Investment Market Update

Issue 47 – Winter 2012

Market update

The last five weeks have seen markets take on a more positive demeanour. Throughout this volatility we have been taking care to manage portfolios for both income and growth, and results have generally been pleasing.

We enjoy our regular meetings with clients but it can be difficult to get through all of the relevant material as well as convey the deeper thoughts that drive not only how we manage your assets, but also how we run CIPL. In this edition I have taken some time to explain some of these matters, and I hope this will provide useful background.

You will also see that we have made some changes to the way the business operates, which we expect will provide significant near-term benefits. We have also included sections on...

- Changing times
- Business Update
- Insurance
- Federal Budget

Over the year we have taken on board many client suggestions and criticisms, and very often these have contributed to better outcomes for all clients. We are always receptive to your feedback, so don't hesitate to contact us if you wish to raise something.

David French
Managing Director
Senior Investment Advisor

Back to the future?

Changing with the times

In a recent podcast by Radio National, the speakers explored whether after a natural disaster like a big cyclone, things really do go "back to normal". The fact is that despite intensive rebuilding efforts things are not the same. People's feelings are different and the buildings that have been rebuilt are likely more modern. Some people, distressed to the core, leave the community and others introduced through the rebuilding and assistance efforts stay. It's probably true to say that while the community has the same name, what that name stands for is different.

As one of the few practitioners who set up a "fee for service" financial planning business in the early 2000's, it's clear that managed funds have not been top of my mind. So why spend time and resources setting up the Capricorn Diversified Investment Fund? To some, it seems downright heretical to suggest that a fee for service financial planner would even contemplate setting up a managed fund. But CDIF is different. It does not charge entry or exit fees, and its management expense ratio is not much different from having money managed in a CIPL portfolio. Suspicious critics ask, "well, why do it?" The answer is that the GFC has taught us that simple portfolios of listed investments are just not diversified. Let me go into this in some detail.

For almost five years we have been weathering the effects of the GFC. Just when things seem to be on the mend, something else comes out of the woodwork – the US was showing signs of life and then the Japanese earthquake hit. Not long after, the troubles in Europe really set in. These matters take up a lot of our thinking time, and now it seems there may be some real understanding of what went on over the period 2007 to 2009, and the legacy that it leaves. These insights put us in a much better position to manage your financial affairs.

Background

Since before the GFC, markets have become very unstable. There are lots of well-known reasons for that, some of which include easy monetary policy (cheap debt), and the quasi-westernisation of countries like China. These are pervasive factors that in one way or another, affect all asset classes. Because they are easily grasped, reporting of their effects is pervasive, and the negative aspects of it have led to a "run for the door" approach. With big institutions holding so much stock, en-masse redemptions from big funds concentrate selling pressure across a few stocks. In effect the baby gets thrown out with the bathwater. The resulting swings in asset values have created a general mistrust of markets, probably best typified by Kevin Rudd's 2009 essay.

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While it is tempting to look on this as just a "phase" or part of a normal cycle, the interesting point is that it is not caused by just the effects of the GFC on the US and Europe, but by a whole range of other issues that don't make the front page. Arguably the most damaging was the trashing of the balance sheets of financial institutions. This was compounded by accounting changes that I believe are grossly flawed, and changes in the very way markets operate. The ensuing volatility might continue indefinitely.

The trashing

Underlying a bank's operation is a Capital Reserve Ratio (CRR). Banks are amongst the most highly leveraged of all businesses. Capital reserves are closely monitored by organisations such as the Australian Prudential Regulatory Authority. As a rough guide, a bank has to keep 10 cents in reserves for every $1.00 it lends and if the value of those reserves shrink (money is lost through making poor investments for example), then the bank either has to find replacement reserves or bring in loans. Bringing in loans might mean calling back loans directly, or simply not lending out as much. The damage wreaked by the GFC trashed the balance sheets of many banks, compromising their ability to lend and to grow lending volumes.

Mark to market rules

Mark to market accounting is a construct that requires assets carried in a firm's balance sheet to be recorded at the prevailing market price. If there is no market price, then financial math is used to approximate a market price.

The adoption of "mark to market" has had a terrible effect on the balance sheets of financial institutions. Once a known quantity, now the assets in those balance sheets are adjusted according to market conditions – with volatile markets they jump all over the place. Since the amount that banks can lend is directly related to its Capital Reserve Ratio, regular and rapid movements in asset values mean that banks have to reduce lending to cope with worst case situations. One way they do this is to hold government bonds or other "risk-free" instruments. This behaviour reduces available funds, and therefore economic growth, and increases market volatility.

