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> ROGER MONTGOMERY

Trust babies show awful truth of easy money

JAMES GERARD

Wouldn't it be great if we didn't have to work and lived off a never-ending river of family money from a bottomless family trust? Surprisingly, that type of life isn't always all it's cracked up to be.

In fact, we need look no further than celebrity chef Nigella Lawson for advice on this front: Her father Nigel was chancellor of the exchequer (treasurer) in the Thatcher era and later a highly paid bank consultant.

Yet to hear his daughter tell it, family trust money was a negative. "It ruins people not having to earn money," she says.

I see examples every day of family trusts that were set up in the 70s and 80s by parents with the best intentions in mind to secure their children's financial future.

Fast forward to today and many of those children (now in their 30s and 40s) live a semi-cushioned life where they get enough distributions of income from the family trust to comfortably fund their existence.

The plain truth is they almost struggle to fill their days around Toorak in Melbourne, Killara in Sydney or Peppermint Grove in Perth, and have a severe lack of initiative, motivation and passion that the desire to generate money usually brings.

Surprisingly, the origins of this money is not from mega-rich family empires, these were middle to upper-middle class parents that worked hard, paid off their homes then purchased property for their children while also accumulating money. More often than not these parents used a family trust: in retrospect those trusts were used the wrong way.

Buffett's rules

The world's greatest living investor, Warren Buffett, summed up the delicate balance nicely when he said "a very rich person should leave his kids enough to do anything but not enough to do nothing". There is also a reason why Bill Gates is reported to only have provisioned $US10 million to each of his children of his $US76 billion net wealth.

So when thinking about how to structure family wealth and inheritances, this is how it should be done.

Family trusts are commonly known for their asset protection and taxation benefits. They are also fantastic vehicles for managing the intergenerational transfer of wealth. Parents contribute money into family trusts and purchase investments, which over time grow in value. As the children grow up, the parents give them parcels of money either as lump sums or as regular income streams. When the parents pass away, the adult children take over running the family trust with the goal to keep building the wealth for their children. The whole cycle then starts over again, but importantly the wealth stays in the family.

The problem with this model is that when the children grow up and are given the keys to the family wealth, it can have the effect of dissipating a lot of desire that working people have and can throw up other issues such as self doubt and poor life choices.

By all means provide for your children, but do it in a way that causes the family wealth to influence in a positive manner and minimise downside risks.

Explore these options

Here's the best blend of family trust planning options to avoid trust fund babies:

- Specify expenses and limits that family money can be used for. Examples include private school education, university fees, car purchase, home purchase, cash to help after having a baby and business set-up costs;
- Provision for a professional trustee to take over after your passing rather than give your children control of the family trust and its full assets;

> They almost struggle to fill their days around Toorak, Killara or Peppermint Grove

- Set up a separate trust for each child for equality and transparency;
- Only hand the keys of the trust to your children after they reach a specific age, such as 40 or whenever you assume they would be mature enough to take on such responsibility;
- Release family trust money to your children at staggered intervals such as a portion at age 20, another at age 25 and a final payment at age 30;
- Alternatively, release family trust money at the retirement age of your children so they are forced to work and have careers but are safeguarded financially with money in their later years;
- Incentivise by providing family trust money on a results basis. Money is released upon certain triggers such as attaining a certain score in the HSC, graduating university or devoting years to a charitable organisation;
- Invest the family trust money into a business that cannot be sold (rather than property and share investments) so that the children have a vested interest to work and preserve the family wealth;
- For the few with significant family wealth, divert a portion to a philanthropic foundation to be controlled by your children;
- Before handing control of the family trust to your children after your passing, provision for life and business coaches, in addition to tax and financial advisory services, to help your children have the right mindset, morally and financially, to take the reins.

Money can buy a lot of things but you can only drive one car at a time, only live in one house at a time and only eat one meal at a time, so at some stage the effect of money can wear off.

Having access to significant unearned money can be a curse, so consider whether your family trust is leaving your children a dynasty or a lifetime of problems, and look to employ strategies to ensure it is the former, rather than the latter.

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

Reporting season unearths three outright winners

ROGER MONTGOMERY

Financial sections are riddled, at this time of year, with columns dedicated to the analysis of reporting season — that period of a couple of months when a majority of Australian listed companies reveal their performances for the year.

