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This Week's Top Articles

Resetting investor expectations

Jonathan Rochford

In part 1, we looked at resetting fund manager expectations in the fee debate. In part 2, it's the turn of the investors. After reading part 1, investors might be feeling vindicated and there may have been some smiling and nodding at the shortcomings of many managers. But this isn't a one way street and there are some expectations that many investors should be changing for their own good.

Investors need to decide if they are fee driven or return driven

Many fund managers are partly right in arguing that some investors don't prioritise total returns, but are instead more concerned with total fees. Focussing on total returns may make sense for an individual investor, but institutional investors are equally entitled to choose a low fee business model for their members and clients. But just as high fee managers are better off not pitching to low fee investors, low fee institutional investors should be transparent and decline meetings if the manager has no chance of meeting the target fee levels. This requires investors to know what they are willing to pay for each particular strategy. It also requires investors to know what split of base and performance fees they will pay and to be upfront in asking managers to work with that.

Low fee investors need to decide how to allocate their fee bucket

Low fee investors may choose to spread out their fee bucket over all sectors, or choose a strategy that has a core of very low fee index investments with a few satellites that will hopefully deliver the most return for the fees available. This will allow the investor to spend time choosing the best managers in their favoured sectors, rather than hearing pitches from managers who have no hope of fitting into the overall strategy.

If you want to beat the index you need to deviate from the index

Some investors seem to believe a fantasy world exists where managers can consistently deliver outperformance relative to the index. As any honest manager will tell you, there is no straight line of outperformance and deviating from the index means there will likely be periods of prolonged underperformance in order to deliver long term outperformance. Many top managers over a ten year period often underperform the average for a two to three year period at some stage during the ten years. Hugging an index means getting returns equal to an index minus the fees charged.

Top managers often don't come wrapped in nice packages

I'll mention two managers you've probably never heard of illustrate this point. Allan Mecham of Arlington Value Management had $80 million under management in 2012 with 12 years of track record and 400% returns over that period, leaving the S&P 500 for dead. Two years later he had $470 million under management and has continued to post extraordinary returns. Strangely enough, Mecham isn't closed to new funds. Despite enormous outperformance over a very long period, institutional investors can't deal with his demand for patient capital and his lack of Wall Street polish.

The next example is Michael Burry, formerly of Scion Capital. He was previously a medical student who took up investing as a hobby then decided to start running his own fund in 2000 after successfully blogging for many years. Like Mecham, his returns were off-the-chart good. By 2004 he had $600 million under management and was turning away investors. Starting in 2005 he began to short sub-prime credit default swaps. His investors, who had seen their investments more than double in four years, were enraged that their manager had moved away from solely stock picking and began to redeem their money. By 2008, despite having made a net 489% for the original investors in under eight years, Scion Capital closed and Burry now manages only his own money.

Both of these guys seemingly came out of nowhere and were not the usual asset manager types. Both managed capital with a long term view, took on concentrated positions and invested where their reading and ideas took them with little regard for typical investment styles. Regardless of the returns, the vast majority of institutional investors and asset consultants will not deal with them. Perhaps the real issue is that investing with people like this carries too much perceived career risk for investors, who work in an environment that relies on safety in the herd.

Top managers will inevitably be closed to new funds and will sometimes return capital to protect returns

In the last 12 months, Paradice in Australian equities and US hedge funds Appaloosa and Baupost have returned meaningful capital to their investors. They believe that their future returns will be negatively impacted by their existing size. Investors need to recognise that top performance often comes in the early years when outperformance is not diluted by size. For managers that do close, new investors that come late won't be able to invest at all.

There is both skill and hard work involved in identifying top managers

There is arguably as much hard work and skill required to select top managers early, as there is required by those managers themselves when selecting underlying investments. As a guide, less than 10% of all managers can be expected to meaningfully outperform a suitable index after fees in the long term. If investors want to have an edge over their peers, they need to be actively searching for top managers and have clear measures to identify early what outperformance looks like.

Investors need to change their managers to get meaningful change in their fees

What most investors mean when they say they want lower fees is that they want their existing managers to charge less. This is a fairly naïve position to hold. In all walks of life people would prefer to pay less, but those who truly care about the issue do something about it. If a manager doesn't have superior performance and won't offer low fees to retain business, the capital should be redeployed to another manager or an index fund. For top performing managers, a balance needs to be struck bearing in mind the potential manager capacity issues and the possibility of an investor's capital being returned.

For many investors, the way they choose managers needs to be changed so that fees are always one of the first points agreed. Another change would be to run an open, publicly advertised tender process. By publicly specifying what fees the investor is willing to pay and the outperformance expectations they hold, an investor is likely to discover new managers, strategies and fee propositions that they otherwise would not have considered.

Whilst many investors would say that this is what their asset consultants are paid to do, there is clearly a breakdown in this process as there has been very little change in fee levels or manager selection in the last decade.

Conclusion

The average manager and investor both have many things to reflect on and expectations to change in the great debate over fees. Managers need to start taking costs out of their businesses and resetting their expectations of what investors should pay. As well as lowering base management fees and eliminating obscure fees, managers should engage with their investors more often noting when their sector is good value and when it isn't. Investors need to be more transparent about their willingness to pay fees, and be willing to change managers in order to have a step change in their fee levels. Investors should actively encourage low fee managers to pitch to them and take action to switch to such managers where the risk and return proposition is merited.

