Investment Market Update

Message from the Manager

We have been running client seminars over the past couple of weeks – two in Melbourne and one in Rockhampton. Almost 100 people came to hear about the outlook for the Australian economy and what that meant for Government finances and the investment outlook. We discussed the role of changes in the banking system and why some of these changes are likely to increase rather than reduce volatility in financial markets. These factors are at the forefront of our minds in recommending the way your portfolios should be run.

It's not a perfect science, but on average our results have been very pleasing. Evidence of just how pleasing was shared with me by one client who pulled me aside to say that, when he started investing through CIPL in 2002, he felt he may not have had enough money to retire on. The actual outcome is that despite pulling a superannuation pension, he and his wife currently have a portfolio value greater than they started with. Of course there are many factors that influence such an outcome, but one very important one is sticking to our tried and tested methods of investment.

It's been a very busy quarter, with tax reports, client seminars and market volatility to attend to. In this newsletter we have devoted a fair bit of space to the origins and expectation for the recent market volatility, it's quite detailed, but we hope that persevering through it will help illuminate this complex matter.

I hope you enjoy the read.
David French
Managing Director

Volatility

Volatility is with us again. During October share markets sold off both in Australia and abroad. The Australian market fell by more than 8 per cent, following the US market, which fell by a similar amount. Once again, news organisations revelled in wheeling out emotive language when describing the falls.

Volatility in markets is nothing new, and managing it is one of the key tasks/considerations of first, the CIPL Investment Committee and second, clients' individual advisers. To manage volatility you have to understand its roots, and ideally, pre-empt it.

Reasons for the recent bout of volatility are varied, and include slow economic growth in Europe and various geopolitical concerns including Russia and the Ukraine, Ebola and the Middle East. Mostly though it is a result of the expected resetting of US monetary policy. For all the talk of the winding back of QE2 (Quantitative Easing, second tranch), it seems to us that many commentators do not understand what this really means. Let me try and explain.

Like the Reserve Bank of Australia (RBA), in the USA it is the role of the Federal Reserve (the Fed) to set the level of "reference" interest rates in that economy. The reference interest rate is very important in economics and finance because it is the rate offered for lending by the Fed, and it is effectively the basis/benchmark against which all other interest rates are set. The lower this rate is, the more money circulating in the economy, and generally speaking, the lower the rates offered by all lending institutions. In the US at present, the "reference rate" is zero – any lower and The Fed would be paying you to borrow!

The way the press talks, you would think that the economists at the RBA and the Fed, wake up in the morning and dictate rates. What actually happens is that The Fed must "operate" in financial markets, buying or selling enough bonds so that the rate approximates the desired rate. You can read announcements by these organisations on-line. For example, the RBA might say, "from 4 November the RBA will operate in the market to set rates at 2.5 per cent". By "operating in the market" the RBA means it will be buying or selling bonds, the supply and demand of which determines the level of interest rates. The more bonds the RBA buys, the higher the price of the bond, and the lower are interest rates. Since the RBA has to pay cash to buy bonds, that means more and more cash circulating in the economy – hence the term "easy monetary policy". In America, The Federal Reserve has bought so many bonds (from banks and from the Government) that it is no longer prepared to pay interest to the issuer.

But what if the Fed is fearful that, notwithstanding a zero level of interest rates, the US economy will still go into recession? How can it get more cash into the economy, if no interest is payable on the bonds being issued? The strategy undertaken by the Fed has been to simply print more money. Known as Quantitative Easing (QE), it's what you do when the price of money (interest) is already zero. Theoretically the effect is no different from reducing rates further – which would mean paying borrowers to take money from The Fed.

To summarise, QE involves The Fed purchasing government or other securities in an effort to bring down interest rates and increase the money supply (which firms and individuals can then spend). This mechanism aims to entice investment into both equity markets (because returns elsewhere are zero) and back into business investment that will in turn encourage jobs growth. The US Federal Reserve began its first stage of QE back in November 2008 in the wake of the Global Financial Crisis and from late last year has begun to wind back this programme.

