AUSE01Z70MA - V1

WEALTH

theaustralian.com.au/wealth

POWERED BY eureka report

"Some can make money by trading shares regularly but to make real money you need to block out all market noise and hysteria"
TONY NEGLINE

Block out the noise and play the long-term game

TONY NEGLINE

WHAT are short-, medium- and long-term investment time frames to you?

A couple of weeks ago I said in this column that seven years is too short for it to be considered a long investment period. I used an example of investing $100,000 in the Australian Securities Exchange's All Ordinaries Index in October 2007 to show that over seven years you can still lose money.

Some readers passionately disagreed with my comment that such a period isn't long-term. According to RP Data the average home is owned for about 10 years. A decade ago the average ownership period was seven years.

One reader said my example was biased. "You clearly picked the worst time to invest in shares to prove that investing in them is 'risky'. What's happened for other seven-year investment periods?" wrote one correspondent.

This got me thinking. Perhaps it might be a good idea to work out over what period you can be reasonably sure that you will make a positive return from investing in the All Ordinaries Index.

I set to work using the index value at the end of each month between March 1982 and September 2014, which equates to about 390 data points. This is an ideal period to test sharemarket performance. It contains bull markets, sharp and deep corrections, periods of high volatility as well as times when the market has aimlessly drifted. The All Ords is a good cross section of the market as it contains good and poor performing companies.

My first objective was to assume that I purchased shares at the end of a month and then exactly one year later sold. This means that over our 390 observations we would have had 379 potential times our one-year investment could have taken place.

Without looking at the impact of inflation and not reinvesting dividends then you would have lost money on 75 occasions or just 20 per cent of the time.

If you reinvested the assumed dividends and wanted to take into account inflation then you would have lost money on 138 occasions or 36 per cent of all observations.

If you had asked me to guess these results then I would probably have assumed that losses would have occurred in more than 50 per cent of cases after considering inflation.

Now there are some important issues that my analysis does not look at. I can think of the following — investment expenses and tax impacts such as capital gains tax and paying income tax on dividends after allowing for franking credits. We might look at these issues in future articles.

If we now expand our investment timeline to two years then we are now dealing with 367 possible investment periods. After reinvesting dividends and taking into account inflation, you would have lost money in 129 cases or 35 per cent of the time.

> Investing in shares is a long-term game — that is, longer than seven years

Now what would have happened over seven-year investment time frames? Well, we have 307 observations. There are no investment losses on a pre-inflation adjustment basis. After reinvesting dividends and considering inflation we would have had investment losses in 51 cases.

So the key question is: over what investment period would you have no investment losses after taking inflation into account? If you're prepared to always reinvest your dividends then your investment time period needs to be at least 13 years. If you don't want to reinvest your dividends then you will need to invest for at least 18 years before the value of your investments is higher than your initial investment.

The benefit of this information — investing in shares is a long-term game — that is, longer than seven years. Trying to pretend otherwise is foolish.

Yes, some can make money by trading shares regularly but to make real money you need to block out all market noise and hysteria. Given we can all expect to have a healthy future lifespan I think this finding is both empowering and comforting.

Tony Negline is author of The Essential SMSF Guide 2014-15.

Oil juniors ready to roll

Continuing strong margins are offsetting any price declines

BARRY FITZGERALD

ALL sorts of conspiracy theories are being put around as explanations for the dramatic decline in oil prices since the end of June.

Saudi Arabia's bid to kill off the US shale boom is one of them, yet the kingdom is working on behalf of Washington to bring Russia and Iran in to check.

But behind the puzzle are reasonable questions around why Saudi Arabia, as the world's big swing producer of oil, has not responded to the price slump with some good old-fashioned production cuts.

The average investor in oil stocks need not worry about any of that. All that needs to be known is that since the end of June, the North American benchmark price (West Texas Intermediate) and the European benchmark (Brent) are down by 21 per cent to $US81 a barrel, and 23 per cent to $US86 a barrel, respectively.

Such dramatic falls create opportunities and it is argued here that the greater opportunities lie among the junior oil and gas producers and explorers.

As a sector, they have been smashed since August when oil's price decline really got going. The 25-35 per cent share price falls among smaller operators compares with the much more sedate 5-10 per cent falls of the big producers.

The common explanation for that from the market analysts is that the weight of opinion — as reflected in futures markets — is that oil will head back to $US100 a barrel before long: that is considered the inducement price needed to ensure the not insubstantial task of pumping out more than 32 billion barrels of the black stuff annually is achieved.