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The best and worst managed fund in Australia

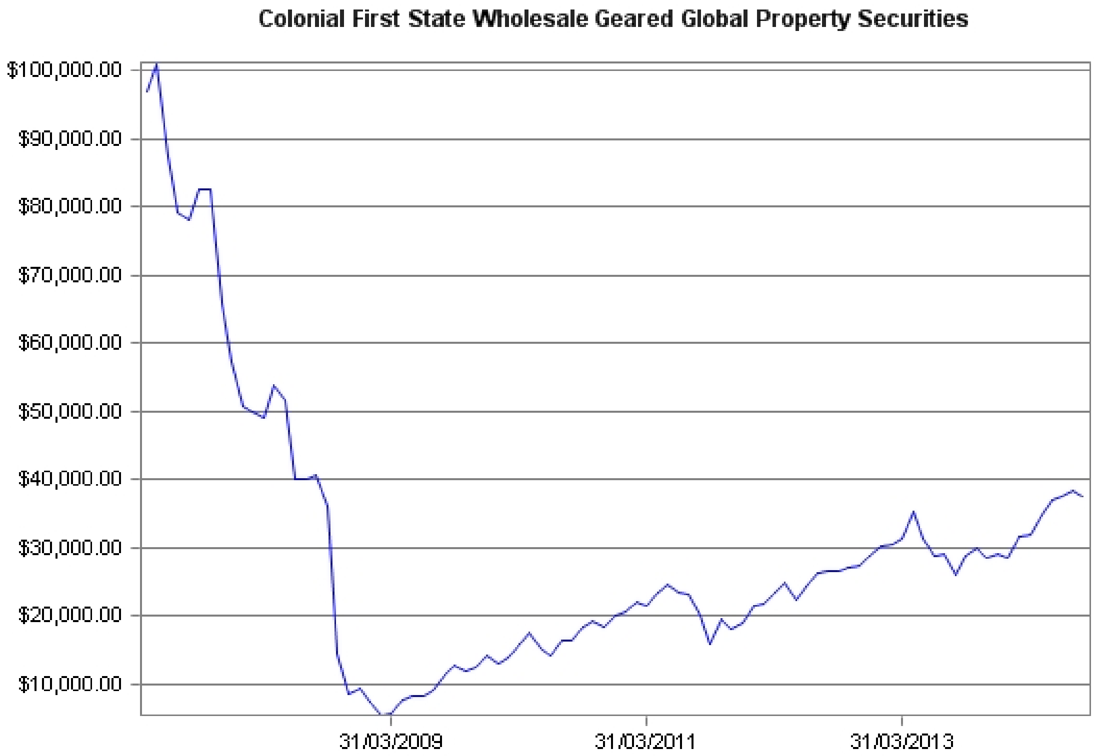
Graham Hand

Anyone who was invested in a listed property fund throughout the GFC experienced a rapid destruction of wealth. Many former high flyers of the property world, such as Centro, Allco, MFS and City Pacific, had become highly geared in complex structures, and in the severe market disruption, were unable to rollover their debt. They faced years of complicated legal battles and capital restructuring.

Amid this imbroglio, the wildest ride of all was the Colonial First State Geared Global Property Securities Fund. Launched in April 2007 at $1, it had lost almost 97% of its value less than two years later in March 2009, when it touched 3.5 cents. It has since risen to over 30 cents. It has almost become, as they say in the trade, an 'eight-bagger' – a return of 767% since the bottom of the market.

These changes in value show that the debate about SMSFs borrowing should not be confined to structures where the fund itself is the borrower. It's the total leveraged exposure and the underlying assets that matter most, not where the borrowing resides. SMSFs investing in this fund had no borrowing in their own name.

Depending on investor timing, and defining 'worst' as biggest fall and 'best' as biggest rise, this is either the best or worst managed fund in Australia. Here's the impact on $100,000 since 2007.



Performance is calculated on an initial investment of $10,000 ($100,000 for Wholesale products), using entry to exit prices, with distributions reinvested. Ongoing fees and expenses have been applied; however individual taxes are excluded (if applicable). A 4% contribution fee has also been applied for all products with a contribution fee. Please note your investment may not have been subjected to the maximum 4% contribution fee so your investment outcome may have been better than displayed in the chart above.

Of course, some other investments in Australia have lost all investor capital, but they are usually a single asset or share, or due to some fraudulent activity. This is a managed fund with rules about maximum investment in one stock and portfolio diversification, and these rules were not breached. Colonial First State has strict investment management compliance and any straying from the investment criteria is immediately corrected. And surely property is something you can see and kick, it's not small resources and it's not technology. How is it possible for a managed fund to go from 100 cents to 3.5 cents in less than two years?

There are two main reasons: first, any geared fund will amplify the losses of an ungeared equivalent fund. For an explanation of how this works, see this article. Second, the underlying assets themselves were highly geared, and while this may have been fine in normal market conditions, it was a volatile combination during the GFC. The strong market conditions of 2003 to 2007 created false confidence for the managers of both property securities funds and their investee companies.