QE has acted to help mitigate recessionary threats and consequently has kept levels of volatility in equity markets lower than they otherwise would have been. The expected winding back of QE therefore raises concerns that US economic growth may slow. Since economic growth is closely linked to business profitability, investors do not like that prospect.

While these are legitimate concerns, in our view, they do not capture the whole picture. First, The Fed will not reduce QE/raise interest rates, unless it considered that such a strategy would not unduly affect economic growth. Second, reducing QE and raising interest rates would strengthen the world value of the $US. That would mean US consumers and businesses would increase the level of goods imported from Europe – helping that region out of the doldrums. Taking a "big picture" point of view, US economic growth would be less than otherwise, but European growth would be greater, and the net effect on world growth may well be positive. This is our long-term expectation.

In the short term however, very low levels of interest rates/QE policy has acted to push up the price of Government bonds and consequently drive down yields. This significant compression in yield has meant that investors have sought out income in higher yielding companies such as our banks and Telstra (to name a few). The expectation that interest rates will eventually begin to rise has caused higher yielding equities to sell off, hence the volatility (similar to what is mentioned above, this is because – all other things being equal - you could earn greater returns elsewhere with less risk).

As investment managers it is important that we abide by our well defined strategy throughout any economic or market cycle. Our investment process is based on buying the highest quality companies that we can access preferably at a discount to intrinsic valuations. The best time to be doing this is generally when markets are selling off.

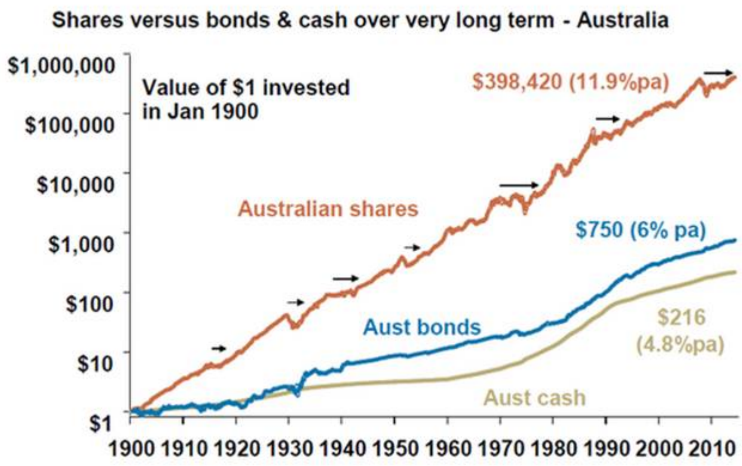
Managing client portfolios is as much about reducing volatility as it is about looking for the best returns. We seek to achieve reduced volatility through the cycle by:

- Investing predominately in low beta companies (companies that exhibit lower volatility than the broader market), both directly and through managed funds
- Including various asset classes such as fixed interest (generally through managed funds)
- Trying to ensure that clients' income needs are, to the extent possible, funded by dividends and interest payments, rather than relying on the expectation of capital gains (this is very different from the philosophy of most fund managers)
- Making strategic investments when stocks are out of favour (lowering the average cost base of the asset and increasing yield)
- Furthermore, the Capricorn Diversified Investment Fund offers another way to reduce portfolio volatility by providing exposure to assets that are predominantly not directly exposed to volatile investment markets.

In summary, we are cognisant of the impact volatility has on the day to day value of client portfolios, and as a consequence clients' feelings of security. However, the unwinding of QE is quite appropriate in light of strongly positive economic data flowing from the US. Overall, equities have a remarkably good track record of compounding returns (11.9 per cent inclusive of dividends since 1900*) offering a source of wealth creation for investors. As a result, we will therefore continue to adhere to our investment process regardless of day to day stock market fluctuations.