But if it is good enough for Woodside, Santos, and the other big oil and gas stocks to only cop 5-10 per cent price falls, what's the issue for the juniors?

It is a question that Baillieu Holst analyst Adrian Prendergast has had a good look at in a recent energy sector report.

He may well have found the answer, too.

Prendergast reckons that unlike the beaten-up junior iron ore producers, the energy sector is unique in that continuing strong margins mean that the decline in oil is not a material risk to the health of the sector. But they are being treated as if their margins have disappeared.

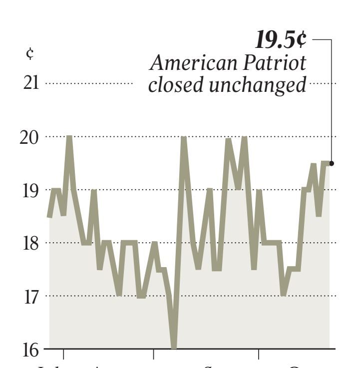
Prendergast did not dwell on the explorers but it can be said that oil's fall from $US112 a barrel (Brent) at the end of June to $US86 a barrel this week does not affect the discoveries they have yet to make, if that makes sense.

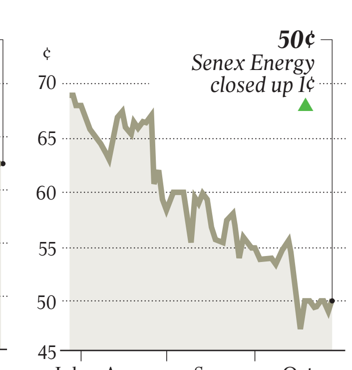
The leverage of these juniors to a discovery is intact, and in some cases can be extreme. Woodside could find a 200 million-barrel field off the east coast of Africa and its share price would barely move. For a junior, it would be a case of off to the races.

Prendergast is slightly more bearish than market consensus on oil prices in the 2015 financial year. He has got oil (Brent) at $US99 a barrel compared with consensus of $US106 a barrel.

Taking that, he has penned in Senex Energy (SXY) as a buy, with a price target of 88c compared with yesterday's price of 49.5c. Lonestar Resources (LNR) is also a buy according to Prendergast, with a price target of 43c compared with 34.5c in yesterday's market.

Since the end of June, the North American benchmark price (West Texas Intermediate) is down 21 per cent





Source: Bloomber

American Patriot Oil & Gas

AMERICAN Patriot Oil & Gas (AOW) has not wasted any time in joining the ranks of ASX-listed junior oil and gas producers, as distinct from the explorers.

Only listed back on July 8 — July 4 would have been more appropriate perhaps — the company has just become a commercial oil producer from a well on the Lustre field in Montana's western Williston basin.

The well has settled down to a stabilised average flow rate of 216 barrels a day. So it's not big by any means. But even at the lower oil price of $US80 a barrel, the payback on the cost of well is all of six months, with every likelihood the well will still be giving in 20 years' time.

More than that though are the 17 follow-targets — all defined by modern-day seismic data — that the company and its joint venture partners will proceed to follow up, plus the series of wells to test the unconventional or "tight" oil potential of the field.

The field, known for carbonate zones with low permeability, was under the umbrella of the mighty Exxon back in the early 1980s but was shut in 1986 when a supply glut pushed oil prices to below $US10 a barrel (an inflation adjusted $US22).

Horizontal drilling has advanced since then, so the upcoming unconventional wells could be worth watching for the newbie, which had a last sale of 19.5c, just under the July issue price.

Pilbara Minerals

TALKING about juniors getting in to production, it is worth noting that Pilbara Minerals (PLS) is about to start production at its high-grade Tabba Tabba tantalum project in the project.

It is a small show but is forecast to throw off $16 million in earnings over an initial eight months. Recent drilling has pointed to a longer life for the project.

But the real interest in the stock is the coming drilling program at the Pilgangoora lithium-tantalum project, some 55km from Tabba Tabba.

Beer & Co analyst Pieter Bruinstroop reflected that interest in last week's research note that placed an 11.3c valuation on the stock — 60 per cent of which came from Pilgangoora despite a heavy risk weighting. The shares were last quoted at 5c.

DIVIDEND DETECTIVE

We could be seeing the next Telstra

Medibank Private

SECURITY PRICE: Between $1.55 and $2
INDUSTRY: Health insurance
FORECAST DISTRIBUTION: 8.4c per share fully franked

DARREN KATZ

AT the right price we think Medibank has the potential to become the next Telstra: a solid, stable, dividend-paying stock.