As the table indicates, even the ungeared version of this fund fell 69% over two years. A multi manager fund in the same asset class over the same period fell 71%, despite an investment strategy which was:

"To invest in a diversified portfolio of property securities. The investments are managed by a number of leading global property securities managers, which is designed to deliver more consistent returns with less risk than would be achieved if investing with a single investment manager. The portfolio aims to hedge currency risk."

<u>Global Property Funds on FirstChoice Platform</u>	**CFS Geared**	**CFS Ungeared**	**Multi manager Ungeared**
	Unit price	**Unit price**	**Unit price**
16 April 2007	$1.000	$2.230	$1.469
9 March 2009	$0.035	$0.481	$0.303
% <u>fall</u> 2007-2009 total	**-96.5%**	**-68.9%**	**-70.6%**
% <u>fall</u> 2007-2009 annualised	**-82.9% pa**	**-46.0% pa**	**-47.6% pa**
8 August 2014	$0.304	$1.629	$0.988
% <u>rise</u> 2009-2014 total	**+767.3%**	**+243.9%**	**+255.2%**
% <u>rise</u> 2009-2014 annualised	**+49.0% pa**	**+25.6% pa**	**+26.4% pa**
% <u>fall</u> 2007-2014 total	**-69.6%**	**-4.1%**	**-9.6%**
% <u>fall</u> 2007-2014 annualised	**-15.0% pa**	**-0.6% pa**	**-1.4% pa**

Source: Colonial First State website. CFS funds managed by Colonial First State. Multi-manager funds have several managers which have changed over time. Performance calculations include distributions, which were nil for the geared fund but significant for the non-geared. Percentages are in nominal terms, not real terms (adjusted for inflation).

What are some of the lessons from this experience?

1. Any gearing structure should watch for gearing on gearing. Although almost all listed companies have some level of borrowing, property funds were historically highly geared going into the GFC, and the major feature of their subsequent restructuring has been to move to lower gearing levels.

2. Internally geared funds have a role to play in a portfolio only where the investor fully understands and accepts the potential downside as well as upside. In general, a fund geared at 50% ($1 of debt for every $2 of assets) will have double the price volatility of an equivalent ungeared fund.

3. Investors need far better performance to recover from a fall than the percentage fall itself. For example, if a $1 investment goes to 50 cents, it has fallen by 50%. But to recover from 50 cents to $1, it must rise 100%. In this geared property case, although it has risen an amazing 767%, it is still down 70% due to the 96.5% fall. The ungeared funds have risen far less but they fell less. On an annualised basis and including distributions, the ungeared funds are not far from their 2007 values in nominal terms (not adjusted for inflation).

4. Excellent investment opportunities can come from periods of crisis. Most property funds rebuilt their balance sheets by issuing shares at fire sale prices, below Net Asset Values, and investors with the cash to fund this recovery have usually had great results.

5. Perhaps most important, there are insights for the current debate about SMSF borrowing, where the primary focus has been on the SMSF itself borrowing to invest in residential real estate. The experience with internally geared funds (and assets which themselves are highly geared) shows it is the total amount of leveraged exposure that matters, not the vehicle in which the borrowing resides.

Property securities have given investors a wild ride over the last seven years, and the most amazing thing about the best and worst managed fund in Australian history is that it's the same fund.

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A guide to real estate investing strategies

Adrian Harrington

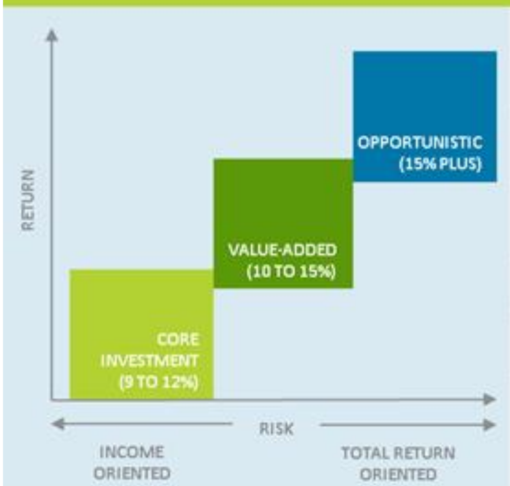
Securitisation and the increased sophistication of the real estate industry have led to new ways to repackage property assets to create a broader menu of investment opportunities. However, the risk, return and liquidity attributes of these investments vary greatly.

This paper provides an overview of different real estate investment strategies based on three risk-return styles (core, value-added and opportunistic) and four quadrants of real estate investing, based on whether they are equity or debt and traded in the public (listed) or private markets.

Risk – return styles

Figure 1 shows three key risk-return styles for real estate investing: core, value-added and opportunistic.

