Investment Market Update No. 29

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Editorial

The rapid increase in sharemarket valuations is causing us to review investment weightings in clients' portfolios. We have also spent considerable effort in getting on top of all the new superannuation rules, for your benefit.

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The Business

We are now managing about $85 million for clients, a substantial increase on the value when we purchased Capricorn Investment Partners from The Rock in February 2006. The business continues to go from strength to strength, and we are extremely grateful for the referrals that existing clients continue to give us. Of course, with the growth comes extra responsibility, and it is important that each client's affairs are being looked after professionally.

At present the rate of takeovers and conversions is astounding, and that has combined with higher than usual demand for financial advice. To maintain our service levels we have employed two new staff. Susan Dunne has extensive small business experience of her own and has completed a Diploma in Financial Planning; Bronwyn Large has come to us from The Rock Building Society, where she was responsible for, amongst other things, reconciling the transactions made by The Rock's fleet of automatic tellers. Susan will assist me in dealing with financial planning queries and Bronwyn will assist Carmen in making sure the PAS is up-to-date and accurate.

In addition, Zac's back from long service leave, and he is assisting me to manage the office, which now has 11 staff.

New Superannuation Rules

Few people would be shielded from the constant superannuation blitz pedalled by fund managers and the government over the last few months. We sent out a letter to clients regarding this some months ago, but here's a snapshot of what we're thinking. The $1 million superannuation contribution concession applied only until 30 June. It meant that a couple could contribute up to $2 million from savings (that is, after tax funds), to superannuation. The problem was having tax-paid money of this magnitude on hand in the first place. The stories of people selling houses etc to contribute money into superannuation before 30 June appear ridiculous. We have done the calculations many times, and have found that in any case where significant capital gains are involved, the payback period implied by lower tax on superannuation fund earnings is simply too long. That is, it generally takes many years of income tax savings to recoup the capital gains tax up-front. Either the advice is negligent, or the clients have sold pre-CGT or CGT exempt assets like their own homes. This would work if clients were to downsize to a unit for example.

The following applies from 1 July:

A couple will be able to contribute a maximum of $450,000 in savings per person (previously undeducted contributions) over a three year period. Capital gains tax concessions available to small business people are additional to this amount. One strategy potentially extends the contribution to $600,000 per person over two years. This involves contributing $150,000 per person in one financial year, then using the averaging rules in the next financial year to contribute a further $450,000 per person.

Taxed contributions to superannuation will still attract superannuation tax of 15 per cent. From 30 June, anyone over 50 years of age can contribute $100,000 to superannuation either as salary sacrifice, personal contributions or self employed contributions. This transitory limit applies to 2011/12, when everyone will be subject to a limit of $50,000.

Self employed people and people making personal contributions can claim a full tax deduction of amounts contributed to super - this is far simpler than the current $5,000 plus 75 per cent rule.

If you are over 60 years old, any withdrawals taken from super are tax free.

If you are under 60 years old, and you take an account based superannuation pension, your fund will be split into taxable and tax-exempt components. The percentage these components comprise will be applied to any withdrawal. The taxable portion will continue to receive the 15 per cent tax rebate when drawing a pension.

Two things are certain....

By now, everyone knows about superannuation. Few people know or understand the consequences of death on money held in superannuation, and we are about to embark on a working bee to assist clients to ensure appropriate measures are in place. Here's a snapshot of what happens when a member of a superannuation fund dies:

Superannuation itself

If the money is distributed to a spouse or a tax dependent (speak to us for definitions) the money is received tax free or with existing concessions. If it is received by a non-dependent, then it must be distributed as a lump sum. The proportion of the fund that is taxable is hit with a 16.5 per cent lump sum tax. Since the fund will probably have to sell assets to make the lump-sum payment, capital gains tax may be payable on the disposal.

Arranging the Distribution

The following applies to all superannuation, whether self managed or not:

Superannuation is not an estate asset. That means you cannot control it through your will. When you die, any money in your superannuation fund is controlled by the remaining trustee, and your executor. The only way to ensure that these people act according to your wishes is to implement a Binding Death Nomination. This can be likened to a Will specifically referring to superannuation fund assets.

Many people are keen to see that their Grandchildren are provided for, in the way of funds for education etc. Children are taxed at the rate of 46.5 per cent on investment earnings greater than about $800, so it doesn't pay to invest large sums in the name of a minor. Money left to adult children is likely to bear a significant tax burden too. Earnings on that money is added to current income, and taxed at the individual's marginal rate. In our view, a testamentary trust (a trust made under your will that takes effect when you die) is a very useful tool that overcomes many of these issues. If you are intending to leave money to children or Grandchildren and your Wills do not include a Testamentary Trust, you're crazy. The way the trust is detailed in your Will is critical, so you need the assistance of a competent solicitor.

