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This Week's Top Articles

- **Small can be beautiful** *Chris Cuffe*
- **Nixon's Mum** *Jack Gray*
- **Is a 'transition to retirement' pension worthwhile?** *Rick Cosier*
- **Bond funds and term deposits are apples and apples** *Warren Bird*
- **Fun at a gold conference, but it's not all glistering** *Graham Hand*

Small can be beautiful

Chris Cuffe

When British economist E.F. Schumacher published his ground-breaking book *Small is Beautiful* in 1973, *Newsweek's* review said it was, "Nothing less than a full-scale assault on conventional economic wisdom." While Schumacher's argument about empowering people and making work available on a more human scale is not the direct subject of this article, I have always believed there are important advantages that relatively small investors have over large institutions. Schumacher faults economics for failing to consider the most appropriate scale for an activity, and the same principle applies to investing. There is no doubt that many fund managers feel they would perform better if they had less to manage.

Notwithstanding conventional wisdom to the contrary, bigger is not always better.

In this article, I will focus not on the small retail investor, but on the 'mid-tier', that group of family offices, wealthy high net worth individuals, and smaller funds that operates across many asset classes. There are thousands of professionals who go about their daily investing without much profile, but with some useful advantages over the big end of town.

Consider a boutique fund manager who sets up a new business with a relatively modest $200 million to manage. It's a fresh start, no existing capital gains or losses to influence a trading decision, no worries about exceeding the 5% and 20% ownership thresholds imposed by the ASX, no moving the market filling large orders.

Typically, a fund manager will have portfolio limits such as:

1. no more than 10% of the portfolio can be placed into any one stock
2. the portfolio cannot own more than 20% of the issued capital of any one company.

Assume this new fund manager has an intimate knowledge of a small company with a market capitalisation of $100 million which he thinks is well undervalued. Under his investment criteria, he can buy $20 million of this company, which will make up a significant 10% of his entire portfolio. Then assume this fund manager is successful and a year later he is managing $2 billion. If he discovers a similar investment, the $20 million he can invest in a similar-sized company is now a meaningless 1% of his portfolio. Even if he is correct and the company's shares skyrocket, the effect on his entire portfolio will be tiny. Although he loves the success of his business and the fees he earns on his big portfolio, he no doubt laments the days when he could be more nimble.

The capitalisation of companies listed on the ASX is surprisingly concentrated. The top 10 companies comprise 63% of the ASX/S&P200, and the top 50 are over 80%. The 200th company on the ASX has a market capitalisation of only $144 million. While 200 companies seems a lot to choose from, there are 2,200 companies listed on the ASX.

So there's the first issue. The big fund managers must invest in the big companies. They simply have too much money to invest, and placing $10 million with a small company is hardly worth the research effort. Furthermore, larger funds are often 'open-ended', which means they are subject to new applications and redemptions. This requires the fund to remain liquid, and the most liquid stocks are the largest. Not surprisingly, since that's where most of the activity is, it's also where the most broker research is targeted. Large fund managers reward brokers with orders based on the quality of their research. Not much use spending expensive analyst resources researching a $50 million company if your clients can't buy it.

Investment markets are comprised of many participants with unique circumstances, mandates and restrictions. Smaller investors should consider where they have advantages which should be arbitraged to the fullest extent possible, including:

- They can be genuine long term investors. Consider the predicament facing large fund managers during the GFC. As investors panicked, securities such as the listed hybrids issued by major Australian banks were sold off heavily. For example, CBA's PERLS III fell from $203 in 2007 to $130 in early 2009. Frustratingly for many fund managers, knowing this represented excellent value for such quality issuers, they were not only unable to buy, but were also themselves forced sellers as their investors lodged redemption notices. A private investor can simply sit out these periods of turmoil and concentrate on the original 'hold to maturity' decision.

- A large portion of the Australian sharemarket is influenced by investors who are offshore or who are measured by pre-tax results. Both these factors mean that franking credits are undervalued. However, most large fund managers cannot take advantage of delivering after-tax efficiency to their clients, because their performance is not measured accordingly. In fact, they can appear to have underperformed pre-tax even if they have done well post-tax. For example, a large fund manager has no incentive to hold a stock for longer than 12 months to collect the capital gains discount, and indeed, may sell after 11 months without realising the impact on the tax bill of the end investor.

