How NIB's nip and tuck hurts Medibank

JAMES KIRBY
WEALTH EDITOR

Whether you are a customer, an investor or an otherwise concerned citizen you might be forgiven for thinking the health insurance system is in crisis.

Costs are rising, claims are increasing and there is mounting evidence of bad behaviour.

Medibank Private is already under investigation for failing to adequately notify customers of policy changes and the competition regulator ACCC warned yesterday it plans to widen its examination of bad practice in the sector.

Indeed, you would be forgiven for thinking nobody wins in this system and the prospects of making money are as likely as getting a single room to yourself should you break a leg.

Some of that impression might have been formed from an inevitable decline in hospital service standards in the face of the broader population living longer and the continuing expansion in the range of medical treatments we regard as routine.

But much of the negative impression formed of late may well have more to do with the well publicised struggles of Medibank Private, which has managed to lure no less than 300,000 shareholders since it was privatised in 2014 at $2 a share.

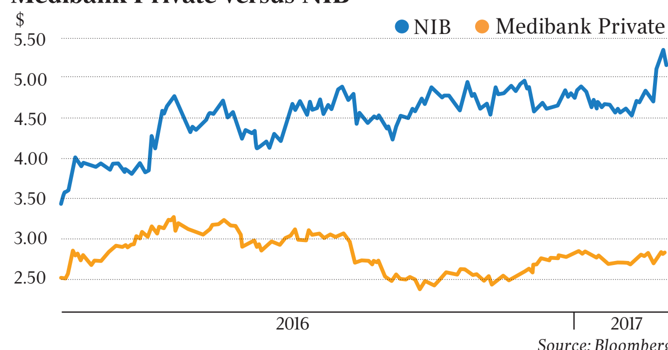
Today the Medibank Private share price is $2.84, which sounds fine until you realise that it has been stuck in a tight trading range for more than a year and CEO Craig Drummond is only at the beginning of a so-called three-year turnaround plan.

Worse still, the decline in Medibank Private's share price is expected to continue — the consensus 12-month price target forecast from brokers who follow the stock is $2.71.

It is hardly surprising the forecasts are so dismal when Drummond plays down the prospects of Medibank Private, referring to "challenges" across the business and how "household budgets are under pressure".

In other words, you won't know for a long time if Drummond and his new regime get Medibank Private back from its battered condition, where market share has been declining for years and a stunning 50 per cent of all complaints in the system are aimed at his brand.

Medibank Private versus NIB



Source: Bloomberg

In sickness and health

Remarkably, while some rivals appear to lose traction, the only other listed health insurance stock, NIB, is thriving: the company best known for its AHRI brand reported powerful interim results this week.

NIB has only 8.5 per cent of the health insurance market, but over the past six months it stole almost half the growth in the entire system.

NIB chief executive Mark Fitzgibbon spells it out: "We had about 70,000 new policyholders and the total policyholder growth across the entire industry is around 180,000." Fitzgibbon went as far as to describe the result as "abnormal" to *The Australian*'s Sarah Jane Tasker.

But Fitzgibbon's fans — and there are plenty of them — don't think the result was abnormal at all. Analysts believe Fitzgibbon can repeat the balancing act of strong margins, cost control and strong growth in the future.

Crucially, those strong prospects are backed by NIB constantly creating new business for itself, such as insuring international workers in Australia or white-labelling (providing behind-the-scene services) to industry partners such as Suncorp and Qantas.

NIB is a well run health insurer proving beyond doubt you can have a private health operator that satisfies investors operating alongside a public health system. Indeed if Medibank Private could look anything remotely like NIB, the future financing of the entire health system would be a lot more secure than it is now.

But the golden nugget of the NIB result is of course the steady stream of dissatisfied customers rolling over from Medibank Private.

Asked directly to offer numbers on the flows across from Medibank, Fitzgibbon says he is not in a position to divulge figures, but you can bet he has a damn good idea.

What's more, it would be perfectly sensible to offer the public an estimate of those numbers in the interest of public disclosure.