Illiquid markets

The simplicity of "mark-to-market" is seductive. All it is saying is that instead of using valuations made up by "dodgy directors" (there is some substance in that - Enron is a great example), we will take a purist approach and use observable prices. This simplicity however, overshadows other serious problems. Economics 101 teaches that for price to reflect value a market needs lots of buyers and sellers and they must be well informed. This idea is a core tenet of the Efficient Markets Hypothesis, which underlies the valuation of most financial instruments. The trouble is the Efficient Markets Hypothesis is just that – a hypothesis. It was developed by Eugene Fama of the Chicago Business School, and it basically says that if there are lots of buyers and sellers in a market, and those market participants have perfect information, then you can expect price to equal value and in effect, not bother researching further. Studies around the efficiency of markets have typically been inconclusive, but over the past few years, factors have come to light to suggest that markets might be becoming less efficient, and that the basic conditions of the EMH are not fulfilled.

Volumes of shares traded through markets collapsed, even before the GFC set in. Not only has this been caused by a lack of interest, proportionally less trades are being executed through traditional markets (such as the Australian Stock Exchange). The ASX estimates that 40% of all trades are done "off market". The absence of buyers and sellers on the ASX creates a smaller market and consequently greater volatility.

Further, many trades that are executed through the ASX are done by computers. Those trades are executed automatically via pre-programmed rules. The ASX estimates that about 30 per cent of all off market trades are done in this manner. Large trades like this hit a smaller, less liquid market, where many companies are facing recessionary conditions and that causes large price movements, often unrelated to the value of the underlying stock.

And as noted previously, massive institutional holdings and the use of leverage concentrate selling pressure on those stocks held by institutions that face redemptions.

Baby-boomers doing it again

There is a fair bit of evidence to suggest that it is demographics that underlies asset price movements. This makes sense because once we look beyond the machines, computers and factories; it is people that are at the end of demand and supply of goods and services. The collective attitudes of people have a big effect on the state of the economy and on markets in particular.

However, while baby boomers and their policy decisions drove the oil-price hikes of the 1970's, the share market bubble of the 1980's, and the property boom of the late 1990's, the market trashing of the late 2000's may not have been of the baby boomers' doing. More likely it was more to do with the structural changes in markets discussed previously, and in particular institutions with leverage (using derivatives or by borrowing stock) operating in markets with less than perfect information.

The fall-out from this, blind-sided baby-boomers, who are nearing retirement. Far from the free-spirits of the 1960's the largest demographic in western society is staying in work longer, saving, not spending, and staying away from anything that looks remotely risky. Across the globe, this last is evidenced by the plethora of rules designed to eliminate even the slightest of risks. In short, baby-boomers are hunkering down.

What role does education play?

If that's not enough to convince readers that times have changed, then let's consider the mechanisms available to correct errors of thinking in our society. Since the mid 1980's, massive changes have affected the way western education is delivered. Prior to that period the focus was on a liberal education, often across a number of disciplines. With few exceptions, universities were about teaching people to think, while colleges of advanced education and institutes of technology taught people how to "do". In Australia, the Dawkins reforms of the 1980's saw the different tiers of tertiary education merged, and with few exceptions the focus is now on careers and outcomes, rather than thinking and understanding. This means that society is losing cross-disciplinary capability and in my opinion that is having a direct effect on financial markets.

If this is not true, then why didn't economists, statisticians, and finance gurus bring the inherent flaws in Collateralised Debt Obligations (the main offending instrument behind the GFC), to the attention of the regulators? And why did "mark-to-market" become so widely accepted when it also has flaws with damaging real-world affects?

Summary

While I am not one to say the "Sky is Falling" I do think we have entered a new era. It's easy to "Pooh, Pooh" a sweeping statement like that, but the fact is things are always changing. There are people 100 years old, who would have been amazed that we can now fly round the world at the drop of a hat. Only 70 years ago people were routinely dying of diseases that are now curable at home by taking just a few pills. Twenty years ago collection of census data meant spending hours going to the ABS offices in Sydney and copying reams and reams of data - now it's all available on-line, often for free. And in the last 10 years, stockbroking and investment has become the domain of all.