Figure 1: Risk/Return Styles



	CORE	VALUE-ADDED	OPPORTUNISTIC
RISK:	Low	Medium	High
TARGET RETURN (IRR – PRE TAX NET OF FEES):	9-12%	10-15%	15%+
SOURCES OF EARNINGS:	Current income (70%) + capital appreciation (30%)	Current income (50%) + realised capital appreciation (50%)	Current income (<20%) + realised capital appreciation (>80%)
HOLDING PERIOD:	5+ years	3-7 years	2-5 years
FINANCIAL LEVERAGE:	0-50%	30-70%	50-80%
BUILDING TYPE:	Quality assets with long leases and quality tenants, fully or almost fully occupied	Assets with upside potential through refurbishment, re-leasing and repositioning	Development assets, distressed assets

Core real estate investing is buying assets that are well located, leased to quality tenants and funded with modest levels of leverage. Such investments typically target 9%-12% p.a. total returns with the objective of providing investors with secure income plus modest capital appreciation. The income component typically represents a significant majority (circa 70%) of the expected total return. Examples of core investments include CBD office buildings, retail centres and industrial warehouses.

The ability to significantly enhance the value of core real estate is limited compared to value-added and opportunistic investment strategies. Core assets generally require little or no short-term capital expenditure other than normal repairs and maintenance.

However, core investing does not mean passive management. Active management of core assets can add value through initiatives such as improving lease profiles and reducing building operating costs. Core real estate tends to be held for the long-term, typically five years or more. Leverage is generally below 50%.

In recent years, real estate related social infrastructure such as child care centres, medical centres and student accommodation have increasingly been considered as legitimate core investments. There are both listed and unlisted real estate funds focusing specifically on these sectors such as the Folkestone Education Trust, the Generation Healthcare REIT and the unlisted Australian Unity Healthcare Fund.

Value-added investing engages in active strategies to create value in the underlying real estate investments through refurbishment, re-development or leasing-up of vacant space. A value-added strategy typically targets 'secondary' assets which for various reasons have depressed levels of income or the value has deteriorated over time relative to the broader market. Through hands on 'active management' there is a focus on increasing an asset's income and hence capital value. Value-added real estate investments will therefore appeal to investors seeking enhanced returns in exchange for higher levels of asset operating risk. These investments target returns between 10%-15% p.a. and typically use modest to high levels of leverage of between 30% and 70%. They have a hold period of between three and seven years, although often at the shorter end, as the successful execution of the strategy will depend on picking the right time in the real estate cycle to exploit the opportunity.

Opportunistic investing targets a range of higher risk strategies such as real estate development, highly leveraged financing or transactions involving 'turnaround' potential (often known as distressed investing), investments with complicated financial structures (including mezzanine debt) or emerging market investments. The focus is on capital appreciation, with the returns typically back-ended and achieved through a sale or completion of a development, often with little income along the way.

Such strategies usually use higher levels of leverage between 50% and 80% and typically target returns of 15% p.a. plus.

Opportunistic strategies require specialised investment and management expertise due to their complexity and to mitigate the higher risk. Investors tend to be sophisticated and well capitalised with a higher risk appetite than core or value-added investors. Opportunistic investing looks at relatively short-term hold periods, in many cases less than three years. The key is to expeditiously exit the investment as the strategy is executed and value maximised.

Value-added and opportunistic investing is not simply the use of high levels of leverage. They require careful analysis of the real estate cycle and market trends to take advantage of dislocations and mispricing in the market.

Four quadrant investing

Four quadrant investing refers to the classification of real estate investing across four financial markets - public and private, debt and equity - as shown in Figure 2.

The most common forms of private market in Australia, other than directly owning a building, are unlisted real estate funds or unlisted syndicates which typically own one asset such as an office building or retail centre and have a fixed term of between five and seven years. These investments are traded in the private market, and between purchase and sale, values are derived from private valuations. Such assets are relatively illiquid compared with the public markets.

Public equity refers to investments in real estate investment trusts (A-REITs) or real estate companies whose securities or shares are traded on a stock exchange such as the ASX. The A-REIT market is the most liquid and transparent of the four quadrant markets, and currently comprises 50 A-REITs with a market capitalisation in excess of $97 billion. There are another 29 real estate-related securities that are classified by S&P/ASX as real estate managers and developers.

Private debt represents investments in direct real estate loans or in funds that hold mortgages on real estate, such as mortgage trusts. The loans maybe first mortgages (senior debt) or second ranking subordinated loans such as mezzanine loans. Typically, the investor or lender will receive periodic interest payments from the borrower and a security charge against the property in the form of a mortgage. At the end of the mortgage term, the investor or lender will receive the balance of the mortgage principal. This type of real estate investing is similar to investing in bonds that are held to maturity.

Public debt represents real estate debt instruments such as commercial mortgage back securities (CMBS) which are traded in the public market or unsecured debt (corporate bonds) issued by A-REITs and real estate companies. Access to investing in the public real estate debt market in Australia is almost exclusively limited to institutional or 'wholesale' investors.

The four quadrant model of investing emphasises the links between real estate and the capital markets. The income from each of these investments relies on the performance of the underlying real estate despite the fact that the pricing, the risk and the liquidity will depend on which part of the spectrum (debt or equity) the investment occurs and whether it is traded in the public or private market.

Conclusion

Whilst the menu of real estate investment opportunities has increased, not all investment styles and strategies across the four quadrants are suitable for all investors. Most investors in real estate will focus on core real estate strategies and will typically invest in the quadrant that best suits their liquidity requirements. If liquidity is an important factor, an investment in public equity such as A-REITs may be a more viable investment alternative than private real estate either directly or through an unlisted fund or syndicate.