- Most professional fund managers manage their portfolios against specific benchmarks. Many are loath to be too different from these benchmarks lest they get the call wrong (even in the short term) and suffer the possibility of loss of business or loss of job. Smaller, private investors do not have this constraint and the investment portfolio can truly be managed in the best interests of the beneficiaries.

- Compared to retail investors, family offices and smaller funds are of sufficient size to negotiate lower agency costs (e.g. stockbroker fees, portfolio management fees, etc.), though they will not have the buying power of the large institutional investors and will obviously incur higher fees than them unless they leverage off a bigger relationship elsewhere.

- Most large managers need to value their portfolios to market regularly, as often as daily, as they have underlying investors coming and going from their funds. This continuous 'marked to market' environment means they are not naturally 'patient investors' and may avoid various illiquid investments, leaving such securities undervalued for other investors.

- There is considerable flexibility to buy and sell parcels of securities at short notice and with minimal effect on prices. Outside of the Top 50 companies, it is common for bid/offer prices on

the ASX to be wide or subject to small volumes. A large investor can take days or weeks to buy or sell a stock, long after the more nimble have moved on.

It must be acknowledged, however, that larger investors do have their own advantages. The obvious ones are access to research and management. Sit in the foyer of any large fund manager at company report time and a steady stream of the highest profile CEOs in the land will parade through with their assistants in tow (whether this is of any value under the strict compliance guidelines of continuous market disclosure is another matter).

More tangible is access to major company placements, where a broker is given a mandate by a company to raise a chunk of cash quickly, usually at a discount to market, and the calls go out to the big managers. A good example is the large placement by Wesfarmers to Capital Research Global Investors ($500 million) and Colonial First State ($400 million) in February 2009 following the company's $18.2 billion purchase of Coles in 2007. The acquisition left the company exposed to the GFC and high borrowing costs, and a worried market sent its shares down 50% from around $30 to below $15. The two big funds stepped up at $14.25 a share, while smaller investors had to be satisfied with a 3 for 7 pro-rata entitlement offer. Wesfarmers' shares rose rapidly afterwards based on an improved balance sheet, and the large fund managers and their clients were handsomely rewarded.

And in the last 12 months, it is the large cap companies which have performed the best, as investors have sought the reliable income from their dividends in the face of falling interest rates. In fact, the ASX20 is only about 10% below its all-time peak, while the ASX200 is still 25% below. Many small companies are still 50% off their pre-GFC levels, so the large funds have not suffered recently from their constrained investment universe.

The conventional wisdom sees the Italian suits in the expensive high-rise offices, supported by teams of analysts and banks of Bloomberg screens, and assumes that's where the action is. Meanwhile, in a small family office in a warehouse in the Inner West, a couple of casually-dressed guys are moving in and out of opportunities the large fund managers don't even hear about.

Small can be beautiful, even if the suits can also do well throwing their weight around.

Nixon's Mum

Jack Gray

The financial services industry is untrustworthy … that's how people see it.

A survey of over 3,000 people across 60 countries found that only a third believe their 'primary investment contact' acts in their best interests. Only a third! Of course we'd be startled if as many as a third believed their used car dealer acted in their best interests but ironically we in finance and investing need to be trusted *more* than do used car dealers. Not only is a car dealer's past performance likely to be a reliable guide to future performance, but used cars can be tested for quality by identifiably independent experts, and one can insure against the risk of lemons.

None of this holds in financial services where the confluence of informational asymmetry and intrinsic uncertainty means quality can *never* be tested. For instance, half a century of data is famously needed to be confident that skill rather than luck best explained a manager's outperformance. All we ~~have~~ had is *trust*, yet the 'market' for trust has failed; demand is increasing while supply is decreasing. The *World Values Survey* asked people in Britain 'can most people be trusted?' In 1959, 57% answered 'yes', but by 2000 that had collapsed to 31%.