A historical parallel to this scenario exists in the banking industry: the original Bank of Melbourne (now a Westpac subsidiary) grew from a regional building society to become a major force in regional banking partly because it promoted itself as an alternative to Commonwealth Bank (after the Commonwealth Bank had botched a takeover of the State Bank of Victoria).

In fact, Bank of Melbourne used to gleefully release regular updates on its inflows from unhappy ex-CBA customers.

Meanwhile, the non-profit sector inside health insurance continues to play a useful role with Bupa (a British-based multinational) and HCF (an Australian fund based in Sydney) taking the fight to the private providers.

In fact, a recent HCF survey answered the question posed at the start of this column ... What are your chances of getting a room to yourself if you have private cover and you break a leg?

The answer is 60 per cent ... fighting odds, you might say.

Riding the real estate train without a stop button

An outspoken property player warns on agents and selling too soon

RICHARD FERGUSON

Buyer's advocate David Morrell has been buying houses for high-end clients for more than 20 years. A scourge of real estate agents, he has been exceptionally outspoken on low-grade apartment developments.

What are your predictions for the property market in 2017?
We've seen nothing out there that suggests prices are going to stop going up. It's a freight train with no stop button. And that's been caused in Sydney and Melbourne by lack of choice.

I think it will take a big global event to stop house values rising, like Trump or China doing something.

What are you advising your clients to do with their investments?
I'm advising caution. Go in the corner and have a Panadol (laughs). I'd say 80 per cent of our clients are buying to live in so there are a lot of emotional issues there — families, schools, marriages, divorces.

As for investors, I tell them to be wary of apartments off the plan. Everyone says that now but I've been saying it for years. If you buy an apartment off the plan, you're giving a developer a free kick.

What are your thoughts on the state of the apartment market?
Apartments go in cycles, more so than houses.

Last time we had a cycle like this, I had a group of investors and we set up a vulture fund. And they went to each apartment block and offered much less than the purchase price and they ended up getting quite a few of them. And it's because you have such a disconnect between the offshore owner and the reality on the ground.

Most of the agent representatives in these new apartment buildings are failed agents who couldn't cut it in the housing market.

Here's a simple investor test — look at how many lights are on in the apartment buildings. If they're empty they've become rental ghettos.

Is a "do-it-yourself" culture among property investors making it harder for buyer's advocates like you?
It's a lot easier for me to get a brief for a $5-$10 million property from a CEO of a company than a first-home buyer. Some first-home buyers think they can do it all, they say, "I could buy a couch for your fee, David."

The smart person thinks they need advice because they know they are spending a lot of money, and they could lose a lot of money. They need someone with a bit of knowledge and no special interest. I mean you don't go to court without a barrister ... do you?

What are your own investments?
I've always diversified my shares portfolio across different businesses but I try not to stray too far from the property core. If you look at the richest families in Australia, they've all made their money through property.

When it comes to property, I've always believed the wise person's core investment property should be the home you live in. But if you have the discretionary ability, you should invest in your children's future through property they can actually have and have a foothold in.

I also invest in art. I started investing in art when I was very young. And art's an area where you really nail it or you don't.

I started out without the knowledge but I went to people with knowledge and I paid them for their expertise.

So you're not actually an advocate of a big investment property portfolio?
If I look at the people who've done better out of property, they don't have a whole portfolio of investment properties. The smarter person invests in their place of residence.

DAVID GERAGHTY

Buyer's advocate David Morrell outside his office in Melbourne's South Yarra: 'Some first-home buyers think they can do it all'

> 'The smarter person invests in their place of residence'
>
> DAVID MORRELL
> BUYER'S ADVOCATE

Why? Because it's a capital gains tax-free zone and I don't think the government can change that. I have had people come in (to his business, Melbourne-based Morell and Koren) and say, "My accountant says I should get an investment property." And my first question is always, "where do you live?"