Given the different markets and risk profiles, pricing anomalies in the short term may occur across the three investment styles and four quadrants. A more sophisticated investor may take advantage of these pricing arbitrages and move across the three styles or allocate between the four quadrants according to where they expect to achieve the best relative risk-adjusted returns at different points in the real estate cycle.

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How to put money away regularly for your kids

Alex Denham

For those that can, it's very satisfying to put away a little money each month for the benefit of our kids. It's fun to imagine the look on your child's face when gifting the money on their 18th or 25th birthday, or to teach them about investing from a young age.

However, there's more than one way to make this money grow, and there are tax implications to consider. It's a long term investment – usually over 10 years – so leaving it in cash isn't necessarily giving it the best opportunity to grow into a real nest egg.

Savings accounts

If you're starting when the child is very young with a small monthly saving, the simplest way is probably a child savings account. For our four-year-old daughter, we have a child account in her name and $50 a month goes into it from our bank account. The standard interest rate is 0.01% unless there is a monthly deposit and no withdrawals, in which case an extra bonus rate of 3.8% applies (3.81% total).

Where an account is held in the name of a child under 16, they are entitled to a PAYG tax free threshold of $420 where no tax will be withheld if their date of birth has been quoted. In our case, with a balance of around $2,500 and interest of $95 or so a year, no Tax File Number (TFN) is required.

Regarding the declaration of the interest income, there are 'special' tax rates that apply to the unearned income of a minor:

Other Income	**Tax Rates**
$0-$416	Nil
$417-$1,307	Nil + 68% of the excess over $416
Over $1,307	47% of the total amount of income that is not excepted income*

* Excepted income includes salary, wages or business income, income earned on assets inherited by a minor, superannuation death benefits and income derived from the investment of other excepted income. There are special exemptions for children with a disability.

When our daughter's balance reaches $10,918, the interest will exceed $416 and the 68% kicks in, obviously something to watch for.

The ATO has provided some common examples of who actually owns the money in a savings account and therefore who should declare the interest. Whether the account holder is the parent, the parent in trust for the child or the child, look to who provided the money and who makes the decisions on the account.

If the account is in the name of the child and the child provided the money, for example from employment earnings or birthday gifts, and the child makes the decisions on the account, it is the child who declares the income.

In most other cases, it is the parent who should declare. That solves the 68% problem, but for those accounts where the child must declare the income, the child needs a TFN and needs to start lodging tax returns. Might be time to look at other options.

What are other options?

If the savings account starts earning interest above $416, or you are seeking superior returns elsewhere, you might consider alternatives to interest bearing savings accounts.

Listed securities (shares)

Shares are a good investment choice for long-term growth and tax-effective dividend income. A well-chosen portfolio of solid, blue-chip companies held over the long-term is likely to provide a superior return than most other investment options.

As your child grows, they can become more involved in the investment process and decision making. It's a fantastic way to learn about money and investing from an early age which will serve them well in their adult years.

The downside is that small investment amounts make it hard to adequately diversify. It is not cost effective to buy a few shares in several companies, paying brokerage on each trade. This is where other options such as Listed Investment Companies (LICs) or Exchange Traded Funds (ETFs) might be better. They can provide exposure to a broad range of companies in one trade.

The tax implications are similar to those of savings accounts. If held for the child's benefit, the child declares the dividend income and capital gains, but if the parent spends or uses the income for themselves, the parent does. It will likely require the child to lodge tax returns in order to declare dividends and capital gains, and to claim franking credits.

Overall, if the child's income is likely to be over $416 a year, it might be best to keep the investment in the name of the parent who has the lower marginal tax rate.

Insurance (investment) bonds

This largely forgotten investment vehicle has a lot of merit for investing for children, mainly due to the convenience. An investment bond is a 'tax paid' investment meaning that tax on investment earnings is paid by the product issuer at the company tax rate (currently 30%).

All returns within the bond are net of tax so while invested, and upon withdrawal after the tenth year, there is no need to include earnings from the investment bond in personal tax returns. This means no TFN required, no child tax returns, no special tax rates and no administration. Furthermore, you can access it at any time: it's not like super where the money is locked up until retirement. You can also choose the investment option, such as Australian shares, fixed interest, high growth, cash etc.

You can also make regular investments and after ten years there is no personal income tax liability for withdrawals. Watch out for the 125% rule that applies to additional investments – I'm not going to cover it here, but it's important to know.

The low entry point suits child investments. The minimum deposit for some is only $2,000, with a minimum monthly investment of $100. If you commit to a regular investment plan, you could start with just $500. This makes it easy to achieve a diversified investment in the Australian share market with no exposure to special tax rates, capital gains tax (CGT) or brokerage. You will, however, be paying management fees in the range of 1.5% - 1.8% pa.

The minimum age at which a child can hold the bond directly is ten years. For younger children, an adult owns the policy with the child nominated as the life insured. The bond then vests or transfers to the child when they meet a pre-determined age (between 10 and 25, but the child doesn't have the power to exercise their investment rights until they turn 16). The (adult) policy owner has full control over the investment and can make switches and withdrawals or change the vesting age at any time.