Trust in the entire financial system has been battered by financial crises and bruised by Madoff-style schemes, both of which are too readily dismissed by the few-rotten-apples metaphor designed to comfort us, to distance us from corruption. Yet we all played a part in small but insidious ways. For instance we eternally qualify with the ubiquitous 'little', as in 'we underperformed *a little*', the strategy 'failed to hedge *a little*', and the one we all fear, 'this might

hurt *a little*.' Weasel words undermine trust inch by inch. Let's say it like it is. Some language goes further than merely undermining trust. Some destroys it. Listen to private bankers striving to increase their 'share of wallet.'

Trust might be cautiously restored if people see ethical behaviour as the norm, if they see us in the business behaving ethically. Some argue we shouldn't try, that ethics inhibits success in commerce, and that it's too onerous. But where trust is a crucial ingredient of 'getting to yes', ethical behaviour is more likely to *enhance* success. And it isn't too onerous. Just the opposite because society's response to poor ethical standards is more regulation. Now that's onerous.

Trust in financial services could be re-kindled if we practised two easily-stated pragmatic principles.

The Oedipus Principle. In commercial dealings always act and behave as you would in dealing (at arms' length) with your mother. We may have complex relationships with our mothers, but most would neither take unfair advantage of them nor mislead them in commercial dealings. We wouldn't lie to them, even though as children we all did.

The Nixon Principle. In commercial dealings always tell the truth, tell it quickly, and tell nothing but the truth. The adverb *quickly* is crucial. The longer you delay telling clients about screw-ups or misleading statements, the harder it is to come clean and the greater the suspicion of a cover-up, which when discovered permanently destroys trust. Judgement is needed in deciding whether to tell the *whole* truth. Sometimes *not* telling the whole truth can be ethical, as might be the case if a long-short equity hedge fund named its shorts. Almost never are ethical decisions black-and-white, but blurring is no excuse for not exercising ethical judgement.

All principles of government, investment, commerce and ethics are easy to live by in normal times. Our commitment to them is only tested when we're under extreme pressure, and we mostly fail. Suppose your child urgently needs a life-saving operation which you can fund via a sale that is far more likely to close quickly if you don't alert the buyer to a half-buried escape clause that applies to a guarantee. Will you still hold to the principles of Oedipus and Nixon?

To embed trust in commerce we also need to exorcise the neo-liberal economic rationalist agenda that preaches selfishness as a virtue and justifies it on the grounds that the invisible hand will serve the common interest. Adam Smith knew the limits to his profound and beautiful metaphor; he warned that free markets ineluctably result in collusion and corruption. Financial markets, being "demons of our own design" must be regulated … wisely. Unfortunately wisdom is in short supply. Would you trust a seller of mortgages regulated by ASIC's requirement that a credit contract be merely 'not unsuitable' for the purchaser? That's but a slight nudge ahead of *caveat emptor*. 'Most suited' or 'the best', but 'not unsuitable'?

Exorcism must be brought to bear on Milton Friedman's rationalist view that a firm's sole social responsibility is to make (legal) profits. Freidman is doubly wrong. First, a firm's aim should be to produce goods and services of sufficient quality that people will want to purchase them. Profit is a *consequence* of production rather than the *aim*. Once profit becomes the aim, as it has on Wall Street, unethical behaviour becomes readily accepted and resources are directed to accounting trickery rather than to production. Profit as the aim allowed Wall Street to *legally* sell 'No-Doc No Income No Job' negative amortisation mortgages to poor unemployed people (and then to blame them.) Second, were Friedman right, companies would be the only institution in society whose *sole* constraint is to obey the law. We rightly expect *more* than that from our schools, our governments, our hospitals, and from each other. We expect them and us to behave considerately, reasonably, ethically – high standards we all fall short of from time-to-time.

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Is a 'transition to retirement' pension worthwhile?

Rick Cosier

In an earlier *Cuffelinks* article (Edition 2: The superannuation essentials), I covered the basic concepts of superannuation and its tax advantages. One of the breakthrough government initiatives was to allow people to access super whilst still working. This has created three broad financial planning strategies:

1. work less hours, and top up your lost income by drawing down from a pre-retirement pension
2. continue working full-time, but restructure your salary and super to give the optimum split that maintains your after tax income whilst tax effectively boosting your retirement savings
3. keep working full-time, maximise your salary sacrifice and convert the bulk of your super to the pension phase to avoid paying tax on performance returns.