Clients can expect to be contacted on these matters within the next few months. We have arranged the services of a number of solicitors, if required.

Asset Classes

In order to properly diversify clients' portfolios, Capricorn Investments Partners regularly review asset selection and from time to time you may be holding any number of different asset classes in your portfolio. The main types of assets in use are as follows:

- Australian Shares;
- Fixed Interest Securities (including reset preference shares and convertible notes);
- Infrastructure Investments;
- Listed and Unlisted Managed Funds;
- Listed Property Investments

Australian Shares
Put simply, if you invest in a share, you are a part owner of that company. You are buying the right to participate in the future growth of the company and you are entitled to receive income by way of dividends. Of course not all companies will perform well and you may not experience growth or be paid dividends. Our philosophy is to pick solid companies that have a strong dividend history backed by a solid management team.

Investments in Australian shares provide exposure to capital growth and a reasonable dividend return.

Fixed Interest
Generally speaking, fixed interest investments are instruments that have a known series of cash flows at the time the investment is made. The simplest example of this is a term deposit with a bank where the interest rate is fixed before the deposit is made. The instruments that are used in this office are sometimes a little more complex than this however the concept remains the same. For example, a preference share will pay consistent dividends but may also entitle you to participate in equity upside upon conversion. Some other fixed interest instruments may have no fixed maturity date.

Fixed interest investments improve certainty of returns and reduce risk in the portfolio.

Infrastructure Investments
Over the last 5 years there have been a number of quality infrastructure plays being listed on the ASX. As most of you would know, CIPL has been successful in securing allocations in many of these floats. An infrastructure investment can be likened to a property trust in that you are investing in a tangible asset such as a toll road or an airport and returns are generated through people paying for the privilege to use the infrastructure. We have had significant success in generating returns for clients through the use of these assets.

Infrastructure investments fall somewhere between the risk profile of fixed interest investments and Australian shares. They generate significant income, often including an income tax-exempt portion, and provide some capital growth exposure.

Listed and Unlisted Managed Funds
A managed fund is simply a pool of money invested in a range of different assets. To write about the different funds available would be as long as a novel. There are funds available to cater for all investment needs, from specific asset classes such as options trading to balanced funds that invest money broadly across shares, property and fixed interest.

A listed managed fund has its units traded on the ASX. It is important to be aware of the costs associated with investing in a managed fund. In some cases an entry fee may be charged in addition to an ongoing fee for the fund manager's services.

CIPL uses managed funds to improve portfolio diversification, and to access asset classes that we cannot reasonably manage in-house – international shares for instance.

Listed Property Investments
Listed property investments are investments in a group of properties. They can be thought of as a managed fund that owns property and as with a regular managed fund they can operate in specialist areas such as retirement villages or have a broader mix of assets including retail space, office buildings and industrial sites.

Listed Property Investments are used in much the same circumstances as infrastructure investments. High valuations and increased operational risk have meant that we have shied away from this asset class over the past few years.

Client Education

Are you interested in understanding more about your investments and other financial matters? Australians are lucky to have a bookshop dedicated to investment matters. The Educated Investor is situated in Collins Street, Melbourne and stocks an excellent range of investment related books. You can use their on-line service at www.educatedinvestor.com.au. Mention that you are a client of CIPL for a 10 per cent discount on all purchases.

For those that would like an introduction to investment, I purchased 5 copies of Understanding Investments by Charles Beelaerts and Kevin Ford, during a recent trip to Melbourne. There are available at no charge to the first 5 clients who ask.

Community Involvement

Many clients may not know the involvement that CIPL has with the community. Over the past few months we have participated in meetings regarding the growth of Rockhampton, which included meeting the Board of Stanwell Corporation Limited. I was lucky enough to sit with Qantas Director Peter Gregg – an illuminating experience.

This week I was privileged to present as the Keynote Speaker for the annual conference of the Central Queensland chapter of the Business Educators Association of Queensland. The conference sported an excellent roll-up of individuals facing an extremely challenging professional environment.

CIPL also sponsors the Rockhampton Ladies Golf Club. This year we will have increased our sponsorship of the club, which annual Open championship is probably one of the best run events we have witnessed. If you are a golfer from outside of Central Queensland, we have some excellent courses round here, and would be happy to make introductions.

Accessing Your Portfolio

Did you know that you can look at your portfolio at any time on the Internet? If you would like this access and do not yet have it, please call Carmen on (07) 4920 4656. If you have trouble using this service, Ben, our IT man can help you on (07) 4920 4622.