Whether a particular sector did better, in aggregate, than another or whether there were more earnings "surprises" than usual, however, matters little to you and me.

What we all care about is whether any high-quality businesses have fallen into the basket we call "good value". Many investors incorrectly believe that good value is only offered when the share prices of high-quality businesses decline.

It is true that in a broad market sell-off — something I believe we will all witness within the next few years — many businesses become "cheap". But it is also true that when a business announces a result that improves estimated valuation, it is possible that even though the share price may rise, it could become cheap if the value rises by more than the magnitude of the share price rise.

In other words, even though the share price is higher than it was prior to the result, the shares are actually now cheaper.

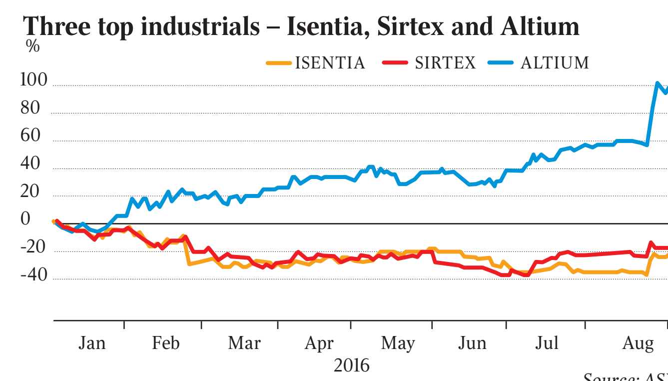
The key is whether high-quality businesses have fallen into the 'good value' basket

Spotting standouts

During reporting season several companies I support reported exceptional results. In each case share prices surged following their underlying company's respective results.

1. Media monitoring and content provider Isentia (ASX: ISD). In the case of Isentia, the shares have rallied 26 per cent in three days from $3.08 to $3.81.

2. Medical device maker Sirtex (ASX: SRX), where shares rose from $30.60 to $35.



3. Printed circuit board (PCB) design software distributor Altium (ASX: ALU). Shares rose 32 per cent from $7.25 to $9.57.

Many investors could be forgiven for believing that the shares of these companies are now expensive. Sentiment towards affordability changes, however, when you appreciate that the underlying or intrinsic value of the business may have also increased and perhaps by more than the share price.

As an aside, this discussion reminds me of the political narrative around Australia's debt position and the Liberal National Party's philosophical objection to borrowing; in the absence of any discussion about the assets that might be purchased with, and funded by, the debt, fears about debt are misplaced or at least uninformed. Borrowing billions at 2 per cent to build an asset that generates cash, and can raise the price of its produce or service by at least CPI, not only benefits from being positively geared but also from an increasing valuation of the underlying asset over time.

Altium ascends

In the case of Altium, while the share price has risen to circa $9.50, the intrinsic value has risen to more than $12. And when the overall market is expensive, rendering it difficult to uncover much value, talking a little about Altium might just be worthwhile.

Altium produces software used by electrical engineers to design printed circuit boards.

A PCB supports and electrically connects electronic components, such as capacitors, resistors or active devices, using conductive tracks and pads etched from copper sheets and laminated on to a non-conductive surface.

Printed circuit boards are used in all but the simplest electronic products because manufacturing circuits with PCBs is cheaper and faster as wiring errors are eliminated, and components are mounted and wired into a single part.

Altium enjoys a relatively small market share in the teens but revenue growth projections, compared with the growth of the market, suggests market gains will be impressive. More specifically the firm has been growing by displacing dominant player Mentor Graphics PADs software with mid-sized PCB customers who represent the bulk of customers.

Altium's customer base tends to "rust on" because the costs (both in time and money) of switching to a competitor's product is relatively high. Altium is leveraging this characteristic by transitioning its revenue model to subscription-based. Over time, we anticipate subs to dominate the firm's revenues, providing a predictable annuity revenue stream.

Speaking of revenue, ALU reported growth of 17 per cent to $US93 million. Net profit after tax of $US23m was up 51 per cent over the year and while it was boosted by a lower effective tax rate of 6.5 per cent for the year compared with 29.5 per cent in FY15, pre-tax EBITDA of $US27.4m was still up 21 per cent.