The attraction of the pension strategies depends on the amount you have in super and your PAYG marginal tax rate, and crucially, whether you have reached your preservation age. For people born before 1 July 1960 the preservation age is 55. People born after 1 July 1964 have to wait until age 60. There is a sliding scale preservation age for people born between those two dates - either 56, 57, 58 or 59. This is one of the many complexities caused by 'grandfathering' where governments try not to disadvantage existing superannuants.

Strategy number one is what the government envisioned when they allowed people to access their super whilst still working. The other two were created by the financial planning and wealth management industry which spotted an opportunity to save their clients tax.

There are a number of iterations of the transition to retirement strategy. In its purest form it comprises three steps:

1. converting most of your super to the pension phase
2. increasing the amount you salary sacrifice
3. drawing down a monthly payment from your pension.

In this way you are creating sufficient after-tax income, but because of the preferential tax rates in super and pension, you are better off from a tax perspective.

I say 'most of your super' because having set up a pension you can't add your future super contributions to it. Consequently, you have to leave a small amount in your super account.

The transition to retirement initiative has opened the door for many people who are still working full-time. Some people do not need to maintain their income as they have sufficient to cover living expenses and emergencies. They are already maximising their salary sacrifice contributions, and are looking for ways to save more tax. For these people, the potential benefit of a pre-retirement pension has nothing to do with maintaining income. The attraction is that superannuation assets in a pension pay no tax on performance returns, whereas in accumulation the tax can be up to 15%.

Furthermore, although it's paying no tax, a pension fund can still claim back its franking credits. For example, if the fund receives a dividend of $700 from an Australian company with a franking credit of $300, it will pay no tax on the $700 dividend but receive a tax refund for the $300 franking credit, giving a total cash return of $1,000.

So should everyone be converting their super to a pension once they reach their preservation age? Well, in at least two circumstances, the benefits significantly outweigh the disadvantages:

1. you are aged 60+
2. you are exclusively using non concessional contributions to start the pension.

In both these instances there's no tax on pension payments or the performance returns in the pension. The only downside is that legislation decrees that you have to withdraw between 3% and 10% of the pension balance each year, so you are lowering your eventual retirement nest egg. But this is not a major problem as you can simply put it back into super tax free (provided you do not exceed your $450,000 non concessional limit over three years). The minimum pension payment rises to 4% next year so you need to take that into consideration.

If you are between 55 and 59 it all depends on a complex set of variables – your super balance, the split between tax free and taxable component, performance returns, the split between income and capital growth, the amount of share transactions, the pension payment amount and your marginal tax rate.

Let's say you have $300,000 in super, totally invested in cash deposits that deliver 4.5% interest and your marginal tax rate is 38.5% including Medicare. The contributions in the fund comprise 100% employer and salary sacrificed contributions (to use the industry jargon, it is 100% taxable component). If you leave it in super, the interest earned is $13,500 which is taxed at 15% ($2,025).

If you convert the super to the pension phase, you will have to withdraw 4% in the 2014 tax year ($12,000). As the money is 100% taxable component you will pay 23.5% tax on the pension (38.5% less 15% tax rebate) which is $2,820. So in this example you are $795 worse off by converting to a pension, and you've taken $12,000 out of a concessionally taxed environment.

Once you start increasing the return, the position starts to favour the pension option, but there may be a joker in the pack if your super fund invests in a managed fund with active share trading. It is common for a fund manager to sell half the companies in the portfolio over the course of a financial year. This often creates realised capital gains that are taxed at 10% in the accumulation phase, but not in the pension phase. This activity could well swing the decision, but it's very difficult to assess.

The variable that really changes the ball game is the split between taxable component and tax free component. The tax free component comprises the after tax contributions you have made to super. Let's say the split between taxable and tax free component is 50/50. Keeping the other assumptions constant, there's still not much saving with $300,000 invested in cash deposits with a 4.5% return. But if you either increase the balance or the return, the picture changes significantly. With a balance of $300,000 and a return of 7%, you are $1,740 a year better off converting your super to a pension. With a balance of $1 million and a return of 4.5%, you are $1,950 better off.