Market Update

The Australian economy continues to run at two speeds, the booming mining sector and in the southern states, sluggish housing, construction and manufacturing sectors.

The interest rate outlook is finely balanced. The much stronger Australian dollar is likely to depress profits of exporters, but will benefit importers and businesses that rely heavily on imported inputs. This will have a dampening effect on economic growth. On the other hand supply constraints have put pressure on fresh food and petrol prices.

Markets have been very strong over past months. Over the past few weeks interest rate sensitive stocks have lagged very strong performances from growth stocks such as mining and construction. Our portfolios can be expected to underperform somewhat in times of very strong economic growth, but this is the cost of shielding them from unexpected market shocks. I was interested (and pleased) to hear from one client recently, who the day after the fall in the market resulting from the “China Crisis”, called to ask why his portfolio hadn’t fallen by much.

Some clients have noted the failure of Fincorp, Westpoint, Bridgecorp and Australian Capital Reserve, and have asked whether they hold similar investments in their portfolios. CIPL has never used these types of assets in portfolios. Their characteristics are high risk from the beginning and they all exhibit an underlying flaw in that they are committed to ongoing interest payments, when they only receive cash inflows from their business activities when they sell their property developments. Obviously, the interest commitment is a regular commitment, and the income is highly irregular. These businesses cover this timing difference by collecting more money from investors, which they use to satisfy their interest payments to unit holders. That’s fine while the inflows continue, but if there is a hiccup in the inflows, or if they can’t sell their developments, then failures will occur.

This also highlights our philosophy of using listed investments where possible. Listed investments, while not perfect, are much more transparent than investments in private unlisted concerns. They are subject to disclosure rules, and scrutiny by journalists and analysts, and they have robust contact details, that can be used to follow up concerns.

Tax Reports

We are in the process of compiling tax reports for the year ended 30 June 2007. We will endeavour to have reports out by end September, however it is common for delays to occur. The most common cause of delays is waiting for managed funds and unit trusts to provide us with their data on trust distributions.

Cash Transactions Report

We recently altered the way the Cash Transactions report works so that clients could see all cash flows, even if we had not completed all of the administrative tasks associated with those cash flows. Entries showing "not allocated" will disappear as the work is completed.

Rights Issues

Under the CIPL investment management contract clients’ authorise us to take up rights issues on your behalf. We will take up rights issues as a matter of course if there is a meaningful discount on the price of the new units compared with the price that the stock is trading at. The recent DUETS rights issue meant that clients paid $3.50 per unit for a stock that was trading at $3.90. Clients can always sell the new units.

Investment Briefs

Here are some trading ideas for non-portfolio clients:

Toll Holdings Limited (TOL)

Toll Holdings has made a cash offer of NZ$3.00 per share for the 16% of Toll NZ which it doesn't already own. The price represents a 10% premium to the Toll NZ market price. Acceptance of the offer is assured with 10% coming from a friendly US based fund and 6% from compulsory acquisition. The effect on profit will be slight but positive. Net profit after tax for the full year 08 is now forecast at AUD$488 and for the year 09 AUD$548. A buy recommendation is maintained with the target price $16.00.

Lihir Gold Limited (LGL)

The new Lihir Gold provides investors with a pure gold investment vehicle - ungeared, unhedged, with funded production growth of 50% over the next 3 years and declining production costs. Its fundamentals are appealing and, in a positive gold price environment, it offers better earnings leverage. For a 10% increase in the gold price, LGL delivers 19% earnings upside. LGL is indeed a turnaround story and new management appear to have the basics right. The target price is $3.60.

Macarthur Coal Limited (MCC)

For some months now, uncertainty has existed as to Ken Talbot's position in the Company and whether or not he would sell down his holdings. There have been 2 important developments. He has sold 15.6m shares @ $7.20/share to Citic Resources and relinquished all executive duties on the Macarthur Board but remains a non-executive director. The share deal not only confirms that Talbot is a seller but it strengthens the view that coal trading houses are seeking to establish large stakes in coal producing companies. Citic Resources is already a substantial shareholder in MCC and is 54% owned by the Citic Group, one of China's largest state - owned companies with assets of US$100bn.

MacMahon Holdings Limited (MAH)

MacMahon Holdings and its subsidiary MVM Rail have won a $250m alliance contract with Queensland Rail for the Jilalan Rail Yard upgrade. The project is part of the Queensland Government's programme to increase rail and port capacity at Dalrymple Bay and Hay Point. Loading capacity will increase 40% by late 2009. MAH has struggled somewhat to enter the east coast civil construction market. This calendar year, however, the Group has won contracts worth nearly $600m and we suspect that the east coast business is well underwritten for the next 3 years. The share valuation has been raised to $1.30.

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

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