There has been much hype around the float, which will raise up to $5.5 billion.

Medibank provides insurance cover for medical, hospital and extras. It has 29 per cent market share and covers 3.8 million Australians. The prospectus says Medibank will benefit from Australia's growing population, increasing wealth and an ageing population.

We don't see Medibank as a high-growth stock. It operates in a highly regulated industry and its premium increases are subject to government control. The issue of health insurance affordability in the future also creates some uncertainty.

But like Telstra it is a stable business and we expect the government will continue to have policies that promote and protect the industry for a few years. Medibank's business is not capital hungry — it doesn't require large ongoing investment in the likes of plant and equipment — and it has an extremely strong balance sheet, with no net debt and cash and investments of $2.2bn.

Medibank says its dividend payout ratio will be 70-80 per cent of underlying NPAT. The company has a forecast dividend of 4.9c per share to be paid in September 2015 representing seven months of operations. That suggests an annual dividend rate of about 8.4c, which should grow into the future if the business grows.

At the low end of the price range, that will give investors a very healthy fully franked dividend of 5.4 per cent. The yield falls to 4.2 per cent at a sale price of $2.

We don't believe the stock will list at $2, and that price has arguably been set so retail investors think a lower price is a bargain; we would suggest a price of about $1.60 is more likely. At the low end of the price range, $1.55, Medibank is just below our intrinsic value of about $1.65; there is the potential to achieve a 10 per cent annual return from the stock over the next five years, though it is not certain.

At the lower end it will be a good option for income investors, with a solid dividend, strong market position and possible upside from enhancing performance under privatised ownership.

Darren Katz is head of distribution at Clime Asset Management.

AMP has long been a letdown but things are improving and it's back on the radar

DAVID WALKER

AMP has been a phenomenal disappointment for investors since it demutualised in 1998.

Scandals and scandalously poor governance dogged the early years before profitability zoomed higher mid-last decade, only to be undermined by the global financial crisis and a related downturn in life insurance.

Over the last 10 years AMP delivered a total shareholder return of just 5.4 per cent a year — an inadequate premium over risk-free rates in return for leveraged exposure to the equity market and the volatile life industry.

AMP is yet to prove itself as an investment-grade stock: one with adequate and reasonably consistent profitability through the cycle. In the last 10 years return on equity peaked at 83 per cent in 2006 before plunging to 12 per cent over the 12 months to 30 June this year.

The profitability of other large wealth management stocks such as Platinum, Perpetual and BT has been more consistent.

The main problem in recent years has been exposure to the life insurance industry, which underwrites group risk schemes for superannuation funds and individual risk policies like term, trauma, disablement, and income protection.

The upturn in profitability in AMP's wealth management operations from the global equity market rally that began in 2012 was outweighed by life claims and policy surrenders way above actuarial expectations. In the difficult post-crisis economic conditions many Australians saw life insurance as an expensive luxury and were also more likely to claim to bolster household finances. The industry has taken years to resolve this.

The industry is also on the nose with the public. Commission-driven selling of life policies was carved out of the Future of Financial Advice reforms to encourage greater uptake by the community.

Nevertheless, consumers remain wary of commissions after miss-selling scandals and dislike policy "churning" by financial planners.

Insurance is always a risky, capital-intensive business but general insurance is a better business for the investor than life. To the best of our knowledge Warren Buffett has never invested in a life insurance company, but general insurance has been central to his career. Through successive mergers and acquisitions the local general insurance industry has rationalised to the point the industry's structure is now quite favourable with mostly rational pricing and plenty of pricing power to recover the costs of natural disasters. In contrast, the life sector is over-capitalised with too many underwriters chasing share in a market smaller than it should be. Australians are underinsured for most risks but especially life, for the reasons discussed. The industry has not yet successfully made its case to the public.

So AMP, despite the promise of its heritage brand, remains little better than other large cyclical stocks. At the moment, however, conditions are improving for AMP. Life earnings recovered somewhat in the first half and the company last week reported decent growth in assets under management and new life business. Policy lapses are down, claims are below budget and these favourable trends have now extended for 10 months. Assuming equity markets continue their rally, earnings upgrades are likely. As a result, AMP is back on our radar.

David Walker is senior equities analyst at StocksInValue, a joint venture between Clime Asset Management and Eureka Report.