We should expect things to change, and we should work hard to assess the consequences of that change. Those of us charged with looking after the welfare of others are tasked with putting measures in place that adapt our work to meet new challenges and to get the best outcome for our clients. The change we are facing now is the global institutionalisation of markets, in an environment where those institutions set the rules. It's an environment where money is made from volatility (consider whether the current Barclay's LIBOR scandal would even be possible if markets were efficient).

With all that as background, the Capricorn Diversified Investment Fund is just a tool. The net financial benefit to CIPL is nil, but the fund gives clients access to bonds, commercial property infrastructure and special situations. This represents true diversification and less volatility.

When I set up CIPL in an era of commissions, I was scorned for building a fee for service business. Now all financial planners have to become fee for service. People require diversification and they want to know who is managing their money. Within 10 years, all the better financial planning groups will have their own managed fund too.

David French
Managing Director CIPL

Business Update

With what I have written above regarding markets, it follows that we are not operating in a "set and forget" environment. A couple of years ago we formalised Bob's share trading role by hiring Lachlan to assist. Their efforts have had definite and observable positive impacts on portfolio performance. It also freed up time for Sue and myself to attend to other value adding measures for clients. We invested a large amount of money into building CDIF, which is already showing positive returns and lowering volatility for many clients.

Now we are reviewing our investment committee. The main change is the joint appointment of Michael Peet and Owen Evans to head up the committee. It is something of a coup to get Owen and Michael on board. Owen has been rated between #1 and #3 for the sectors he researched at various times over the past 17 years, and was fund manager of the year in 2002 and 2006. Michael has been in investment research for about 18 years, recently as vice president for Alliance Bernstein and as a director at UBS. Hugely well connected and with markets in their blood they have taken a big interest in this task, and for clients even better results are sure to follow.

Following several months of negotiation, we have appointed Michael Blanchflower as Head of Strategy. Michael built his own financial services business in Sydney and will share many of the day to day tasks of running the business, as well as looking after some of the bigger ticket items that can, from time to time be a distraction. That combined with the efforts of Chris O'Brien has meant that more and more of my day is dedicated to looking after client's affairs – which was the whole idea in the beginning. While I don't see clients as much as I used to, most written work is still vetted by me, and anything difficult usually gets resolved through a discussion between myself and other advisors. The hands-on philosophy of the firm means it is really important that advisors have the time and tools to attend to client's affairs and Michael brings a mixture of youth, skills and industry experience that is bound to show wide-ranging benefits.

CIPL's client work has presented some interesting aspects, quite a large number of new clients have attended meetings and some have contributed welcome testimonials for CIPL. We are helping one client establish a portfolio of gold investments (at his request), and helping another with an analysis of a property project he is involved in. Many clients have Telstra shares and will soon be receiving advice to sell some of their holding. We have had a target price of $4.00 on Telstra, and notwithstanding its great yield, we are concerned that its sale of infrastructure to the NBN (for which it will get $12 billion or so) is going to leave the company in a weakened competitive position. It is only because we have the Portfolio System that we can act quickly on such opportunities.

We have also had the fortune to be asked to participate in some interesting major projects. Currently we are assisting with the Economic Impact Assessment of a coal loader at the mouth of the Fitzroy River, advising a company establishing a staff share plan, doing book-keeping for a number of complex firms, and assisting with the recapitalisation of a rapidly growing consultancy in Western Australia, and helping the owner of a dental laboratory with a succession plan.

Insurance Matters

Death Benefit Pensions

Life Insurance gives you the financial strength to support you or your family through their most difficult times. During your lifetime there's a pretty good chance that you'll need a hand at some stage.

- 50,000 Australians have heart attacks every year. *Ref 1*
- One third of women and a quarter of men will suffer cancer at some stage in their lifetime – over 60% of whom will live longer than 5 years after diagnosis. *Ref 2*
- More than 43,000 people are expected to die from cancer in 2012. *Ref 3*
- Half of all men and a third of women will be diagnosed with cancer before age of 85. *Ref 4*
- Over 1,600 people die on Australian roads every year, most aged between 25-59. *Ref 5*
- One stroke event occurs in Australia every 12 minutes. *Ref 6*
- Just under half of the population with an arthritis-associated disability are aged 15-64. *Ref 7*
- With symptoms generally developing between ages 20-40, Multiple Sclerosis is the most common chronic central nervous system condition among young Australian adults. *Ref 8*

Having the right level of life, injury and illness insurance cover in place allows you to:

Preserve your family's lifestyle – Life, injury and illness insurance enables you to continue to make mortgage, rent and other payments that can help you to pay off your debt. More than this, it empowers you to keep on doing everyday things such as spending precious time with family and enjoying the other things you love.