*AMP Capital Note (Oliver's Insights)

David French, Owen Evans, Lachlan McKenzie-McHarg



Christmas

Office opening hours over Christmas

All of our offices in Rockhampton, Melbourne and Sydney will be **closed over the Christmas period from Monday 22nd December reopening on Monday 5th January 2015.**

All recommendations will need to be approved by Monday 15th December to account for processing and any funds transfers will need to be submitted before the cut-off date of Friday 19th December 2014 in order to be processed before our shut down period.

Insurance

Are your retirement plans safe?

If you're approaching retirement, you may be wondering how life is going to treat you on the health and financial fronts. These can be challenging times in themselves, as we all know from recent times.

However, if something happened to your son or daughter and they weren't insured, you'd want to make sure your children and grandchildren were looked after financially, whether you became the legal guardian or played a supportive role.

Raising children is expensive. It is estimated to cost $800,000 to raise two children from birth to age 21. This does not allow for private education but would certainly put a serious dent in your retirement nest-egg.

By investing in Life, Total & Permanent Disability, Trauma and Income Protection insurance your adult child can ease the financial pressure of raising their children. Or, you could pay for your children's premiums if they are not in a position to do it themselves. This would mean that your focus could be on providing emotional support and family structure to stabilize your grandchildren's home life during a family trauma.

Premium amounts vary according to age, gender, occupation, smoker status and health. Best of all, they are affordable. For example, to insure a female, age 28, non-smoker, professional for $500,000 of Life and TPD cover it would cost approximately $400.00 per annum or $33 a month - a small price to pay for family security.

Taking out protection at a young age ensures protection for the long-term. Whilst still young and healthy there is less chance of premium loadings and exclusions being applied to cover as a result of health issues.

So take the time with family to talk about your children's financial obligations because if your adult children haven't planned ahead, there could be serious financial pressure on your retirement funds. You owe it to yourself and your grandchildren to start the conversation as soon as possible.

Morgen Harris
National Risk Protection Adviser

Financial Planning

Changes to assessment of Superannuation account based income streams

From 1 January 2015 deeming rules will be applied to superannuation income stream products such as account based pensions where they are set up after that date.

It <u>will not</u> affect you if:

You are in receipt of a Centrelink benefit prior to 1 January 2015;

And

You receive an income stream from superannuation that was established prior to 1 January 2015.

It <u>will</u> affect you if:

You begin to receive a Centrelink benefit after 1 January 2015

And

You commence an income stream from superannuation after 1 January 2015

Or

Your superannuation income stream is fully commuted and a new income stream is commenced.

An example is shown in the table below right, based on an income stream recipient with a life expectancy of 17.7, drawing the minimum of 5% for the year and no other financial assets. Under the new rules, this couple would each lose approximately $12/fortnight from their Centrelink benefit.

Pension balance	285,377
Amount drawn	14,270
Deductible amount	20,597
Deemed income	8,794
Pension under old rules	644
Pension under new rules	632

Your adviser will be checking existing income streams and will be checking to see if people who are not currently in receipt of an income stream from superannuation should have one established prior to the end of this calendar year. Don't hesitate to contact your adviser if you have any questions or concerns.

Sue Dunne
Senior Adviser

Client Focus

Highlights from a French Adventure

Travelling by Eurostar from London we arrived in Paris late afternoon. After a short taxi ride from the station we moved into our apartment located on a cobbled street in the Marais district of Paris. Le Marais neighbourhood is one of the oldest districts of Paris with narrow cobbled streets lined with 17C mansions restored into residences, apartments and museums. It is a thriving community of restaurants, trendy boutiques and antique shops. Metro stations were very close by and this allowed us to easily explore Paris. The first morning we were awoken by the chatter and laughter of children walking to school, delivery trucks and street cleaners. Our apartment was centrally located with Notre Dame Cathedral only a few minutes' walk, as was Place des Vosges, a beautiful historic square displaying a rich architectural history of Paris and lined with museums and restaurants.

