Investment Market Update

Issue 40 - Spring 2010

Welcome...

Many clients will be aware of the significant behind-the-scenes work that we have been undertaking on clients' behalf to add to portfolio performance following the downturn, and to improve the way we interact with and service clients.

The downturn taught us that clients require not only technical attention and results, but ongoing and increased personal service too. CIPL's new Financial Services Guide, and the employment of a number of new staff, are initiatives focussed on enhancing client service levels.

In addition CIPL is about to launch its own managed fund, which will provide additional diversification opportunities for existing clients and an appropriate manner in which to service smaller accumulation clients. The low dollar-value entry level and absence of entry and exit fees make the fund especially suitable for saving on behalf of children.

We hope you enjoy the contents of the newsletter, and as usual, please contact us if you have any queries or concerns.

Regards

David French

Managing Director

Senior Investment Advisor

A STRONG QUARTER FOR EQUITY MARKETS

Renewed optimism helps lift markets both here and abroad

After a period of poor stock market returns in the first half of 2010, it was apparent that the market had perhaps slipped to a level not warranted when contrasted with improving economic news in Australia and the major advanced economies.

Heading into July, what was needed was a spark of some sort to bring the bulls out of their slumber and ignite a share price rally. In the end, a series of favourable events and economic readings were responsible for lifting investor sentiment, which culminated in the ASX All Ordinaries returning 7.22% over the quarter.

Overseas equity markets performed even better than in Australia, with the Dow Jones recording its best September return since 1939.

The rally initially started following comments by the US Federal Reserve in early August that it would begin to inject further liquidity into markets through the purchase of mortgage debt. At the same time a sequence of positive economic data in the US began to trickle out.

This included:

- US housing starts rising 1.7% in July
- consumer spending up 0.4% in July, and consumer confidence higher in August
- rising US home prices, up 4.4% in second quarter of 2010
- a reasonably sound profit reporting season in the US and Australia.

The major concern had been that the US economy would slip back into recession (a so-called double-dip recession). This would have had serious implications for the global economy. Despite the recent battering, the US economy is still the largest and most important in terms of driving global growth.

ASX 200 Performance – An improvement but still a fair way from the top

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The final spark to the rally occurred in mid-September, when the US Federal Reserve indicated that it was preparing to announce a further significant level of quantitative easing.

This strategy, first used by the Fed in March 2009, essentially amounts to turning on the money printing-press – the Fed creates liquidity in capital markets, pushing down interest rates and encouraging investors to invest in riskier assets such as shares and bonds, rather than keeping their cash in the bank (at interest rates of less than 1% in many cases). The oversupply of money also affects exchange rates, making $US denominated debt worth less when measured in other currencies (an Australian lending in $US, would get back about half the $A for the $US denominated debt compared with 8 years ago).

While the Fed is yet to announce the exact details or the actual amount of quantitative easing, its effects have already been shown through rising stock markets and weakness in the US dollar.

Not out of the woods just yet

While the stock market gains have been welcome, there are still a number of broader issues which must be monitored.

The Australian economy is in a sweet spot with regards to all the key economic variables: growth, inflation, interest rates and unemployment; but there are a number of global issues which will ensure that markets remain volatile.

Rising global tensions over currencies have the potential to escalate into currency valuation wars, which could cause significant damage to global trade and economic growth (setting up trade barriers through means such as tariffs is one poorly-thought-out measure already being called for).

The underlying issue is that some countries, notably the US, UK and Eurozone countries, have experienced quite sharp falls in the value of their currencies (for example, the Australian dollar is now worth about one US dollar, a level not seen since David was in Grade 3). At the same time, countries with fewer economic problems (most emerging and developing economies) have witnessed substantial appreciation of their currencies.

In general terms, a weaker currency is preferable to a stronger one. A weaker currency makes exports more affordable in global markets, and this helps encourage domestic economic growth. Developing nations such as India, Brazil and others, suspect that the advanced economies are intentionally devaluing their currencies in order to simulate their own domestic economies (a claim that is not entirely without merit).

The US Dollar – few friends

The danger is that countries will begin to engage in successive rounds of competitive devaluation, each seeking to gain an advantage over their trading rivals, benefiting their own economies at the expense of those countries with stronger currencies. Such activity is a zero sum game – if everyone devalues, no-one is better off.

Nations may also attempt to place pressure on their trading partners to allow their own currencies to appreciate – the United States is currently pressuring China to allow the yuan to appreciate, knowing full well that this would be detrimental to the Chinese economy, which relies heavily on export markets as a source of economic growth. Japan has also recently intervened in currency markets to try and weaken the yen.