Stay in control and enjoy freedom of choice – some of the biggest benefits of life, injury and illness insurance cannot be seen and touched. Having sufficient funds to be in control during difficult times and having the freedom to choose treatment and lifestyle options are priceless.

Reduce stress and take better care of yourself – suffering from a serious illness or overcoming the death of a family member can be made even more stressful if you're struggling to meet your financial commitments. Adequate insurance can reduce your stress so you can focus on your emotional or physical recovery.

1. *Heart Foundation, Australian facts 2004: Heart, strokes and Vascular diseases 2004)*
2. *Cancer Council: Cancer in Australia, an overview 2008 Australian Institute of Health and Welfare.*
3. *Cancer Council: Cancer in Australia, an overview 2008 Australian Institute of Health and Welfare.*
4. *Cancer council: Cancer in Australia, an overview 2008 Australian Institute of health and welfare.*
5. *Australian Government, road deaths Australia 2007*
6. *Australia's Health 2008, Australian Institute of Health and Welfare June 2008*
7. *Australia's health 2008, Australian Institute of Health and Welfare June 2008*
8. *Multiple Sclerosis – a $2 billion disease in Australia 'Media release by MS Australia.*

Source: One Path Life lines, issue 7, 2012.

Jason Fagg
Life Risk and Financial Advisor

Investment Briefs

Corporate actions for the June quarter

BHP: We have recently grappled with BHP as an investment. On the one hand the business is patently good value, trading on a forecast 2012 Price to Earnings multiple (PE) of 9.2x, a 2012 EV/EBITDA of 5.5x and not to mention a whopping 2011 17.2% free cash flow yield. But it is the free cash flow yield that is the contentious issue when making forecasts. BHP has been riding the perfect storm leading up to the GFC and for the recovery that ensued post 2009, with metals prices soaring to all time highs and energy components such as crude oil and thermal coal experiencing strong runs. But times have changed and BHP management are less optimistic about prices realised for at least the medium term. As a result, management have curbed Capital Expenditure (CAPEX) plans and are rethinking the Olympic Dam expansion whilst possibly curtailing the West Australia Outer Harbour iron ore project.

But the market will be wrong at some point and we may be looking back in a few years time lamenting the opportunity that was. Granted revenues will most likely fall away to a degree in the next few years but it appears the market has already factored this into the BHP share price. Interestingly management changed their rhetoric at a recent meeting stating their focus was not in the resources business but in the shareholder returns business. This bodes well for an increase in capital returns to shareholders, something that is long overdue. Regardless, BHP now trades on a not insubstantial fully franked 2011 dividend of 3.3%. Management have made some faux pas decisions recently such as the two large gas acquisitions in the United States and we would be a lot more satisfied if future free cash flows were allocated to either organic growth plans (Outer Harbour especially) or an increase in this dividend. However, there is a good case for making an investment in BHP at these low levels.

HSN: In uncertain times where growth is hard to find such as now, it is sometimes best to stick with companies that can deliver regardless of the economic conditions they are dealt. Due to reliable cash flow streams and defensive nature of their business such companies stand the test of time. One such company that has performed very well throughout the GFC and certainly qualifies is Hansen Technologies (HSN). HSN is a provider of utility billing for the gas, water and telecommunications sectors (all defensive in nature). However, it also is heavily involved with smart metering technology aimed at improving the efficiencies involved with the utility billing process.

HSN is a well managed company generating consistently strong operating cash flows and solid operating profits. The company has no debt, large (and growing) EBITDA margins (c35% in FY2011), a competitive dividend yield (6.5% in FY 2011) and a high return on equity (26% in 2011). Management are looking to capitalise on the increasing emphasis on efficiencies from the escalation of deregulation in global utilities sectors. HSN is also well placed to profit from the rollout of smart meter technology both in the United States and Australia and due to the high level of cash on its balance sheet is able to selectively seek out acquisitions to further broaden the company's earnings base. HSN is able to

forecast future cash flows with relative ease due to the 'stickiness' of customers because of the time taken and high costs involved with switching to competitors (HSN generates a high level of recurring revenue – c70%). HSN has been a beacon in the storm throughout the GFC to now, with its share price up by 171% against the broader market being down by 39% over the same period. We believe more growth is in store for HSN in the future.