While revenue was impacted by currency translations, the number of Altium Designer licences sold increased 20 per cent to 5180 seats and the number of subscribers to the AltiumSubscription product increased 11 per cent. Excluding acquisitions total costs grew by just 6 per cent.

Many analysts would have picked up that the EBITDA profit margin increased to just over 29 per cent from 28 per cent in the prior year but what many should be aware of is that the second half EBITDA margin was nearly 33 per cent.

The 2016 full-year profit reporting season will perhaps be remembered as a year when many companies ceased providing profit and revenue guidance. ALU, on the other hand, said it was confident of exceeding its previous revenue target of $US100m (excluding acquisitions) by the end of 2017. ALU has set itself a target of $US200m of revenue by 2020 implying 17 per cent annual growth over four years excluding acquisitions.

If low returns and low growth are the "new normal" economists and market commentators are referring to, then Altium might just be one of the few abnormal investment opportunities around.

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

Don't tar all legal stocks with Slater & Gordon brush

RICHARD HEMMING

Investors know the cliche "one bad apple spoils the barrel" all too well.

Just think of those invested in the education sector, which has collectively plunged since the high-profile fail of training provider Vocation in 2014.

Then there was the even higher profile demise of Slater & Gordon, the negative sentiment from which has infected all the stocks on the domestic legal landscape.

When misfortune does happen in a sector, there can be opportunities to make money.

Here are some crucial differences between Slater & Gordon and three other firms in the legal services sector — the intellectual property specialists IPH, legal services group Xenith IP, and the litigation funding group Bentham IMF.

Slater & Gordon's business model is to employ large numbers of staff to run personal injury cases, while IPH and Xenith also employ large numbers to provide services such as commercialisation and enforcement of IP rights. A key difference is that Slater & Gordon's profitability is heavily based on success in legal cases where the result could go either way, while IPH and Xenith generate profits based solely on billable hours.

Bentham IMF's business model is based on winning or successfully settling cases, but it employs a very small number of staff, who run an investment portfolio of legal cases.

In this way, its business model is much more leveraged, and not reliant upon continually merging with other businesses to lower costs.

On the management competence front it doesn't look good for Slater & Gordon.

In buying the professional services arm of the British insurance claims company Quindell, did Slater & Gordon take a good business and make it bad, or was it so obsessed with growth at any cost that if it wasn't Quindell, it would have been something else?

In a similar vein to when the US insurance group AIG blew up, helping to precipitate the global financial crisis, the banks and the regulators had no idea how to manage the assets and were forced to either rehire or keep hiring the management responsible.

Bentham IMF has had its managerial problems and is now moving from funding a small number of high value cases to a large number of smaller cases. Separately, the company has big cash reserves and has had a couple of big wins this year. Arguably you would give management the benefit of the doubt on this new strategy.

On the accounting front, the litigation funder's profits are incredibly lumpy.

In the final quarter of the 2015-16 financial year it made more money than the rest of the year combined.

But its profitability should be smoother if the new strategy works out, plus its accounting policies are conservative. It doesn't account for revenue until the final cash is received.

Similarly, the accounting policy for IPH and Xenith IP is straightforward, being based simply on billable hours.

You couldn't get a bigger contrast when it comes to Slater & Gordon. In 2014-15 the firm's reported profits were up 23 per cent at $83.8 million, while net operating cash flow fell 25 per cent to $40.7m.

The group's profit was climbing because it was bringing forward revenue receipts in its "work in progress" account. In hindsight it was overly optimistic in anticipating expected cash won through successful cases.

One of the big red flags for any company is when there is a big change in accruals. Companies can record revenues, but not actually receive cash. Fortunately for shareholders in Bentham IMF, IPH or Xenith IP, this is something they don't have to worry about.

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THE COACH

I have read various headlines over recent years about parents buying property for their young children. If I wanted to buy a property for my eight-year-old daughter, can I do this?

A minor is anyone under 18. Under Australian law, minors can own property in their own name. However, it is not as simple as turning up to the auction and having your child scratch their signature on a contract. There are short and long-term issues you need to consider.

While legally a minor can buy property, a problem can arise in having a vendor enter into a contract to sell a property to a child. A minor is deemed to lack capacity to understand or enter into a contract and therefore cannot be bound by the contract. Unlike a contract with an adult, a vendor runs the risk of not being able to enforce the contract with a minor or keep the deposit paid in the event that the child cannot settle the sale.