Investment bonds are an appealing option for saving for education expenses, but check the tax consequences of making a withdrawal before the ten year period is up. Also, they may be less tax-effective if one of the parents is always in a tax bracket of less than 30%.

Managed funds

Managed funds provide access to a diversified range of investments and allow regular contributions. Most managed funds require an adult to be the legal owner and provide their TFN. They tend not to allow child investors.

When using managed funds for a child investment, open the account in the name of the spouse on the lowest marginal rate to minimise income tax or CGT liabilities from the investment.

It is possible for an adult to hold the investment in trust for a child (where the child is nominated as the account designation) however the 68% special tax rate rears its ugly head in this case.

Management fees apply in the range of 1.5% - 2%, although index funds on some platforms are less.

So what to do?

You need to weigh up the tax issues including CGT and special tax rates, long-term performance, diversification, fees, simplicity, and investment control amongst other things. The table at the end of this article might be a good reference point.

Now that the balance of my daughter's savings account is $2,500, I am leaning towards an insurance bond into a high growth or Australian shares option, with a regular investment amount of $100 a month (if you have a lot of kids, $100 a month for each might not be feasible. You can have multiple beneficiaries on one policy so the regular savings amount goes to all.)

When Miss 4 is older, we might decide to go to direct shares, and start her on the journey to learning about investments, the economy and the markets.

Or we might keep going with the investment bond. The ease and lack of tax return obligations are very appealing to me. But that's just me – every situation is different, so please seek your own advice.

COMPARISON OF INVESTMENT OPTIONS FOR CHILDREN		
Investment	**Advantages**	**Disadvantages**
Child savings account	• Low entry point • Regular savings plan • No need to quote TFN if interest is below $420 • Compound interest • Capital protection • Low cost • Full access	• Special tax rates on interest above $420 • Low interest rates • No growth opportunities • Interest needs to be declared in tax return • Child may need TFN
Direct shares	• Investment control • Superior long term performance/ growth opportunities • Franking credits • Ability to involve child in investment decisions • No ongoing fees • Full access	• High entry point due to brokerage and diversification issues • Exposure to capital gains tax • Requirement to lodge tax returns • Possibly extra accounting fees • Child may need TFN • Exposure to special tax rate • Possibility of capital loss • No regular savings plan option
Investment bonds	• No requirement for TFN or lodgement of tax returns • No accounting fees • No exposure to capital gains tax • Full access (tax implications if held less than 10 years) • Regular savings plan • Low entry point • Ability to diversify • Long term growth opportunities	• 30% tax rate may be more than marginal tax rate. • Ongoing management fees • No investment control – subject to manager based on investment option chosen. • Need to watch 125% rule • Possibility of capital loss
Managed funds	• Low entry point • Ability to diversify • Regular savings plan • Full access • Long term growth opportunities	• Tax returns required – extra accounting costs • Exposure to special tax rate • Exposure to capital gains tax • Ongoing management fees • Possibility of capital loss

General advice disclaimer: *Information is of general nature only and is not intended as personal advice. It does not take into account your particular investment objectives, financial situation and needs. Before making a financial decision you should assess whether the advice is appropriate to your individual investment objectives, financial situation and particular needs.*

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Deep dives make better investment decisions

David Buckland

For those ASX-listed companies with a 30 June balance date, investors will have two or three opportunities over the next few months to perform a deep dive behind the words and phrases within each company's releases. These include the Preliminary Final Report (Appendix 4E), the Annual Report and the Chairman and CEO addresses at the Annual General Meeting.

Commentary from companies acquiring or divesting businesses or interest in businesses need extra attention in terms of the true 'like for like' comparison, often due to the objective of painting a positive outlook. It is only through deep analysis that investors can make more educated investment decisions.

For example, if we backtrack two years to August 2012, many Australian resource service companies were recording record revenue, profits and margins. Large contracts and acquisitions were being announced and the outlook was buoyant.

To illustrate the deep dive approach required, I will use the following ASX announcements from Ausdrill Limited (ASX: ASL) with the objective that investors may learn from this experience.

On 28 August 2012, Ausdrill announced the "strategically important acquisition" of Best Tractor Parts Group (BTP) for $165 million, on a debt-free basis, to be completed on or around 31 October 2012. In the year to June 2012, BTP generated revenue of $176 million and EBITDA of $50 million (unaudited).

"Subject to completion occurring, all profit generated by BTP from 1 July 2012 will remain within BTP (and the Ausdrill group will therefore become entitled to the benefit of such profit from completion)."

On 29 August 2012, Ausdrill released four documents: its Appendix 4E, a Media Release on the 2011/12 Results, the Annual Report to shareholders and a Results Presentation. The electronic version of these reports totalled 191 pages.

The results for the year to 30 June 2012 were at record levels with revenue up 27% to $1.06 billion, EBITDA up 48% to $288 million and Net Profit After Tax up 53% to $112 million.