What was your first investment?
I bought my first house when I was 18. I thought it was a marvellous proposition. I bought it for $16,000 and sold it the next year for $20,000 and I believed I was the world's best property developer.

It was the worst thing I've ever done.

There's actually a house in Armadale (a Melbourne suburb bordering Toorak) up for auction now that I used to own and I should never have sold it. I sold it for $440,000 and the current owners want $3m.

So my No 1 rule for investing in property is simply to hang on to it.

Is buying a house at that age — 18 — simply out of reach for young Australians now?
Until we see a change in young people's spending habits, the gap in the market between older and young buyers is going to widen, it has to. You've got to make sacrifices. My kids go out every night of the week. I'd have loved to go out every night but I had a budget and a mortgage ... there's that generational change, you see.

BHP's recovery could still leave investors feeling short over time

ROGER MONTGOMERY

In the middle of a lively reporting season, it's easy for investors to take their cues from short-term influences or even from the share price reactions. But taking cues from share prices can lead investors astray.

Witness, for example the performance of the companies whose shares are collectively referred to as the materials sector. BHP, the kingpin of the materials sector, is up over 70 per cent in the past 12 months — our biggest mining company has just reported a $US3.2bn profit after a $US5.7bn loss a year earlier.

Meanwhile, high quality companies with dominant competitive positions and the most valuable competitive ability to raise their prices without a detrimental impact on unit sales volume, have declined or performed poorly on a relative basis.

Globally the move out of higher quality businesses and into materials stocks has been described as a "rotation" from "defensives to cyclicals", "defensives to growth" or "quality to junk".

Importantly, this rotation has been driven by large funds with hitherto underweight positions in resource companies.

So are professional investors who have recently bought the shares of surging iron ore companies prescient or omniscient investors, or are they merely examples of what the value fund manager Howard Marks calls "lucky idiots"?

Looking only at the short-term price performance you might conclude they possess some genius. The problem with this appraisal, however, is that one should not take guidance from short-term prices: they simply don't confer superior status upon the underlying business. Conversely, a falling share prices does not deem the underlying business inferior.

Investing legend Ben Graham (Warren Buffett's mentor) once observed that in the short run the market is a "voting machine" but in the long run it is a "weighing machine". If that is true — and keep in mind Graham arrived at his conclusion without the benefit of computers — then the change in price of BHP may have very little to do with the underlying economics of the business..

An analysis of the historical economics of BHP reveals some useful insights. Imagine kicking the BHP business off in 2007 — 10 years ago — with $36.7bn of your own money (equity) and borrowings of $14.6bn. In the first year of business a net profit after tax is realised of $15.9bn. It's fair to say you would be delighted with this turn of events and the 43 per cent return on your initial equity in just one year.

Now, with such a lucrative business, and following one of the biggest resource booms in history, it would be reasonable to expect that borrowing more money, reinvesting profits and injecting additional equity to expand the business would also expand the profits.

So let's suppose over the subsequent decade you do exactly that; an additional $1.4bn is invested directly by you, $34.4bn of profits are reinvested rather than paid out to you as dividends and an additional $34.3bn is borrowed on top of the $14.6bn in debt already held.

Now you would hope that holding more than three times as much debt and investing twice as much equity, over a decade, would yield a satisfactory increase in profits above the $15.9bn earned in the first year.

But, unfortunately, the 2017 profit is forecast to be 42 per cent less than it was in 2007. And last year, in 2016, it was 87 per cent less than in 2007 .... that's a decade ago!

Sadly, every dollar of equity invested and reinvested by you, as the owner of BHP, over the past decade, has yielded a return of minus 18.8 per cent.

You've put more money into the business — a lot more — and now you are earning less. It's throwing good money after bad.

Losing in the long run

To my way of thinking, BHP's longer-run economics are not attractive. And the economics of the underlying business are, unsurprisingly, reflected in BHP's share price being lower today than it was 10 years ago.

Contrast the hypothetical ownership of BHP in its entirety over the past decade with owning another business, the online real estate company REA Group (owned by News Corporation, the publisher of *The Australian*) over the same period.