Each day was filled with adventures that provided wonderful experiences visiting the sights around Paris. At night our street came alive with tourists and locals heading out to the numerous bars and restaurants.

We would recommend apartment living as a wonderful way to experience the Parisian lifestyle.

The Somme battlefields were next on our agenda. A journey back in history to a place that claimed the lives of 150,000 soldiers from Britain and the Commonwealth in WW1. We visited the Australian National Memorial near Villers-Bretonneux, a memorial commemorating 10,773 Australian soldiers killed with no known grave on the Western Front during WW1. The journey through the Somme visiting Le Hamel, Peronne and The Thiepval Memorial to the missing of the Somme was extremely emotional. It was difficult to comprehend how such a peaceful beautiful French countryside was such a place of bloodshed and tragedy for thousands of soldiers. The stories of the battles, the viewing of the trenches and the discovery of a relative's grave moved many of us to tears. The cemeteries were numerous down many a quiet country road through peaceful villages and in unexpected places, but all impeccably maintained.

1 Villers-Bretonneux Cemetery

"For our tomorrow they gave their today"

Memorials dedicated to the Australian forces were scattered throughout the area with the most moving being the Bullecourt Digger statue and "cobber" memorial.

Figure 2 Cobbers Memorial near Bullecourt

Our travels continued visiting the WW2 D-Day landing on the Normandy Coast and many locations around that area. What a different war it was with tanks, planes and other weapons involved.

The beautiful Loire Valley, land of vineyards, rolling green hills and Châteaux, the most spectacular of all the Chateau de Chenonceau, were next on our agenda.

Finally our holiday was completed with a river boat cruise down the Saone River. We left France with wonderful memories and vowed to return very soon.

Noeleen Bieske & John MaGrath
Melbourne Clients

Investment Briefs

medibank
For Better Health

It is hard to escape what is set to be the second largest listing by the Australian Federal Government since the float of Telstra back in 1997. As a firm we have taken a very close look at the Medibank prospectus and have formed a favourable view of the company. Healthcare is a significant component of the Australian GDP weighing in at 9.7% in 2013. Furthermore, Private Healthcare Insurance (PHI) which forms the main portion of Medibank's earnings (circa 90%) has grown at a very healthy compound annual growth rate (CAGR) of 8.6% for the last decade. This is significant when you compare it to nominal GDP CAGR which has averaged 6.6% - a huge 30% differential.

Healthcare expenditure is becoming increasingly burdensome for Governments as the population ages and the requirement for treatments increases. As a result, we have witnessed bipartisan support for policies incentivising the take up of PHI. Medibank is currently the largest player in the PHI industry with market share recorded at close to 30%. In an industry that rewards scale through pricing efficiencies Medibank's scale is an advantage.

However, there are limitations to pricing premiums as the scale of regular price increases are dictated by the Federal Government. Another factor known as 'risk-equalisation' causes PHI providers to effectively share the risk burden of policy holders equally. This places limitations on the potential upside in pricing meaning that margin gains predominately need to be made through cost efficiencies. It does mean that the industry has utility-like characteristics which suggest Medibank should trade with low volatility characteristics, something we look for in equities investments. We believe efficiency gains will be made by Medibank once in public ownership and the company will be placed on our internal Approved Product List.

PIMCO

On the morning of Friday the 26th of September, we woke up to news that Bill Gross had departed Pacific Investment Management Company (PIMCO). PIMCO is a US based global investment management organisation focused on the bond market. The news was significant as Gross helped establish PIMCO some 43 years ago and many considered Gross synonymous with bond markets.