"Based on current trading conditions, and excluding the effects of the Best Tractor Parts acquisition, the Board is confident that continued growth can be achieved in 2012/13 with a targeted growth rate of 15% in revenues whilst maintaining similar operating margins." The final sentence of the media release touched on *"Targeted areas for expansion over and above growth in core businesses."*

On one hand, things could not have been more positive. In addition to the record earnings and even better outlook for 2012/13, Ausdrill had recently welcomed back a senior executive to take up the newly-made Chief Operating Officer - African Operations position, and had signed a US$540 million five year contract in Mali, West Africa with Resolute Mining Limited.

The consensus immediately added 15% to the just-released 2011/12 revenue and EBITDA numbers and then added at least two-thirds of the historic numbers from the proposed BTP acquisition (given it was to be completed on or around 31 October 2012) to arrive at a FY13 forecast for EBITDA of $364 million on revenue of nearly $1.34 billion.

On the other hand, Ausdrill did cast a warning on page 3 of the 132 page electronic Annual Report for the year ended 30 June 2012: *"As we look ahead there are conflicting signals in terms of the outlook for the mining industry. In Australia, junior exploration companies are having difficulty raising funds. As a consequence the demand for exploration drilling has reduced. However, as a result of our focus on production-related services under medium to long term contracts, combined with our strategy of working for major mining houses, the effect on the company should be minimal."*

During October 2012, Ausdrill had refinanced its debt and signed a new three year dual currency, syndicated facility for a total of $550 million, as well as completing the BTP acquisition.

By late November 2012, investors and potential investors could view two releases to the ASX: a Market Update, dated 22 November 2012 and the Chairman's address from the Annual General Meeting, dated 23 November 2012.

"Revenue guidance for the 2013 financial year now includes BTP and is revised to a 20% increase from 2012."

Deep dive: this equates to $1.27 billion ($1.06 billion X 1.2), or around $70 million or 5% below the consensus forecast three months earlier (of $1.34 billion).

"The BTP business will be consolidated into Ausdrill's financials from 1 November 2012 and is expected to account for 10% of consolidated revenues."

Deep dive: Assume BTP accounts for $130 million of the lower $1.27 billion revenue forecast for 2012/13. Then the traditional business would contribute $1.14 billion. This is a 7.5% boost to the 2011/12 revenue figure of $1.06 billion, and compares with the targeted growth rate three months earlier of 15%.

From the Market Update, dated 22 November 2012: *"We also anticipate that the 2013 financial year results will include a number of one-off costs, amounting to approximately $15 million before tax"…"The overall results will be skewed to the second half of the financial year as the first half is expected to be impacted by prevailing market conditions."* Three months earlier we had read the phrase: *"whilst maintaining similar operating margins."*

Through a more careful analysis, investors could infer that the outlook for the company may not be a rosy as once thought. This is not to say that they should make immediate changes to their invested positions, but a rare signal that required further scrutiny and analysis was now publicly available.

The best part of this process is that the majority of investors will not undertake this higher level of due diligence. Whilst more work may be required, more information will result, and more information tends to create better investment decisions and likewise better portfolio returns.

So without being a Chartered Accountant or a Chartered Financial Analyst, all investors have the ability to deep dive into the words and statements of the companies in their portfolio. It's a simple trick but it can vastly improve performance over the long term.

David Buckland is the Chief Executive Officer of Montgomery Investment Management. Montgomery Investment Management did not own Ausdrill during the periods mentioned within this article, and has not owned it since.

Investing and jogging for the long run

Ashley Owen

Last week I ran (or jogged actually) my first Sydney 'City2Surf'. It is a picturesque 14 kilometre course from the city to Bondi Beach. I had not run or jogged for about 35 years but I decided to do it as a personal challenge and to get fitter, as I had just turned 55.

Having finished – alive, with no injuries – I was struck by the similarities between running and investing. Success requires specific goals and strategies, avoiding the big risks, and not diverting from your plan.

Goals

I had three main goals for the run. The first was to avoid the 'big risks' – death or injury. With investing the big risks are blowing up your money, usually through fraud, bad investments or taking excessive risks.

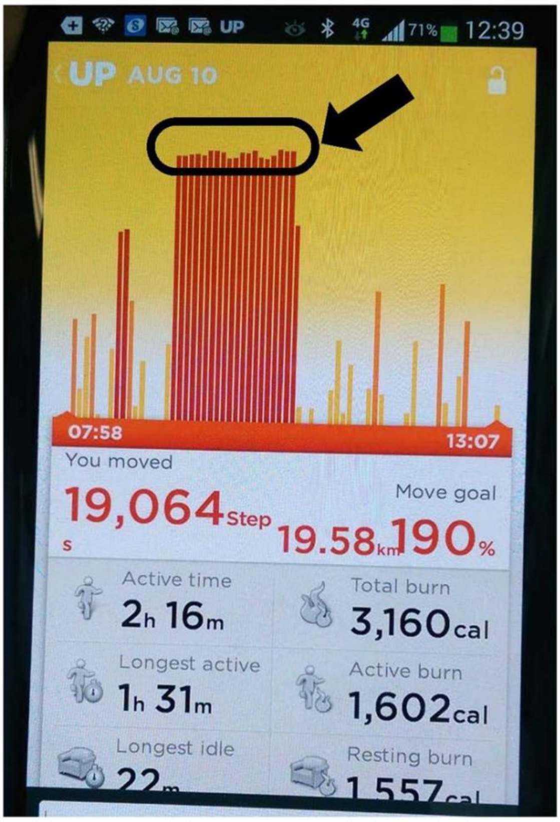
As I had not run or jogged for 35 years, I did training runs for a couple of months leading up to the race. There have been a number of deaths during the City2Surf over the years. This year, a man had a heart attack and collapsed as he crawled over the finish line, literally, and died later in hospital.