Imagine kicking REA Group off in 2007 with $67 million of your own money and borrowings of $8m. In the first year of business a net profit after tax is realised of $15m. It's fair to say you would also be delighted with this 22 per cent return on your initial equity in just one year.

Now let's suppose you add another $41m over the subsequent decade, reinvest $573m of profits and pay off the debt.

With almost 10 times as much equity, profits should now be higher, perhaps even 10 times higher. Happily, in 2017 they are forecast to be almost 17 times higher than in 2007. Every dollar of equity invested and reinvested by you, as the owner of REA, over the past decade, has yielded a return of 38.8 per cent.

Unsurprisingly, this superior return is, over the long run, also reflected in a superior share price performance.

While BHP's share price is lower than it was 10 years ago, REA Group's share price is more than 10 times higher than its $5 price of early 2007. There is also little point in adding franking credits and reinvesting the proceeds: REA still trounces BHP.

Share prices can rise and fall on fads, fashions and factors than have no relevance to the underlying business.

You should never take a cue from share prices. Instead investors should see shares as pieces of a business, which over the long run will reflect fully the performance of the underlying business.

Roger Montgomery is founder and chief investment officer of the Montgomery Fund. www.montinvest.com. Interests connected with the Montgomery Fund own shares in REA but do not own shares in BHP.

I am 61 and will receive a $100,000 non-indexed defined-benefit pension. I also have $450,000 in our SMSF account. My non-working wife has an account balance of $220,000. Under the new rules it looks like I must either withdraw the $450,000 from the SMSF or upon retirement transfer this sum to my wife's SMSF account via a withdraw and re-contribute strategy. Is my understanding correct, and are there other options I could consider?

From July 1, 2017, a limit applies to the amount of superannuation an individual can hold in pension phase in a tax-free environment. For an individual the limit is $1.6 million for an account-based pension. For those with a defined-benefit pension, the equivalent calculation towards this limit is 16 times the annual pension payment. So in your case your $100,000-a-year non-indexed pension would take up your entire limit of $1.6m.

If your pension were higher and would have tipped you over the $1.6m cap, from July 1 the excess portion of the pension income would be taxed at your marginal tax rate. So, for example, if your annual pension benefit was $120,000 then 20 per cent of the income would be subject to tax at your marginal tax rate.

As you exceed the $1.6m transfer balance cap, the superannuation balance of $450,000 held in your self-managed super fund cannot be transferred to a pension account and will be required to remain in accumulation phase and subject to tax on earnings at 15 per cent. You are not obliged to remove the money from the superannuation system. However, if you satisfy a condition of release, by retiring or reaching your preservation age, you may withdraw $450,000 from super and invest outside the super system.

Given your wife's superannuation balance is well below the revised limits, you could look to make contributions to superannuation on her behalf. If your wife is under the age of 65, you could make non-concessional contributions into her fund. If she is over the age of 65, you could make contributions provided that she satisfies the work test of 40 hours' work in a 30-day period in the financial year prior to making the contribution.

From July 1, the non-concessional contribution cap has been reduced to $100,000 per annum from the current limit of $180,000. Up until June 30, the current rules apply. It will be possible to make a non-concessional contribution of up to $180,000 for one year, or to bring forward three years' contributions ($540,000) provided the recipient was under the age of 64 as at July 1, 2016. If you do not use the full limit of $180,000 or $540,000 in the 2016-17 financial year, then you will be limited to the $100,000 annual and $300,000 bring-forward caps for future years.

As your notional superannuation balance is in excess of $1.6m, after July 1 you will be unable to make further non-concessional contributions to your superannuation fund. Up until June 30, 2017, the current rules apply as mentioned above. So the only future option available using superannuation would be to contribute to your wife's fund, provided she is eligible.

An alternative would be to invest outside the superannuation system, either in your own names or via structures such as trusts or investment bonds.

Seek advice to ensure you understand what structures will work best for you. Between now and June 30, make the most of the current rules.

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