TCL: Another company that should perform well regardless of economic conditions is Transurban Group (TCL). TCL is involved in the development and management of electronic toll roads. TCL owns the Melbourne CityLink and the Hills M2 in Sydney but also holds an interest in the Westlink M7, Eastern Distributor (M1), M4, M5 and Pocahontas 895 in the USA. The beauty of the TCL business model is the relatively predictable nature of traffic numbers and consequently cash flows to the business. TCL's flagship asset is the Melbourne Citylink toll road of which it holds a licence to operate until 2034. Citylink has been a success from the outset, with traffic numbers and Average Daily Revenue figures growing consistently and recently despite major upgrade works. Management are continually working on ways to grow earnings organically, such as a major upgrade of its part owned M5 South West Motorway in Sydney.

TCL is a standout income related stock due to its reliable growth in dividends and more importantly forecast 14% growth in dividends per share per year, an excellent return for the longer term investor. TCL provides an uncomplicated structure offering solid current free cash flows but more importantly forecast growth in free cash flows enabling management to pay higher dividends in the future. Furthermore, the company has already met a large portion of CAPEX requirements and the company successfully refinanced $375m of debt in December last year meaning no senior corporate debt matures until March 2014.

Lachlan McKenzie - McHarg
Equities Advisor & Dealer, and

Bob Stewart
Senior Advisor

Federal Budget 2012/13

Individuals

In delivering his budget for 2012/13 the Treasurer has projected a budget surplus, and has made changes to the tax thresholds and superannuation contribution limits.

Individual tax rates for this financial year are:

Taxable Income	Residents tax payable
$0 - $18,200	nil
$18,201 - $37,000	$0 + 19% > $18,200
$37,001 - $80,000	$3,572 + 32.5% > $37,000
$80,001 - $180,000	$17,547 + 37% > $80,000
$180,001 +	$54,547 + 45% > $180,000

For an individual who earns $45,000 per annum, this equates to a small tax cut of $878. The standard tax deduction that had been announced in the 2010/11 budget has been scrapped, along with the 50% discount for interest income on the first $1,000 of interest income which was due to commence at the beginning of the 2013/14 year.

The mature age worker tax offset has been phased out from 01/07/12 for taxpayers who were born on or after 01/07/1957, but will be maintained for taxpayers who are aged 55 years or older in 2011/12.

Several dependent offsets are to be consolidated into a single non-refundable tax offset from 01/07/12 and will only be available to taxpayers who maintain a dependent who is genuinely unable to work due to carer obligations. The medical expenses offset is to be means tested. For people with adjusted taxable income over $84,000 (single) and $168,000 (couple and families), the thresholds above which a taxpayer may claim an offset is increased to $5,000 and the rate of offset has been reduced to 10% of the excess over $5,000.

Businesses

The proposed reduction in company tax to 29% has been scrapped.

Companies conducting a business will be allowed to carry back losses to offset past profits and receive a refund of tax previously paid on that profit. Companies can carry back up to $1m worth of losses to get a refund of tax paid in the previous year, and from 01/07/13, companies will be able to carry by up to $1m worth of losses against the tax paid up to 2 years earlier.

Small businesses can claim up to $5,000 as an immediate deduction for motor vehicles acquired from 01/07/12 and the remainder of the value is pooled in the general small business pool and depreciated at 15% for the first year and then 30%.

Superannuation

The concessional contribution cap has been reduced to $25,000 for all individuals contributing to superannuation. If you are currently salary sacrificing to superannuation and you have not already done so, it is important that you contact your pay office to ensure that you do not breach this cap. Concessional contributions are all contributions upon which a tax deduction is made i.e. employer contributions, salary sacrifice, personal pre-tax contributions.

Individuals with income greater than $300,000 will have tax concessions on superannuation contributions reduced. The current tax rate of 15% on pre-tax superannuation contributions will double to 30% for these individuals.

Susan Dunne
Financial Advisor

Client Services Update

Rewards Program

CIPL is set launch its Rewards Program in the next couple of months. The program has been developed to extend a monetary reward to our **platinum clients** whereby they can spend this amount at any one of our exclusive list of businesses who have signed up to be part of the program.