Ask the right questions or risk gambling on a fixed match

JUSTIN EPSTEIN

SINCE mid-2005, Australia's four major banks have increased their market share across funds management, financial planning and advisory services — a growth that will continue with further acquisitions of smaller players.

Investors must question whether the growing dominance of the major banks is likely to hinder product choice and innovation and whether this could lead to a misallocation of savings and inefficient investment decisions.

Macro-economics' recent report, Review of the Major Banks Control of the Wider Financial Sector, found that Australia's four major banks, as well as AMP, accounted for 49 per cent of financial planning and advice revenue in 2012-2013. In funds management, the four major banks accounted for 34 per cent of industry revenue over the same period — up from 25 per cent in 2008-2009 — and 70 per cent of total market share if Macquarie Group and AMP are included.

Despite these figures, there has been much hype about the Future of Financial Advice reforms, which aim to improve the quality of advice in Australia and enhance investor protection. The effectiveness of FoFA is, however, questionable, especially in light of its recent changes to the Corporations Act; changes that give financial planners a reduced checklist in their duty to act in the "best interests" of their clients, thereby weakening the framework under which advisers operate.

This highlights the vulnerability of investors. Following a number of high-profile collapses — including most agricultural schemes, Westpoint and Storm Financial — there is increasing evidence to suggest some investors are encouraged into investments as a result of the adviser's commission and remuneration structure. In such cases, self-regulation and the legislation fails to mitigate the conflict of interest inherent to the industry.

Recognising that a balance needs to be struck between strong financial institutions and the market's competitive structure, the underlying questions must be: who is best able to create a product; and who is best able to manage that product? Another question is: are the managers treating the invested money like their own? In my experience, it seems that many of the larger managers might not be.

There is a role for investors. They must approach their strategy carefully, and question whether the major banks are best placed to create optimal investment products. Investors should also question their adviser's recommendations. Has their adviser undertaken sufficient research in recommending a specific product? Has a reasonable sample of competing products been reviewed? Does the product meet the investor's profile?

It is noted however, that planners, and their adviser groups, often respond to such queries by arguing that their approved product lists, exist for risk-management purposes. Yet ASIC's Regulatory Guide 175 says advisers may need to go outside their licensee's APL in order to meet their clients' best interests. ASIC has also expressed concerns about the risk of actual or perceived conflicts of interest existing in vertically integrated large dealer groups owned by product issuers.

While the legislation has a role in preventing conflicts of interests, it is difficult to be optimistic about how current legislation alone can achieve this. It is also challenging to remain optimistic that providers, in undertaking a fiduciary duty to their clients, could be expected to act in the best interests of clients when the manufacturers own both the advice and distribution lines.

It is therefore left to investors to educate themselves and ask the right questions otherwise, they may be blindly gambling on a fixed match.

Justin Epstein is executive director of One Investment Group, an independent responsible entity and trustee company.

Keeping track of super age milestones

MONICA RULE

LIKE most people, I did not take an interest in superannuation until I was in my mid-30s. Fortunately for me I was able to put plans in place to make my superannuation work for me.

Here are some of those crucial superannuation milestone ages:

18: This is when you can become a trustee of a self-managed superannuation fund (SMSF).

18-55: Most of us will be holding a job of some sort or even be self-employed. It is better to start superannuation at a younger age so that you can take advantage of compound savings.

55: Once you reach your preservation age, which is normally 55 for anyone born before July 1, 1960, you can start a transition to retirement pension. This gives your SMSF a tax exemption from any earnings generated from investments that are supporting your pension. Where else can you get a 100 per cent tax exemption from investment earnings?

60: Superannuation benefits paid to SMSF members aged 60 and over are tax-free.

65: Once you are 65, you will need to be working at least 40 hours in a period of not more than 30 consecutive days to make contributions into an SMSF. So make sure you accumulate your wealth before this date, especially if you are intending not to work beyond 65. You can also no longer take advantage of the two-year bring-forward rule for non-concessional contributions.

70: You can no longer make contributions for your spouse, once your spouse is 70 or over.

75: You can no longer make personal contributions into your SMSF. You can also no longer take advantage of a re-contributions strategy to leave more tax-free money to your children.

It pays to have some awareness of these milestones. Time flies and our birthdays are upon us before we know it. Don't miss out on opportunities to save for your retirement just because you haven't paid attention to milestone ages.

Monica Rule is the author of The Self Managed Super Handbook — Superannuation Law for Self Managed Superannuation Funds in plain English.

www.monicarule.com.au