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Financial Pitfalls 2005 Style

None of us is infallible, not even the great Warren Buffett, but avoiding most of the worst pitfalls will result in us being much better off relative to our professional peer group. Long experience in providing investment advice to client superannuation funds and portfolios as well as reviewing their practice accounts and benchmark performance highlights some pitfalls.

Blue Sky Mining Prospects and Barbershop Rumours

In the recurring stock market cycle of boom and decline, each boom brings a particular segment to the top. At the height of the tech boom, all manner of small “dot com” companies raised money on the stock market. In most cases, the money was spent quickly and the company either went broke or sold the residue of its business to a bigger operator. In some cases, the “dot com” vehicle became a backdrop for a subsequent backdoor listing of an unrelated business.

This time, the boom is in resource stocks, but a close look at the stock market indexes reveals that most of it lies in the hands of the big players. Nonetheless, all manner of players are dusting off reworked copies of old prospectuses and disclosure documents and are rushing to raise capital from the gullible public. There are now a plethora of “Blue Sky Mines”, a creation of financial journalist, Trevor Sykes. The mythical Blue Sky Mines makes no attempt to mine the ground, but is fully engaged in mining the stock market and spends the capital raised in payments to, and benefits for its Board of Directors. It is now the silly season for mining players, and clients are beginning to ring me with the latest hot tip that they gained at the golf club or from their barber. Inevitably, a few large mining houses will expand production and make a lot of money while the boom lasts. As the boom recedes, they will slow their production, but the vast majority of the small players will retire to the shadows, spend the money raised and wait for the next boom when they can once again raise money as a gullible public rushes to get on the tail of the boom. If we think about it, it takes a huge effort to find minerals, prove a deposit, negotiate the necessary access agreements with Governments, bring in heavy equipment, train a workforce, establish a means of conveying the product to a rail or shipping facility and realise a profit. Next time you are invited to put money into a company with a hot prospect in a mineral you’ve never heard of in a part of the world that you have to search the map for, do yourself a favour and toss it in the bin.

Are Call Centres Replacing Nigerian Letters

One of the reasons that Nigerian letters exist is that they are surprisingly successful. A great many people are prepared to provide bank account details and send money in order to share in the fortune of a mythical General or Admiral in some African Kingdom who is seeking a place to shift his fortune to, and is willing to share it if you could only be decent enough to help the poor chap.

Of similar nature are the boiler room schemes where a telephone call comes from an office set up in the Philippines, Thailand or somewhere else with a smooth talking American voice and a company name which sounds very similar to a major Wall Street firm. A surprising number of people who would otherwise guard their personal privacy quickly fall into the trap of telling the con artist about the business they run and the money they earn. Low and behold, they are persuaded to put money into the shares of a company they have never heard of on the other side of the world. They send off their cheque and sometimes receive impressive looking share scrip run off on the desktop publisher next to the con artists telephone. Whereas it is commonly believed that these people prey on the poor, it is in reality the comparatively wealthy who are persuaded to put a few hundred thousand dollars into these schemes. Talking to a few finance industry professionals and stock brokers, you quickly realise that they have all had a client or two who has fallen for one of these schemes in a major way. Invariably, where the con artist has struck once, another individual with a similar sounding job title and an equally fancy company title follows up with another unbelievable investment. In reality, they are part of the same scam. A third tier of the scam is that they endeavour to raise more money through an additional share replacement because of the great prospects of the enterprise which they have sold you. Needless to say, you never see any of the money again. The final insult and injury is administered by what purports to be a firm of American lawyers hot on the trail of the con artists who ask the victims to join a class action. To do so, they need to send a cheque to the lawyers. They never see that money or the lawyer again.

Call Centres

These now abound and seem to get people as they are sitting down for dinner at home after a hard day at work. Now that the wealth creation seminars of the likes of Henry Kaye have been ceased by ASIC action, those intent on selling junk property or other marginal investments track down their victims via call centres. Once again, it is amazing that people who would otherwise guard their privacy are willing to tell a stranger in an overseas call centre how much they earn, what their house is worth and how big their mortgage is. This information is followed by an invitation to have a consultant call upon them. Surprise, surprise, the consultant will be selling geared investment apartments and will be armed with a sheet of impressive, but entirely misleading statistics about capital appreciation. Invariably, the property goes up by less than the statistics indicated, the rent is lower than expected, and the ownership costs are higher. By the time the unfortunate investor has realised how they have been conned, the slick talking salesman has moved from Australia and is busy selling apartments in Auckland or some other part of the globe.

Selling Your Personal Details

If you have just spilled important personal financial details to a call centre in India, it is likely that those details will quickly be on-sold and lead to further attempts by other con artists to relieve you of your hard earned wealth.

Listed Shares, Thin Markets and Dental Related Companies

If the market in a company's shares is so thin that sometimes a week goes by and there are only one or two trades, the stock should be treated warily. A quote which goes something like, last sale $1.08, buy $1.01 and sell $1.13 with the stock having traded 6 times in the last month should ring alarm bells. It is too easy for the unscrupulous to maintain an unrealistic price and therefore prevent the company's true capital value showing on the market. This is particularly so if 80 or 90 percent of the capital in the company is controlled by one individual. The risk is that in a market downturn a number of investors in the company disappointed at its performance, may suddenly decide to sell together, and the share price falls into an abyss. Just imagine the possible scenario. A company lists a tiny proportion of its shares with the rest withheld. The listing occurs in a favourable market and there are sufficient punters who will buy any stock which is offered to them for the float to be oversubscribed. Because of scarcity, the IPO is slightly oversold, and this encourages some persons who couldn't get the stock to buy on day one. As a result, the stock finishes a few percent up on its IPO price. A year later, the company produces a modest profit and announces a nil or small dividend. When this occurs, rational shareholders ask themselves why they are invested in this stock and sell. In such a company, a dozen or so sales might take the price down by 25 or 30 percent. This in turn alarms other shareholders and pretty soon the company is struggling at about 50 cents per share with no buyers.