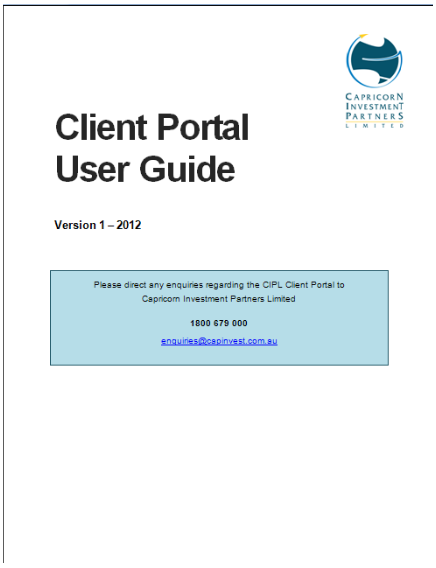
We are at the **'Sourcing registered businesses'** phase of our Rewards Program. Please feel free to recommend a high quality local businesses in your area by emailing enquiries@capinvest.com.au or phone 1800 679 000 with the details.

Stay tuned for further updates on our new Rewards Program.

CIPL Website

Did you know CIPL has a comprehensive website where you can find a vast amount of information on our business and also on financial planning and investment in general? Check out www.capinvest.com.au for more information on service options, FAQ's, Education, Staff; or maybe an update on our Financial Services Guide (FSG).

Client Portal



Client Portal User Guide

Version 1 – 2012

Please direct any enquiries regarding the CIPL Client Portal to Capricorn Investment Partners Limited

1800 679 000

enquiries@capinvest.com.au

Have you tried out the CIPL client portal? The client portal is a web based tool designed for clients to securely access their portfolio information online, it also serves as an interactive tool for CIPL to contact clients regarding share recommendations and for clients to respond with an Authority to Proceed (ATP).

Clients can retrieve and print documents from any location where they have access to the internet. The functions and reports available include, but are not limited to archived quarterly reports, archived tax reports, reports set to your specified parameters; and approval of 'Authority to proceed' documents.

You will also find a Client Portal User Manual with this mail out. Please don't hesitate to phone the office if you would like someone to step you through the process or need your username and/or password updated.

Prepayment of Annual Fees

The last quarter has seen a number of clients saving a large amount of money through paying their fees upfront. You are entitled to a 10% discount on your yearly fees if you decide to pay in one transaction, please call 1800 679 000 or email enquiries@capinvest.com.au if you would like us to calculate your discounted fees for you to review.

Tax reports

Tax reports will be completed and distributed to clients' in approximately mid October 2012. This can occur once we have received and processed all Annual Tax Statements from investments paying Trust Distributions. We thank you for your ongoing patience with this process.

Rose Sladden
Client Services Manager

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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CHART PACK

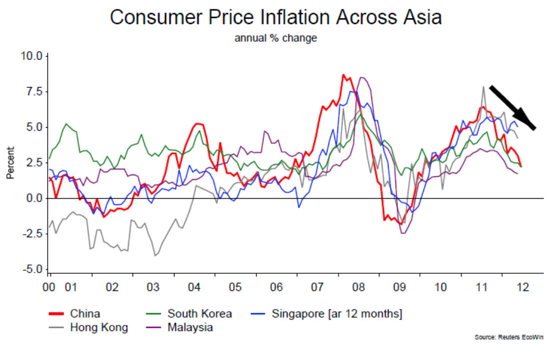
***Information at a glance** (Reuters, NAB)*

China Export & Import Growth

China has not yet transformed itself into an import led economy.

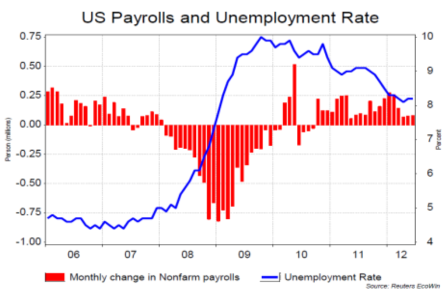
Consumer Price Inflation Across Asia

Controlled slow down of overheated economies



US Payrolls & Unemployment Rate

None since FDR have won office with unemployment over 7.2%, will Obama be the first?



Australian Retail Sales

Retail climbing out of its trough. Are there now opportunities in the Retail sector