All this is occurring against a backdrop of continued weak growth in major developed economies, stubbornly high unemployment in the US, and fragile housing markets in both the UK and the US. What is really required is for the Chinese to start buying Corvette's and Maytags. Don't laugh, it may happen.

The International Monetary Fund has been tasked with mediating and defusing currency conflicts, a tough task but one which is crucial to prevent a dangerous rise in protectionism.

The Seer-Sucker Theory

The folly and dangers of forecasting

All the major financial institutions in Australia (and overseas) employ highly-paid economic analysts, who often appear in the media to comment on ongoing developments in both the economy and bond and stock markets.

Whether it's Shane Oliver from AMP, Chris Caton from BT, or Bill Evans from Westpac, there is an apparently unlimited supply of commentators ready to share their economic or stock market forecast with the viewer or listener.

Whether it be the next movement in interest rates, future GDP growth rates, or the peaks or troughs of the stock market, it may come as a surprise that most of the forecasters' commentary is just plain wrong.

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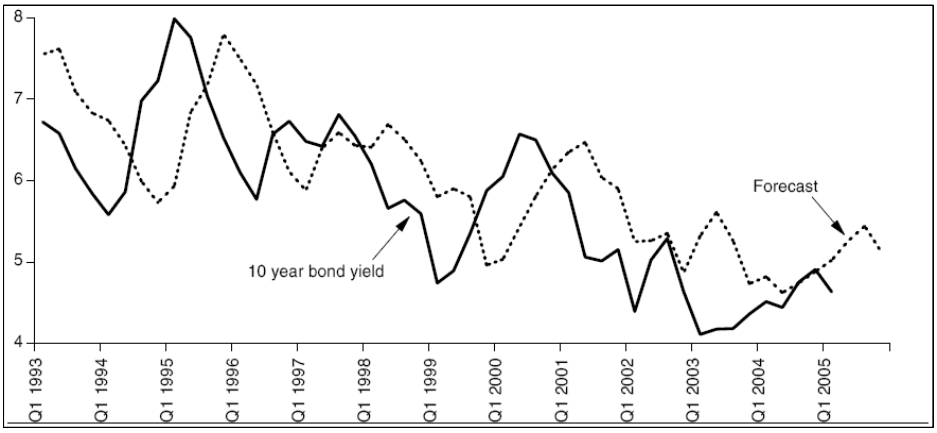
The chart below, for example, shows the accuracy of bond market forecasters in predicting the yield on 10 year bonds one year in advance.

Forecasting the future – a tough job



(Source: James Montier, The folly of forecasting: Ignore all economists, strategists, & analysts. Dresdner Kleinwort Wasserstein 2005)

In most cases, the consensus forecast for the bond yield was wildly incorrect - in fact when bond yields were forecast to rise, they actually fell 55 per cent of the time. A closer look at the graph reveals why: See how the forecasts simply mirror what happened earlier. Many commentators' forecasts are not forecasts at all, they are simply a reflection of prevailing thought. That is, if the economy is strong, commentators assume it will remain strong, if it is weak, they assume it will remain weak. That's not forecasting, that's spruiking.

A possible explanation for the apparent inability of forecasters to get it right, are two behavioural characteristics called *overconfidence* and *optimism* – human beings tend to believe they are far better at a specific activity than they really are. For example, a study by Swedish scientist Ola Svenson found that 93% of American drivers believed they were better drivers than the average driver (Swedes must be more humble than Americans, with only 69% of Swedish drivers stating that they were more skilled than the average driver).

Research also found that the experts tend to be even more over-confident in their own abilities and optimistic than lay people - in fact forecasting accuracy appears to drop once people reach a certain level of expertise. *Confirmation bias* may be one explanation of this phenomenon – another behavioural trait which means that experts are more likely to believe their own opinions and less likely to seek out evidence which contradicts their views.

As the 6th century BC poet Lao Tzu observed "Those who have knowledge, don't predict. Those who predict, don't have knowledge".

Despite all the evidence that forecasting is of little value at best, forecasters, pundits, seers and commentators continue to be paid large sums of money to proffer their services to the community, and the financial sector in particular.

Which leads us to the "seer-sucker" theory. As stated by researcher J Armstrong of the University of Pennsylvania – "No matter how much evidence exists that seers do not exist, suckers will pay for the existence of seers".