Scrip Buyout Risks

The experience of dental laboratory proprietors who sold their businesses to Pearl Healthcare Limited and received a mixture of cash and share scrip was that the share price at the end of day one of the IPO was 19 cents whereas the subscription price had been 25 cents. From that point it continued to slide, and has recently traded as low as 3 cents. Unfortunately, those dental laboratories who took share scrip as a significant part of their sale consideration, had their shares locked up in escrow for 12 months and could only watch in horror as the price plummeted. Even at 3 cents, any significant volume of shares offered for sale on the market is likely to see the share price immediately crash to, perhaps, 1 cent. Naturally, if Pearl Healthcare is able to produce a substantial profit and pay a dividend, the price will jump. Its results to date suggest that this is unlikely. The history of Pearl Healthcare shows the danger in selling practices if the share scrip in the buyer is a significant part of the consideration for sale of the individual practice business. For this reason, any dentist approached to sell their practice to a listed dental company would be wise to demand cash payment in full.

Unscrupulous Accountants and Advisers

Olives, Eucalypts, Pine trees, Tropical Timber, Syndicated Vineyards and Widget Plantations.

The issue here is simple - the management companies don't wish to invest heavily in the capital intensive business of actually owning the plantations. It takes years to plant, nurture and harvest the product. No listed company could utilise its capital in this way and produce acceptable returns for the stock market. Instead, they invite individual investors to tie up their money in "widget plantations" for 10 years or more. The management company gets fees for planting and managing the plantation, and makes a margin when the plantation is harvested and sold. Basically, a well managed management company can't lose, but the risk is born by the plantation owners. These investments are usually sold on the basis of some tax benefits and are invariably sold through accountants offices. These days, because of licensing, the accountants are usually accompanied by a "tame" in house financial planner. The trigger for the accounting firms is that often these products pay a 10 percent commission and for tax planning reasons, people are persuaded to buy $200,000 or more in one transaction.

In reality, the only investment that might make any sense would be an investment in the management company after subjecting it to careful analysis. The accountants and tame financial planners selling you the wood lot on a 10 percent commission are certainly not going to tell you to purchase the management company instead and ruin their pitch. To make it worse, some unscrupulous accountants intentionally wait for their client to develop a tax problem, then step in at the last moment with their scheme. If they truly had their client's wishes at heart, they would be advising them of the emerging tax scenario at an earlier stage. The enormity of the sudden tax problem and its proximity to 30th June catches the dental client in a confused state. He or she is usually busy in their practice and has little time to think through the issues and seek alternative advice. The "widget farm" planting scheme is put in front of them with a chart showing the tax that will be saved in year one (it's actually not a saving, but deferred to a later year) and a loan document from a financier associated with the scheme who will lend the money immediately.

The Verdict

1. There is not a competent accountant or financial adviser who cannot find a better financial option for clients than one of these schemes.

2. I have never met a dentist who had become engaged in one of these schemes who didn't later regret it.

The Peril of Over-Insurance

Life insurance agents are taught to use emotional selling techniques. The reality is that for most dentists some insurance is a necessity, but as wealth increases, the need for insurance should decline. Ultimately, financially secure practitioners can elect to bear all of their own risk, i.e. they become self insurers. As with all our needs, we should ration our insurance needs against other needs. A life insurance representative who dwells on what can befall us, our spouse, our business associate, our children and the percentage risks of all manner of misfortune can make a strong and highly emotional case for a huge annual expense in term life cover, trauma insurance, income protection insurance, business overheads insurance, spouse insurance, associate cross insurance and more. It is best to take their proposal home, work out what minimal level of risk you need and put a red pen through some of the numbers.

The Good News

Our close observation of the actual financial performance of many dental practices who utilise the Synstrat Group as accountants and financial advisers reveals that despite the trauma of overregulation, the dental profession is doing well. Those dental practitioners who are not preferred providers are now more profitable as a group than at any time in the past 10 years.

Buying or Starting a Practice

Often financial advisers who are not experienced in analysing dental practices dismiss the hidden value in an existing practice, including country practices. The reality is that if a practice is in suitable premises which are available at reasonable purchase or rental cost and have a good fee base without being a preferred provider, there is a value in the actual infrastructure of the practice. The infrastructure of the practice includes the fact that there is established parking, a well established and published telephone number and Yellow Pages listing, an experienced receptionist at the front desk, a pattern of existing heavy bookings, patient referrals and treatment plans in progress. Comparing that with all of the stress in establishing infrastructure from scratch in a start up, even in a town where there is demand for additional practices, means that there is often substantial residual value in an existing practice compared with the start up option. We are often consulted by dentists facing this choice. For this reason, we believe that many country practices, as well as outer suburban practices have significant value. Of course, there will be cases where a practice is so run down that the investment in rebuilding it virtually negates the advantages. Again, expert advice is required.

The Greatest Pitfall

The greatest pitfall a dentist confronts is that of buying the wrong practice in respect of cost of occupancy of premises or the fee income which can be generated. Once bought, it is invariably the case that the dentist conducts the practice as a proprietor for 25 years or so. A differential of say $50,000 per annum long term when translated into earlier repayment of home loans, or funding of superannuation or reinvestment in practice premises etc probably means the difference between having the freedom to retire at age 55 or having to slave on to age 65. Of course, some well off dentists will choose to work to 65 and beyond, but it is nice if they have the choice.

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