Investment Market Update No. 30

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Editorial

If Santa Claus should fail to call bears will come to Broad and Wall". Extended stockmarket valuations, particularly in the resources sector mean that we are positioning clients portfolios for an extended period of market volatility.

In this issue we cover:

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2. New Superannuation Rules;
3. Asset Classes;
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The Business

The business continues to grow and we have 11 staff, including 4 qualified to give financial advice. We are now managing about $90 million for clients, and we recently submitted our annual returns to ASIC, which showed a clear profit after appropriate payments to all staff. We only mention this, because some commentators suggested that CIPL could not survive outside The Rock.

We have been busy re-weighting client portfolios and this will continue over the next month. The aim is to help protect portfolios from what could become a bear market, and to position them to take advantage of a more positive investment environment, when that returns.

Industry Developments

It has been another busy six months for the superannuation and financial planning industry. On top of the major changes that came about on 1 July 2007, which we discussed in our July Investment Market update No. 29, the Federal election on 24 November led to a wide range of promises from both sides of politics (if you would like a copy of the July update just give us a call).

Since we now know who won, let's look at the promises made by the Labor party and their potential impact on how we work and save.

Personal Income Tax

Predictably the election campaign opened with a big splash regarding party policies concerning income tax. The tax cuts outlined in the 2007-08 Budget will remain, with further cuts applying from 2010-11. If the economy remains sound, the Government hopes to implement further cuts by 2013-14.

The current and future income tax rates are shown in the table below.

The big losers are the few lucky wage earners who make over $180,000 a year, as the ALP deferred the tax cuts that were promised by the outgoing government to those high-earners in the 2010 tax year.

For wage earners lower down the tax scales, the Low Income Tax Offset will increase from the current $750 to $1,500 in 2010-11 and $2,100 in 2013-14. Since income received from superannuation funds is no longer taxable for those over 60 years old, this will have a positive impact on many clients. It also makes the use of family trusts more attractive, by increasing the tax free unearned income that can be received by minors.

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Current		2010-11		2013-14	
Taxable Income ($)	**Rate (%)**	**Taxable Income ($)**	**Rate (%)**	**Taxable Income ($)**	**Rate (%)**
0 - 6,000	0	0 - 6,000	0	0 - 6,000	0
6,001 - 30,000	15	6,001 - 37,000	15	6,001 - 37,000	15
30,001 - 75,000	30	37,001 - 80,000	30	37,001 - 180,000	30
75,001 - 150,000	40	80,001 - 180,000	37	180,001+	45
150,000+	45	180,001+	45		

The other big tax related announcement made by the ALP was a 50% Education Tax Refund.

Under the refund, families who receive Family Tax Benefit (Part A) will be able to claim:

- A 50 per cent refund every year for up to $750 of education expenses for each child attending primary school (maximum $375 per child, per year);
- A 50 per cent refund every year for up to $1,500 of education expenses for each child attending secondary school (maximum $750 per child, per year).

Therefore a typical family with a primary school aged child and a secondary school aged child would receive a tax refund of up to $1,125 per year, to compensate for spending on laptops, home computers, printers, home internet connection, education software and school text books.

First Home Saver Accounts

We are excited about the potential for the establishment of First Home Saver Accounts. Designed to help aspiring first home buyers save a larger deposit to put towards their first home, these accounts will be modelled on superannuation rules – contributions and earnings on new accounts will be taxed at 15 percent (compared with say, 31.5 per cent). You can salary sacrifice/make a tax deductible contribution of $5,000 each year, and add a further $5,000 of your own money. Total contributions to the account cannot exceed $50,000, and it has to stay in the account for a minimum of 4 year. If you meet those criteria, withdrawals will be tax free.

Superannuation and the new government

Superannuation barely rated a mention during the election campaign. Given the number of changes the industry has faced recently, an opportunity to bed down all the existing changes will probably be welcomed by those in the industry.

Economic outlook

We do not agree with the view that China and India will save Australia from the fallout from the housing and loans crisis in the USA. Our research suggests that about 15 per cent of China's GDP results from exports to the USA. Falling home prices and the massive decline in the world value of the $US, mean that the value of Chinese exports to the USA is likely to fall. At the same time, the UK housing market has the wobbles, which will further reduce demand for Chinese exports. At the same time, the Chinese Government has begun to implement measures to assist in containing inflation. We believe these factors signal a slowing in economic growth in China and therefore reduced demand for Australian commodity exports.