Can't be bothered with the hassle? Well, a 55-year-old couple with $1 million each in super which delivers an average return of 8% per annum could pay an unnecessary $73,000 more in tax over the five year period by waiting till they reach 60 to convert their super to a pension.

So my advice is to get out the calculator, or better still, consult a financial adviser who has access to modelling software. You may get an early Christmas present from the Tax Office.

Bond funds and term deposits are apples and apples

Warren Bird

Is the choice between bond funds and term deposits (TD) a choice between apples and oranges? On the surface, it's understandable if many investors see them as quite different.

Bond funds are a more complicated investment choice, but when you look closely at the investment outcomes that each gives you, it's more accurate to say that they are different kinds of apples, rather than different kinds of fruit. In the end both bond funds and TDs deliver returns that come from income.

When someone invests in a TD they outlay a specific amount, and they can see on-line that their investment is always 'worth' that amount, which they'll get back at maturity. They also know the interest they'll get. For example, a $100,000 investment in a 3 year, 4% TD becomes $104,000 in a year's time and $112,486 (with compounding) in 3 years' time.

Compare this with the way the unit price of a bond fund changes daily, and how there's no certainty about the capital value at any point in the future; compare the predictable interest income of a TD with the way a bond fund's income distributions change from year to year. And this all happens without the same upfront indication of the interest rate that you get with a TD.

Investments that mature

Bond funds don't mature. To get capital back, an investor has to redeem units. However, bond funds hold securities that mature, just like TD's. In Australia, funds hold government bonds that tend to have an average maturity profile of around 4-6 years, while corporate bonds typically have around 2–4 years average maturity. Comparing bond funds with TD's of these sorts of maturities allows for an appropriate comparison.

Although bond funds invest in securities that have to be repriced daily, which flows into a changing unit price, the nature of fixed interest is that none of the price changes are permanent. Every bond whose price has risen above par (100 cents in the dollar) will eventually mature at par (assuming no defaults); and every bond marked at less than 100 cents will eventually rise back to par value at maturity.

This means that over time, the capital value of a bond fund investment (encapsulated in its unit price) will tend to revert to its long run average. All capital gains are either realised (and thus boost income) or evaporate once the bonds approach maturity, and all capital losses eventually are made up as bonds amortise to par.

No one would look at the 3 year TD example above after just one year and say, 'this isn't worth $112,486, it's let me down'. Neither should an investor look at a bond fund after 1 year, which is too short a time to let its dominant feature – its interest earning capacity – come through.

Returns come from interest income

It may surprise some people, but the return from investing in bond funds does in fact come from the interest income they earn. When you look at a bond fund's returns over periods of 3 years or more, shorter term volatility largely evens out. Over the medium term, fund returns are dominated by interest income. To see this, look at the split between the 'distribution return' and the 'growth return' that fund managers report. The longer the time period, the smaller is the growth component for bond funds.

A bond fund investor can't be told exactly what their interest payments will be, because a unit trust doesn't have static holdings. The exact flow of interest payments is harder to predict. But investors can be told the yield being earned by the fund at a point in time, which is comparable with the interest rate on a TD.

The most useful yield measure is the weighted average yield to maturity of each bond in the portfolio. Strictly speaking, only individual bonds have a 'yield to maturity'. To say that the yield to maturity of a bond is X%, is to say that every future cash flow – the interest payments and the repayment of par at maturity – is priced to deliver a return of X% pa.

Because funds don't have a maturity date, they don't have a yield 'to maturity'. But the average of the yields of the individual bonds in the fund can be calculated, and it provides a similar indication of the future return. It might be higher or lower in any one year, but over 3 to 5 years - no matter whether market yields rise or fall after the investment is made - the annualised return will end up close to the initial average yield.

This information can then be used to assess the relative attractiveness of a TD or a bond fund for meeting your investment needs. It's not all that the investor needs to know, but is an important piece of the puzzle. Unfortunately, most fund managers don't routinely provide investors with yield data on managed fixed interest funds. Investors wanting to compare the manager's products with TDs should ask them for the information.