At Capricorn Investment Partners we take note of economic consensus and opinions in formulating our investment strategies, but we do so with full knowledge of the limitations and perils of forecasting

(David's note – as an economist with a fair amount of training in forecasting methods, I believe it is the rigour of determining the possible errors in the forecast that provides the value - and not the forecast itself. Economic theory is in fact quite useful in predicting direction – you don't even have to go to the trouble of formal forecasting. What is much more difficult is quantifying movements in any direction. Ask any meteorologist).

BUSINESS UPDATE

A variety of improvements

The last few months has seen CIPL very active in modifying and improving our service offering to clients. After months, and in some cases, years, these projects are coming to fruition. The first is the roll-out of CIPL's new Financial Services Guide. This guide clearly explains all of the services CIPL offers, and is a great tool for helping clients decide what service level they need.

The most important part of this process is freeing up time so that advisors have more time to listen to your needs, to make appropriate recommendations. To assist with that CIPL has employed a number of new staff.

- Annette Waddell started with CIPL in September as Front Office Administrator. Annette is responsible for many administrative and organisational tasks. We want to be much more proactive regarding our meetings with clients, and Annette's presence has already begun to make that process much smoother.
- Lachlan McKenzie-McHarg started with CIPL in October as dealing assistant. Lachlan's role is to run the asset selection committee, to source and collate research and to

assist advisors in making recommendations for client portfolios. Lachlan will also be available to clients who want a more pro-active two-way approach to portfolio recommendations and will be helping Bob to expand our share trading offering. Lachlan was previously an analyst with IWL and has moved from Melbourne to take on this role.

- On 1st November, Ruth Turner joins us as Client Services Manager. Ruth will be responsible for streamlining and formalising client service levels, and for making sure reports and other client communications are relevant and timely. Ruth will also be organising regular seminars, and ensuring that advisors are well prepared in advance for meetings with all clients.

We have also sent existing staff on a wide range of training courses, some technically based, and some aimed at offering even better service to clients.

Launch of the Capricorn Diversified Investment Fund (CDIF)

On 1st November, and after 2 years work, CIPL will launch its own managed investment fund. CIPL has in the past used managed funds to increase portfolio diversity or to access assets that might be difficult to include in individual portfolios. That intention has been increasingly thwarted by the lack of stability in funds' management teams, and the erratic nature of their distributions. Certain assets useful for diversification may not be suitable to include in an individual portfolio, but as part of a large portfolio may be entirely sensible. CDIF will provide excellent diversification benefits, with a stable, known management team.

We will be writing to clients with portfolios containing managed funds, in relation to CDIF. Where CIPL makes a recommendation regarding the fund, CIPL clients will not be charged a portfolio management fee on that asset.

Aside from the benefits to providing an investment vehicle by which investors will have access to a wide range of assets at a reasonable price, CDIF will for the first time enable CIPL to offer a service for saving clients. The fund will accept smaller contributions and there is no entry or exit fee.

Combined, these initiatives represent a big investment by CIPL, and are evidence that our primary concern is for our clients. We hope you are as excited as we are about them.

Would you like lower fees?

From October 2010 clients will be entitled to a 10 per cent fee discount, when fees are paid 12 months in advance. Paying fees 12 months in advance also protects from increased fees due to improvements in portfolio values (it does however mean that falls in market value are not reflected in lower fees). If you would like to take advantage of a 10 per cent fee saving, simply contact one of CIPL's staff.

INSURANCE MATTERS

Business class for an economy price

Does your insurer provide guaranteed upgrades to its products?

Following the recommendations of his advisor, Bob (not our Bob) a carpenter took out an income protection policy back in 1994. Over 10 years, Bob never needed to claim, but in 2004 he was faced with open heart surgery. His insurance took care of the financial side of things.

Of even more value, an upgrade to his policy in 1997 meant double benefits would apply to by-pass heart surgery. A further upgrade in 1999 meant these double benefits would apply in his case even though they did not apply to Bob's policy when he originally took it out (on account of his occupation).

Bob actually received a monthly benefit of $9,250 - two and a half times his insured benefit. In total he received $27,750 more in benefits than he had originally anticipated. Had Bob insured elsewhere, it is unlikely he would have automatically received the improvements in benefits that made all the difference.

CIPL works with several insurance companies to ensure you have appropriate cover for your needs at any particular time. One particular insurer that we work with passes on all product enhancements to existing clients at minimal or no extra cost. Since 1986 they have passed on almost 240 essentially-free upgrades to their insurance clients.