Reasons for Gross' departure are blurred. However, as investment managers ourselves it was important to quantify the implications of his departure. We currently invest through the PIMCO Diversified Fixed Interest Fund (a combination of international and domestic bond investments) and as a result took a keen interest in happenings at PIMCO in the aftermath of Gross's departure. Following extensive correspondence with the firm it appears for all intents and purposes it is broadly business as usual. Gross' influence on the Diversified Fixed Interest Fund appears minimal and PIMCO's overarching investment strategy has been maintained.

Bond markets themselves have been involved in a significant bull market assisted more recently by the $3 trillion Quantitative Easing programmes by the US Federal Reserve. As a result of this, the consensus expectation is that interest rates will 'normalise' (move back to rates seen prior to the GFC) over the medium term. In this environment, the price of bonds will be affected to the downside especially those with a long duration (long period until the bond matures). Because of this, certain fund managers are positioning portfolios to be 'short duration' (collective duration period of the portfolio). PIMCO on the other hand believe in a 'new normal' whereby they believe due to a number of reasons that interest rates will remain suppressed for longer. PIMCO have positioned their portfolio slightly longer in duration than a number of other bond funds on our Approved Product List which has enabled the fund to collect a higher income distribution.

We will continue to watch the situation play out at PIMCO due to the significance of Gross. However, we are comfortable with a PIMCO without Gross due to the developed investment culture at the organisation and PIMCO's strong track record of delivering returns to investors.

We have not been adding to existing CBA positions for some time in portfolios. However, we will revisit this position when we once again see value emerging.

bhpbilliton

Over the last decade we have all taken a keen interest in the price of iron ore due to it forming an important part of our economy. We have seen the price of iron ore compound at a phenomenal 30% growth rate from $13 in February 2001 to a peak of $187.18 in February 2011. Since this point, iron ore has sold off by 56% to a current spot price of $82. This has caused bankruptcies in some parts of the iron ore market and throbbing headaches in others.

The declining iron ore price can be attributed to a number of reasons. Primarily, due to an elevated spot price for some time this has caused a massive influx of supply on to the market which has acted to suppress the price.

Secondly, demand emanating out of key nations such as China has slowed. In fact steel demand shrunk for the first time in 14 years in September.

This decline has impacted our preferred resources company BHP Billiton (BHP) causing its share price to decline by 32% since its highs in 2011. However, we see value returning to the company now as it undergoes a significant shift in strategy transitioning from a capex investment phase to an efficiency and capital management phase. Furthermore, due to BHP's scale and efficient mining techniques it is comfortably positioned in the lower cost quartile meaning it can ride out the current lower price of iron ore. Iron ore contributed 52% of BHP's earnings in FY14.

We are continually looking for companies exhibiting value with a degree of margin of safety. Similar to our Woodside Petroleum (WPL) 'ex-CAPEX' strategy recently we see parallels with BHP. There is the likelihood that an imminent growth in free cash flows will flow through to capital returns predominately in the form of dividends. Sometimes it can be difficult as portfolio managers to buy when others are selling however we believe this strategy is integral to longer term investment success.

Lachlan McKenzie-McHarg
Adviser Equities Dealings and Research

Client Services Update

Welcome, farewell and position changes

Our team would like to warmly welcome Jo Grosskopf - Receptionist/ Administration Officer in the Rockhampton office and Michael Azzato – Manager, Client Service & Implementation in the Melbourne Office as our newest members of the CIPL / Pentad team. A big welcome to Raina Poddar and E-Lynne Yeong who commenced work in our Melbourne office as Assistant Client Service Officers on a casual basis.

We farewell Ken Maher who was part of the Melbourne team for approximately 9 years and wish him well in his future endeavours.

Congratulations to Josh Scipione who is our newest Financial Adviser and Supriya Kamat who is moving into the role of Portfolio Manager.

Reporting

Delay with taxation reports

There has been a requirement by the ATO for the provision of certain additional information in our reporting that we have not been required to submit previously. This has taken up considerable time and effort but is now complete and the final checks are currently being carried out.