A significant implication

Many investors are concerned that if they buy into a bond fund and yields in the market rise significantly, then they will lose their capital. They would rather buy a TD which seems 'safer'.

Formally, it's true that TDs don't fall in value. But if you invested $100,000 in a 4 year TD at a rate of 4%, and soon after the same bank offered a 4 year TD at a rate of 7%, then you have missed out on $3,000 a year of extra income. You will still get $100,000 back at maturity, but the economic reality is that your investment isn't as valuable as the new TD now available. (Vice versa if you invested in the TD at 7% and then saw rates fall to 4% - you'd be over the moon, but the bank wouldn't tell you that the TD was worth any more than your initial outlay.)

With bonds, these disappointment or 'over the moon' factors are made explicit in the price, and the unit price of bond funds.

So, what happens if you invest $100,000 in a bond fund with an average maturity of 4 years that is yielding 4%, but soon after market yields rise to 7%? You will see a fall in the unit price of about 10% and your investment falls in value to about $90,000. But if your time horizon is 4 years and if you don't redeem, then the mark to market loss isn't realised. Just as with the TD, you will keep being paid a distribution as the bonds keep paying interest. And as the bonds in the fund gradually appreciate in value back to their par values, the unit price will gradually recover to reflect that reality. (These comments leave aside any active decisions by the fund manager, which could either help or hinder the outcome.)

In addition, in a bond fund which has securities that will mature during the course of the next 4 years, those will be reinvested at the higher yield and start to earn 7% for the fund. Thus, in 4 years' time you can still expect your investment to be worth $100,000, plus the fund's distributions will amount to a bit more than 4%.

If you believed that the rise in yields was going to happen you wouldn't do either – you wouldn't lock in through the TD any more than you'd invest in the managed fund. The point being made here is simply that investment outcomes between TDs and bond funds are actually similar. In neither case does a sharp rise in yields mean the investor has permanently lost their capital.

Both term deposits and managed bond funds can play a role for investors who want relative capital security and reliability of income. Despite their obvious differences, they are really apples and apples rather than completely different types of investment.

Warren Bird was Co-Head of Global Fixed Interest and Credit at Colonial First State Global Asset Management, and is now a consultant and writer on fixed interest, including for institutional magazine KangaNews.

Fun at a gold conference, but it's not all glistering

Graham Hand

It's entirely appropriate that the famous phrase from Shakespeare's *The Merchant of Venice*, "All that glisters is not gold", is most often misquoted as "glitters". Gold is a confusing subject, especially for an investor trying to predict its future price. It produces no income, costs a lot to mine, store and insure, and yet many see it as an essential part of a diversified portfolio. It's certainly had a good run in the last 10 years:

So I spent two days at a gold and other minerals symposium to learn more.

Oscar Wilde said, "The optimist sees the doughnut; the pessimist sees the hole." If you sit through a couple of dozen presentations by the CEOs of junior mining companies, especially gold prospectors, at a resources conference, the only thing you hear about are the doughnuts. The holes are confined to massive craters in remote locations. There's a wonderful optimism that the next big strike is just a bulldozer gouge away, and you have to admire the conga line of unbridled, fund-raising enthusiasm. Perhaps you need the self-confidence of Lady Gaga, the zeal of Pink and the resilience of Mick Jagger to dig a kilometre underground in a desert 500 kilometres from the nearest town.

They make it sound so exciting, and it's little wonder these prospectors and miners love their industry. The maps show Botswana and Namibia and Brazil and Indonesia and Mongolia. Take a jet to a South American capital city, hop on a helicopter, fly over rainforest, and there's a scarred clearing covered in mining equipment. Not for the new breed an opal mine in Coober Pedy or gold prospect in Hill End. Let's make it complicated, let's bring in some sovereign risk and an uneducated native workforce. And did you know that the Government of Congo is very friendly to foreign miners, with special tax incentives, relaxed safety laws and environmental concessions. Just don't mention the dengue fever.

