-tested principle of aiming for a stag profit in order to maximise their fees on the float itself.

Here's how it works: they run what's called a "book-build", which is a sort of private auction designed to set the price that then flows through to everyone else. Sensible institutional investors usually stay off these book-builds because they know the whole thing's a rort, so it's mainly the hedge fund mates of the investment banks that get involved.

And they put high prices into the book-builds knowing they will lose money, on the understanding that it will be made up to them later by the investment bank that's managing the float; that is, they'll get first dibs on the next sure-fire winner.

Everyone's happy except the schmucks like us. The float vendor gets an inflated price, the investment bank gets a whopping fee, the hedge funds are owed a favour, the institutions stay away and buy cheaper in the secondary market and the ordinary investors get fleeced.

Myer is trading around $3.50 because that's what it is worth, always was. It's a terrific company, well managed by Bernie Brookes, with a good brand and a strong future. It just wasn't worth $4.10 a share.

So let this be a lesson: stay away from floats … all of them, all the time. They're simply a way to tear up money.

Steve's Great Escape

My task today, once I've finished writing to you and had breakfast, is to install a new cat flap in the laundry door. Steve, you see, has destroyed the old one.

He might look as if butter wouldn't melt in his mouth, and he might jump on one's lap and purr fetchingly, but underneath that beige exterior beats the heart of dangerous desperado.

Steve is an indoor cat. This is because I got sick of the vet bills from him coming home in morning with cuts and bruises after taking on all comers in neighbourhood Fight Club. The vet suggested the only way to deal with this is to keep him inside all the time; cats, he explained, can jump fences, but dogs can't, which is why dogs can be let out into the yard but cats can't.

So I popped down to Bunnings and bought a jigsaw (which hasn't been used since) and thence to the pet shop for a lockable cat flap for the laundry door, so Steve could get to his food and poo-tray during the day, and be locked in there at night (and Sam could still use his dog door to get out to his poo-tray – which is the entire backyard, of course, although he favours around the clothes line, so we can stand in it).

Last week Steve decided he had enough of incarceration. His spirit needed to be free – "don't fence me in" and all that – so he spent the night playing Steven McQueen, playing Virgil Hilts, the "Cooler King", in The Great Escape. He worked on that pet shop cat flap until he broke it, and then escaped out the dog door into the wide open spaces.

When I got up in the morning … no Steve. He was in the vegetable garden waiting for me. As I approached, he ran away and smiled at me from behind the zucchinis. Nyaa nyaa, he said.

"Right," I replied. "No breakfast", and went inside and fed Sam. And – guess what? – Steven quietly appeared in the kitchen, rubbing himself against my leg. "I was only fooling around," he purred. "I promise to be good if you'll just give me some of that nice meat."

I quickly slammed the dog door shut and Steve "The Cooler King" was behind bars once more.

Next morning – same routine. I tried to fix the flap, but he had ruined it. It's time for a new one, but this time no fancy pet shop product – I got a simple, unbreakable one from Bunnings. Brew ha ha, Steve – you are no match for Kommandant Kohler.

Next week

The main thing to watch next week, apart from Steve's attempts to break through the new flap in the laundry door, will be the CPI on Wednesday.

The TD Securities-Melbourne Institute inflation gauge last week suggested that inflation is going to fall, largely because of lower import prices due to the higher dollar. If so, the pressure will come off for a rate increase at the February meeting of the Reserve Bank board.

The TD-MI gauge actually fell 0.1% in the December

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quarter and with import prices down 4.3% in the quarter, I think inflation could surprise on the downside.

In any case, it looks firmly in the middle of the RBA target range of 2–3% and could even be at low end.

Yes, it's true that everyone has been surprised that unemployment peaked at 5.8%, which is why the RBA put up rates three times in a row late last year, but if Wednesday's CPI is soft, then they should pause in February, and possibly March as well. However, if the underlying rate keeps edging up, as it's been doing, then the RBA will look to get the cash rate to 4.5% by mid-year.

Apart from that there'll be the Rismark RP Data home price figures for December on Friday, which should further widen the disparity between US and Australian house prices.

US home sales data is due on Wednesday, along with a Federal Reserve interest rate meeting, but US rates are going nowhere. ◆