The same issues arise if your child was to sell the property. Most states require the age of the owner to be noted on the Title Deeds, so a purchaser is aware if they are entering a contract with a minor. In Victoria a minor must first obtain a court order to enable the child to sell a property.

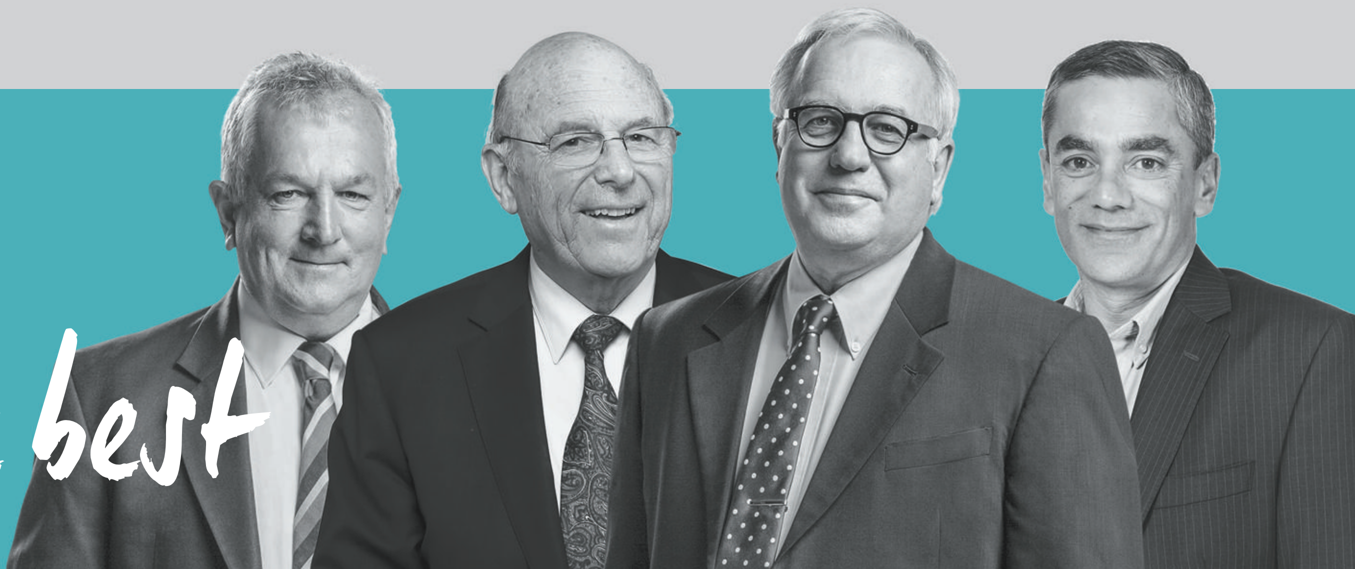
A similar issue arises when it comes to mortgages. A mortgage contract with a minor may not be binding on the child. Accordingly, any mortgage offered by a lending institution to buy a property for a minor most likely will include some form of guarantor arrangement by the parents, usually incorporating the parent's property as security. Alternatively, parents can act as the "bank" and lend the money to the child, either personally or from a family trust — but not from a self-managed superannuation fund, where this is specifically prohibited.

An alternative to direct ownership by the child is ownership via a trust. An adult or guardian can hold the title for the property as a trustee for the child. The adult trustee will be able to borrow money against the property and deal generally with the property for the benefit of the child. Care needs to be taken in how you structure the trust. With some trust structures, transfer of title to the child at some stage in the future may trigger a change of beneficial ownership and possibly lead to stamp duty and capital gains tax liability.

Income earned from a property is classified as unearned income. Unearned income for minors is taxed at the top marginal tax rate of 47 per cent if the taxable income is greater than $1307 a year. Minors are entitled to claim the usual tax deductions associated with operating an investment property such as management fees, repairs and interest costs. However, unlike adults, children do not have the same low or no-tax thresholds, so tax could prove expensive until they are no longer considered minors and taxed as adults.

When a child turns 18 or whatever date a trust deed determines appropriate, they are able to do whatever they want with that asset.

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



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