We apologise for the time taken in getting your reports to you however much of the delay has been due to circumstances outside of our control.

If you have any questions in relation to your contact information, the client portal, review scheduling or reporting, please call the office on free call 1800 679 000.

Rose Sladden
Client Services Manager

Our offices Rockhampton / Melbourne / Sydney

Rockhampton – 1800 679 000 or enquiries@capinvest.com.au

David French	Managing Director
Sue Dunne	Senior Financial Adviser
Bob Stewart	Senior Financial Adviser (Equities Dealings)
Jo Grosskopf	Receptionist/Administration Officer
Rose Sladden	Client Services Manager
Jane Eklund	Compliance Manager
Kevin Piche	Consultant / Analyst
Bronwyn Nunn	CHESS Administrator
Kathy Donaghey	Portfolio Administrator
Amy Gill	Technical Support Officer
Christine King	Bookkeeper
Sandra French	Bookkeeper

Melbourne – 03 9813 0133 or clientinfo@pentad.com.au

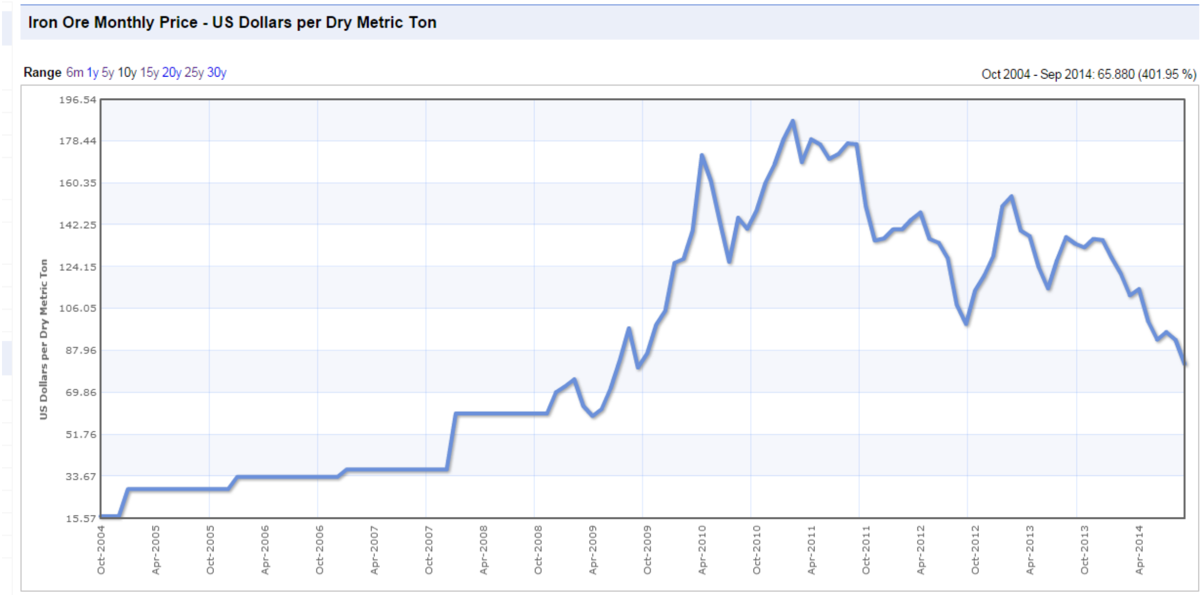
Russell Warmington	Senior Financial Adviser
Chris Heyworth	Senior Financial Adviser
Lance Livermore	Senior Financial Adviser
Robert Syben	Senior Financial Adviser
John Robson	Senior Financial Adviser
Joshua Scipione	Financial Adviser / Client Support
Morgen Harris	National Risk Protection Adviser
Lachlan McKenzie-McHarg *(Melb)*	Adviser Equities Dealing and Research
Ming Hou *(Melb)*	IT Manager
Michael Azzato	Manager – Client Service & Implementation
Supriya Kamat	Portfolio Manager
Paul Young	Senior Paraplanner
Michael Roberts	Paraplanner
Stephen Coniglione	Investment Research Officer
Raina Poddar	Assistant Client Services Officer
E-Lynne Yeong	Assistant Client Services Officer
Jaben Heyworth	Client Support
Janice Vass	Reception / Administration
Rebecca Gough	Administration Assistant