The hoopla is palpable, even from the explorers who have little more than the rights to prospect over an island off Indonesia without a single sod yet turned. This guy has been going to Zambia three times a year for a decade. There's the diamond company that has just hit a single gem-quality stone which will fetch half a million dollars. There's the lithium producer salivating at the growth of electric vehicles needing lithium batteries for the next few decades. And if you think the case for investing in gold is strong with government defacing fiat money, then the silver story is even better.

But just as you want to rush out of the room and buy some shares in this sure thing at five cents, you find out they did a capital raising last week at three cents. That's half the current price! So

you wait for the next presenter. This one is the lowest cost producer in Africa. Didn't someone else say that this morning? And did you know Indian households hold more gold than the US Government and all European Governments combined? The seven billion people in the world will soon be nine billion, and their demands for food will met by super phosphates. But this phosphate company just did a capital raising, and its shares are worth less than the cash backing? It's crazy, how can that be?

Then you notice something strange. This conference is 'the number one event series for mining investment and capital raising', with representatives from dozens of junior resource stocks, mining equipment companies, consultants and mining magazines. There must be more trade magazines in mining than show business. But where are the folks from BHP, Rio or Fortescue? Wait a minute. Even more serious, where are the investors? The big resource funds are not here, because they want to buy in chunks of $10 million but not own more than 5% of the stock, so no point listening to a company with a market cap of $20 million, regardless of how good the story is. The fund managers are saying: come back to me when you're out of training wheels. Most resource companies are tiny, using the ASX as a place to raise a few million dollars to finance the sinking of some holes before the money and the ideas run out.

It's charming how all the CEOs flick past the disclaimer at the start of their talks, then proceed to go so close to giving investment advice that any ASIC official would blush. One CEO tells us it's time to invest in uranium because, thanks to Fukushima and earthquakes and tsunamis, prices have never been lower. Then the next guy says it's great to invest in gold because, thanks to global uncertainty and Indian weddings, prices will go through the roof. One chart has a long-term $30,000 an ounce forecast. Obviously, anyone who lives in a Zambian jungle half his life and feels more comfortable in a safari suit is hardly likely to worry about a bit of exaggeration in a Powerpoint presentation. And everyone may be 'the next Sirius Resources', which almost ran out of cash and saw its share price fall to five cents, only to fly to $3 on the back of a major nickel-copper discovery.

The only large miner to make a presentation was Hancock Prospecting, and it was hard not to be impressed by the sheer audacity of the project. Its Roy Hill development in the Pilbara is a brave leap of faith. Hancock is a private company so it's not so beholden to equity markets, but it still needs to raise the debt. They intend building a 440 kilometre heavy rail line to the coast from the site in the Pilbara, with rail construction camps along the way and an airstrip at the mine. It depends on the iron ore price for the next 20 years, in a market that does not have much idea what it will be next month. Good job Gina is the fifth wealthiest woman in the world.

Then amid this optimism and faith, along comes somebody to spoil the party. Andy Xie was Chief Economist for Asia Pacific at Morgan Stanley from 1997 to 2006, and now is one of China's leading independent economists. He calls the controlled economy of China "the biggest misallocation of capital in history." Government officials whose first priority is keeping their jobs tell factory owners that they must continue to produce their goods to maintain local jobs. If there is no demand for the product in such a controlled system, the government buys the output and stockpiles it. A large proportion of government revenue comes from land, and so people keep building even though there now almost 10 billion square metres of buildings finished or nearing completion with no occupants. Xie says ongoing urbanisation is a fiction because rural villagers do not have the money to live in the cities, and in any case, most rural land is free so why would they move. He sums up the claims on economic growth by saying that all aggregated numbers in China are made up. He even says much of the demand for steel in China comes from building new steel mills. Government stimulus is simply building more capacity nobody wants.

Most of the resource projects presented at the conference are facing far more of the hole than the doughnut. As one presenter said, there are 250 gold companies listed on the ASX. You can guarantee that the one you choose to buy will be the one that goes broke.

Even if Andy Xie is wrong and China continues to grow strongly for another 20 years, then the vast majority of these juniors will never be another Sirius Resources. Sirius is the brightest star in the night sky, but down on earth, the money raised on many projects will just be used to make the holes bigger.