This is very dangerous for our resources companies, and the companies supplying them. Already costs are through the roof, and the labour market is tight (this week, our babysitter asked for a reference so she could drive a truck at a mine – the kids are fine, so I guess she'll look after the trucks well too!). Any fall in commodity pricing or volumes will crucify mining industry profits. The past few months have seen a large number of profit downgrades made by a variety of companies, and we expect them to respond with lay-offs, and reductions in capital expenditure.

In the US, the loans crisis is already costing jobs in the building, and financial industries. Banks globally will not lend to each other, mainly because they are concerned as to the volume of bad loans each other might be carrying (its more complicated than that – but that's the simple explanation) Citigroup, UBS and others have already taken huge write-down on their loan books, and the debt markets will not recover until all of that flushes through the system – that is, a lot more financial institutions will have to come clean.

Effect on your portfolio

The current market is probably the most difficult I have ever dealt with. On one hand, investors see the All-ordinaries performing strongly; on the other they wonder why their portfolios may not reflect these gains.

As at December 1st, the sharemarket was up by about 14 per cent for the calendar year. This overall gain, masks a number of important points. First, if you strip out the influence of BHP-Billiton, the index is only up 7.6 per cent. If you take out BHO, RIO and Fortescue (which is not even operating a mine yet), the return is only 4.7 per cent. The narrowing of focus on stocks in the index is often the precursor to a downturn.

Second, our view is that resources stocks are not a generally sound portfolio investment for people using the money to provide for their retirement. They pay next to no dividend, and they are too volatile. People with longer memories might remember that the reason BHP is now BHP-Billiton, is that in the last down-cycle, it nearly went broke.

CIPL's focus is on income generating investments, with a good track record, or with substantial security. In the current environment of increasing interest rates, these investments have not performed well compared to the market as a whole. On the other hand, their cash flow generating ability has remained strong, and generally speaking our portfolios have avoided the recent rash of profit warnings. Our policy is that the cash generating ability of the portfolio is more important than day to day movements in the overall value of the portfolio. Cash flows can be used to pay superannuation pensions and to make additional investments, without selling assets. Capital gains are nice but they cannot be used in that way.

Our view is that the Australian economy will begin to soften throughout 2008. If that happens CIPL's conservative, cash flow focused portfolios will again be in favour, probably resulting in substantial capital gains.

Since inception, our portfolios have on average returned about 12 per cent per annum. There is no reason to believe that this will not continue to be the case, but right now for the firs time in 7 years, we are underperforming. We are reviewing all portfolios to make sure they are well positioned to deal with further volatility, and eventually more normal economic conditions.

Investment Briefs

Here are some trading ideas for non-portfolio clients:

Watpac Limited (WTP)
A Queensland based construction company, focused on building construction, refurbishment and property development. Projects cover sporting complexes, hospitals, universities, retirement villages, shopping centres and residential housing. Subsidiary Kaybuilt Pty Ltd, is involved in smaller fit-out projects, with recent acquisitions enabling expansion into NSW and Victoria. Management is forecasting profit for 2007/08 of $39.8 million, up 46 per cent on PCP. Brokers suggest a valuation of $5.96 compared with the current price of $4.81.

A.P. Eagers Limited (APE)
Eagers is Australia's largest listed automotive retail group and operates dealerships in Brisbane, Darwin and Newcastle. The dealerships provide sales service parts and finance across more than 18 brands, including Holden, Ford and Toyota. Growth arising from volume and efficiency gains totalled 40 per cent for 2006/07, while acquisitions (including Kloster Motor Group, Surf City Holden and a stake in Adtrans,) contributed 60 per cent. All up, Eagers have projected a 654 per cent increase in net Profit before tax for full year 2007/08. The price target is $18.26 against a current share price of $16.00.

Western Areas N.L. (WSA)
Western Areas is a minerals exploration and development company, focusing mainly on nickel deposits. The flying fox project in the Forrestania area contains reserves of 1.16mt of 5.6 per cent Ni and is in production. Three other projects, Diggers South, Cosmic Boy and Copper Hills have resources aggregating 211,000 tonnes. The ramp-up to full production at flying fox is going smoothly and is the key to the near-term performance of the stock. The market looks forward to further drill results and resource updates. Analysts value the stock at $6.55 compared with a current price of $5.89.

You are advised to seek advice regarding your particular situation before acting on anything contained herein.

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