Investment Market Update No. 26

May 2006

Editorial

Fears of inflationary pressures led the Reserve Bank to launce a pre-emptive interest rate strike against inflation. We believe that the RBA's assessment of inflationary pressures is too narrow. At the same time the Government announced sweeping changes to superannuation that will be beneficial to many clients.

In this issue we cover:

1. Changing our name
2. What we've been doing for you;
3. Interest rate increase
4. Budget briefing;
5. Investment briefs.

David French
Managing Director and Senior Investment Advisor

Changing our name

We are pleased to announce that we have changed our name to Capricorn Investment Partners Limited. We provided new contact details in the last newsletter, and general contact details are included on the last page of this one.

We hope you like the new logo, which highlights the Tropic of Capricorn, where we are situated, and our capability of servicing clients outside the area. Of course, no financial planning logo would be complete without an arrow aiming skyward!

Our new website is expected to be completed within 2 weeks.

If you have any queries regarding our change of name, please contact us.

What we've been doing for you

At The Rock Investment Planning we aim to offer superior client service. Notwithstanding the distractions of the change in the business we have been able to make significant contributions to many client portfolios.

Contrary to general perception, strong investment markets can be more difficult to deal with than weak ones. Investments can become overvalued, and because our philosophy is to buy investments that meet objectives outlined in financial plans, we tend to hang back in these times. Nevertheless, we have been making limited purchases whenever the market has a bad day. In this way we have been able to continue setting up portfolios that are expected to meet projected cash returns.

We are in the process of accepting Toll Holdings Bid for Patrick Corporation, which has been good for those clients with Toll and Patrick ordinary and reset preference shares.

Some clients have called to discuss excess cash in their portfolio. After spending nearly a month scouring the market, and waiting for a meaningful correction, we have mailed out our new investment recommendations for clients with excess cash.

We have also mailed out some information and suggestions regarding end of financial year matters. This is especially important for clients in allocated pension phase.

Investment outlook

At its recent meeting the Reserve Bank of Australia increased official interest rates to 5.75 per cent. The bank cited raw material prices and a more buoyant consumer outlook as factors likely to exert inflationary pressure.

While we maintain great respect for the RBA's capabilities, overshooting in interest rate increases and decreases has in the past, been a common problem. There are two reasons why we believe the RBA has increased too aggressively.

First with the exception of Queensland and Western Australia, Australia's economy is not strong. Weak housing markets in New South Wales and Victoria, and the follow on effects from that, have almost pushed those states into recession.

Second, the buoyant economic conditions enjoyed by Queensland and Western Australia are driven by global factors – specifically high commodity prices. Similarly, high petrol prices, which the RBA expects will eventually flow into the prices of everyday items are an international phenomena.

An increase in interest rates affects everyone domestically, but does nothing to dampen the global factors that are contributing to the apparent buoyant economy. The RBA is trying to fillet a fish with an axe.

Coming on top of very high petrol prices, and in common with several other economists, we believe that domestic economic growth will slow over the rest of the year, making markets volatile.

Budget Briefings

The recent federal budget was incredible in its concessions to retirees and its treatment of superannuation. The main points as we understand them (not all have been fully bedded down yet) are as follows:

Positives

- From 1 July 2007, non-public sector superannuation benefits paid to a person over 60 years of age will be exempt from tax. This includes pension payments and lump sums.
- Reasonable benefits limits (the maximum balance within a superannuation fund that is subject to concessional tax treatment on withdrawal), will be abolished.
- Superannuation contributions made by self-employed people will become fully tax deductible (currently the first $5,000 and 75 per cent of the balance up to a maximum contribution of $132,449).
- Self employed people will be entitled to receive the government co-contribution of $1.50 per dollar of personal (untaxed) contributions made to super (depending on the level of income earned).
- Individuals will be free to make tax deductible superannuation contributions up to age 75.
- The Centrelink assets test will be relaxed, so that a person will lose only $1.50 of pension for each $1,000 in assets, rather than $3.00. The current assets test exemption for complying and term allocated pensions will be abolished.
- The top marginal tax rate will only apply to earnings over $150,000, and it will be reduced from 47 per cent to 45 per cent. There will be other significant increases in the marginal tax rate thresholds, and a drop in the 42 per cent rate to 40 per cent.
- There are also increases in family tax payments.