Sydney – Business Consulting
0419 394 397 – roger_cameron@capinvest.com

Roger Cameron	Senior Consultant
Alex Evans	Consultant

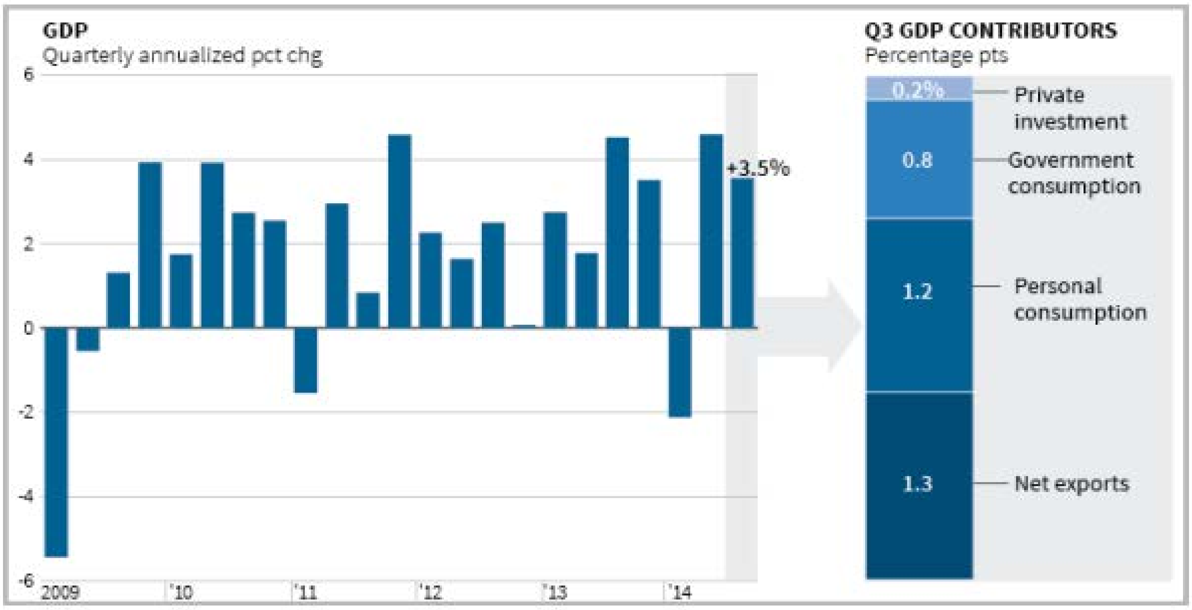
CHART PACK *Information at a glance*

Iron ore coming back to earth



Source: Indexmundi
Since its 2011 peak, iron ore has fallen sharply in two stages (February 2011 – September 2012 & February 2013 to today).

US economic growth rebounding strongly



Source: Reuters (Inside Debt)
After a brief dip in the first quarter of 2014, the US economy has hit its straps once again and is growing at a respectable rate.

CHART PACK *Information at a glance*

<u>January 2013</u>

<u>Has the gold bug finished?</u>

Gold is in a perilous position. The risk-on proxy may have reached its peak.

<u>November 2014</u>

Gold has continued lower after we made our last update in January 2013. We don't think the move lower has finished and as a result have avoided the sector entirely.

The content of the newsletter constitutes general advice and does not take into account your particular needs. Please seek appropriate advice before acting on anything contained herein.

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the Pentad Group
Lifestyle through strategic financial management

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