My second goal was to not stop, walk or give up. The investment equivalent is to avoid running out of money, or to fall behind inflation. This was covered by my strategies, outlined below.

My third goal was to finish in less than 90 minutes. This is the equivalent of having a specific return goal for investments, for example: to accumulate $2 million in 20 years, or to retire on $100,000 per year, rising for inflation to maintain the real value of my capital.

Why 90 minutes? My plan for the run was to do the 14 kilometres in around 84 minutes by maintaining an average speed of six minutes per kilometre, which I had done in training consistently and comfortably. Given what I had been told about the extra time and energy needed to weave through the other 85,000 people on the course, I made my goal 90 minutes.

Maintain a steady pace



I needed a strategy to achieve my 90 minute goal. I decided to maintain a steady pace so I would not get exhausted, and so I would not have too much left in the tank at the end. I needed to maintain a pace of 160 paces per minute, regardless of the terrain. I kept the pace consistent throughout the race but adjusted the length of my stride depending on the conditions – longer strides downhill and shorter uphill.

This is like 'dollar cost averaging' when investing, maintaining a constant rate of regular contributions, but buying fewer shares or units when markets are expensive and more when markets are cheap. When investing, we need discipline to stick to this plan, and avoid the temptation to invest more in bull markets (or worse, gear up at the top of the market) or be scared off in bear markets (or worse, sell out at the bottom).

It was the same during the race. This is a hilly course, with a two kilometre 'heartbreak hill' in the middle and many smaller hills along the way. On each of the hills I was amazed at the number of people who sped past me early but were soon exhausted. They were walking by the top of the hill and didn't have the energy to accelerate on the downhill runs.

Avoid the crowds

Another strategy, as with investing, was to avoid the crowds. This meant bypassing the drink stations along the way. It is a relatively short race, so I avoided the melee by drinking before the race, eating carbs over the prior couple of days, and carrying a couple of sachets to drink along the way.

A large part of success with investing is learning how to avoid the crowds and fad investments. Every cycle has different fads: tax-driven agricultural schemes, tiny speculative miners in the late 1960s and 2000s mining booms, cash boxes with no plan in the 1980s boom, 'dot coms' with no revenues in the 1990s boom, structured low-grade credit in the 2000 credit boom, interest rate derivatives in the early 1990s structured credit boom, consumer and property finance companies in the 1960s boom, Gold Coast flats every decade since the 1960s, and so it goes all the way back to the tulip boom in Holland in the 1630s.

I have seen every boom and bust in Australia since the late 1970s property bubble burst in the 1981/82 recession, and the results are always the same. Novice investors and even experienced investors are lured in by the hype in the booms and then suffer big losses (often losing their house and other assets as well) in the busts that always follow. The 'secret' is not a secret at all – have a plan, stick to it, and avoid what the crowds are investing in.

Have your individual plan and avoid diversions

To keep up my optimal pace, I maintained my breathing at four paces per exhale. If my breathing started to speed up (ie less than four paces per exhale) it meant I was going too quickly and I would soon be exhausted, so I shortened the stride length (eg uphill). If my breathing started to slow (ie more than four paces per exhale) it meant I was going too slowly and I would fall behind the required speed, so I lengthened the stride length (eg downhill).

To keep the constant 160 paces per minute and four paces per exhale, I sang songs in my head that were 160 beats per minute and that kept me on track. That's where the problems started.

This is the world's largest 'fun run' and so all along the course there were several loud bands playing all types of music, from heavy metal to military brass bands, mariachi and even reggae, and everything in between. They were all good fun but they put me off my rhythm. Every time I passed a loud band I found myself wavering off my set 160 beats per minute. Each time I wavered from the rhythm it slowed me down and used up extra energy to get back on track.

The investing equivalent is to avoid the temptation to listen to the 'hot tip' at the local barbeque or the on-line tip sheets or late night 'investment' talk shows. Avoid 'black box' trading schemes, and even avoid copying what other seemingly successful investors are doing. Even if their investments are legitimate and successful, they might not be right for the next person. Every individual and every entity has different needs, goals, risk tolerance, tax circumstances, health issues, family concerns, retirement needs, etc, and so every investor should have their own investment goals, plans and strategies.

It is also important to remember that almost all of what we hear and read in the daily 'news' is just noise, and we should not allow it to affect our focus on our long term investment plans. For me the race was a powerful reminder of the simple keys to success in any endeavour, including investing: have specific goals, have strategies to achieve the goals, avoid the big risks, avoid what the crowd is doing because it's probably wrong or will set you back, and avoid being diverted off your plan by the daily 'noise'.

I did it in 87 minutes. Next year's goal: 80 minutes – and earphones to stay focused!

Ashley Owen is Joint CEO of Philo Capital Advisers and a director and adviser to the Third Link Growth Fund.