Perhaps positive, perhaps negative

- From 1 July 2007, all people under 50 years of age at that date, will in future be restricted to a maximum tax deductible contribution to superannuation of $50,000. For people over 50, there is a phase in period between 2007/08 and 2011/12, where a maximum of $100,000 applies.
- From budget night, a restriction on undeducted contributions to superannuation (undeducted contributions are those made from money that you have already paid tax on – that is, savings). An annual maximum of $150,000 will apply.

Consequences

People over 60 and drawing superannuation pensions may be significantly better off. While many people in this situation pay no tax anyway, it will be vastly simpler to calculate after tax income. For people who do pay tax, there will be an obvious gain, particularly where individuals have earnings outside superannuation. This is because those earnings are currently added to part of the superannuation pension and tax applied to the lot. From 1 July 2007, the superannuation pension component simply won't be included, lowering overall taxable income. It makes one wonder whether those over 60 will require ETP calculations any longer.

Delaying taking a superannuation pension till 60 year of age, will be a sensible strategy. For people who wish to retire early, it will be useful to have alternative income sources outside of superannuation available to bridge the period between retirement and receiving the superannuation pension.

It will be trickier for people over 50 to get large tax deductible amounts into superannuation quickly. Spreading the contributions over a number of years may be possible, and the Government is considering making the maximum apply to an average maximum contribution across a number of years. In any case the changes will be phased in.

People under 35 will be able to enjoy tax breaks on up to $50,000 in contributions to superannuation, about $35,000 more than currently. This is a great incentive to contribute something extra to superannuation early on.

There will no longer be a need to use complying and term allocated pensions, to gain Centrelink Assets Test exemptions. This is very beneficial, as these products are generally expensive and inflexible.

Investment Briefs

Here are some trading ideas for non-portfolio clients:

David Jones Limited (DJS)
The company reported net profit after tax of $54.5 million for the first half of 2006 – an increase of 14.7 per cent. This was a solid result against a backdrop of weaker consumer sentiment. The interim dividend increased 16.7 per cent to 7 cents per share.

Tighter inventory management saw an increase in gross margins, cost reduction initiatives were ahead of schedule and free cash flow reached $70 million. DJS is currently trading at about $2.89 and is yielding 4.84 per cent fully franked.

QBE Insurance Limited (QBE)
Despite cyclones and hurricanes, QBE was able to produce a record profit for the first half of 2006. Net profit after tax increased by 27.3 per cent to $1,091 million, and the company declared a dividend of 38 cents per share, 50 per cent franked. This was an excellent result that demonstrates management's expertise in limiting exposure to large loss situations. Continued strong growth in premium income is expected to underpin future profit increases, complemented by selective acquisitions.

Woolworths Limited (WOW)
First half earnings increased by 22 per cent, underpinned by a strong result from it's supermarket business. Despite costs associated with changes to its distribution network, this division increased earnings by 23 per cent. Analysts are expecting a 35 per cent increase in earnings between financial year 2006 and financial year 2008, making the stock still reasonable value despite being at almost $20.00 per share.

Goodman Fielder Limited (GFL)
In the first half trading update since listing, the company reassured investors that earnings are in line with forecasts, despite a weaker $NZ. GFF has highlighted several strategic initiatives for the future, including expanding distribution, developing new products and making acquisitions. The company seems relatively cheap, trading on 2007 P/E projections of 12.9X and a 6.2 per cent fully franked yield. We would like to see more track record before committing ourselves further.

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