This means you don't need to remember what has or has not been added to your policy, because upgrades automatically apply, your cover then is constantly updated.

INVESTMENT BRIEFS

Here are some ideas for our trading clients:

APA Group (APA)

APA is the industry leader in gas infrastructure, and is responsible for delivering half of the nation's domestic gas usage. The result for full year 2009/10 was solid, but a little below expectations with EBITDA rising 3% to $460m. Full year for 2010/11 guidance is slightly softer than expected at $465 — $485m. The balance sheet is in reasonably good shape with gearing of 69.8%. A 17 cps distribution was paid on 15 September bringing the full year payout to 32.75 cps for a payout ratio of 64%. APA is a high quality infrastructure investment offering a 9.2% unfranked yield, growing to around 5% pa over the medium term. Brokers suggest target price of $4.10.

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Ramsay Health Care Limited (RHC)

RHC is a premier private hospital operator generating industry leading margins. Strong cash flow from the portfolio of quality hospitals is invested to enhance facilities. RHC has over 100 hospitals and day care facilities, 20,000 staff, manages over 8,000 beds and has annual revenues of over $2bn.

RHC reported its core NPAT up 22% to $178.5m, in line with market expectations. Earnings per share growth was strong, at 14%. Guidance for full year 2010/11 is for NPAT growth of 13% - 15% and for EPS growth of 10% - 12%. Full year 2010/11 will see the contribution of several large expansion projects. Australian hospitals are the dominant source of earnings contributing 80% with UK contributing 10% and France 2%. Brokers suggest a fair value of $16.20 and a recommendation to accumulate under $14.80.

AGL Energy Limited (AGK)

AGL Energy is Australia's leading renewable energy company and is Australia's largest private owner, operator and developer of renewable generation assets. The company has major investments in wind and hydro, as well as ongoing developments in key renewable areas such as solar, geothermal, biomass, bagasse and landfill gas. Earnings are expected to improve on the full year 2009/10 result of $428.9m to $462.6m in full year 2010/11 and $494.9m in full year 2011/12. A payout ratio of 60% is expected to provide shareholders with consistently rising dividends and enable the Company to retain sufficient earnings to service renewable energy commitments for the next 3 — 4 years. From a balance sheet perspective, the Company is well positioned to play a significant role in the NSW Government's sell down of key generation and trading businesses.

The Company has been building its reserves of coal seam gas, and with additional resources in the Hunter Valley and Queensland coming on stream, it should meet its contractual needs in the future. Brokers suggest that the stock be accumulated with a target price of $17.70.

NRW Holdings Limited (NWH)

NWF is involved in the civil construction and mining services business. It generates the majority of revenues from services to the Australian iron ore industry, where demand has been strong for five years and the outlook appears to be robust. The group has grown rapidly by consistently expanding the range of services it offers. The WA iron ore industry accounts for nearly 100% of civil revenues and more than 55% of mining revenues and it is expected that production capacities will double over the period 2009 – 2016. This will undoubtably involve capital costs but with gearing at 23% the company's balance sheet seems well positioned to manage the expansion. Revenues are expected to grow from $610m in 2010, to $721m (2011) and to $4,748 (2012) while the dividend yield is expected to grow from 4 per cent (2010) to 4.5 per cent (2012). Brokers suggest a target price of $2.10.

QR National

After studying the prospectus, and talking to other industry participants, we are excited by the upcoming float of QR National.

The features of the float as far as we can see are:

- Revenue forecasts are generally underpinned by long term contracts. Increased revenues due to strong volumes of coal haulage have a much greater than proportional impact on profitability. In 2010/11 for example, a revenue increase of 16 per cent results in a 42 per cent increase in EBITDA (a measure akin to cash flow).
- While the company faces some large capital expenditure requirements, these are expected to also help underpin volume increase in the future.
- Pricing has generated a fair amount of commentary, but our view is that the offer is very attractive if priced at the lower end of the $2.50 to $3.00 range. Additional incentives mean that at $2.50, Queensland based investors actually receive stock at $2.25, if they hold it for at least 12 months. That represents a multiple of 15x forward (2011/12 earnings, and we don't think that is expensive for what will be a growing top 50 stock.
- Every Government sell-down that we can think of has performed well in its first two years after listing on the ASX. We can't see Andrew Frazer (Treasurer of Queensland) wanting to face question time over a dud float. We suspect that the float team has thought long and hard over that one, and that as a consequence the numbers are probably more than achievable.

A more detailed note on QR appears on the CIPL website.

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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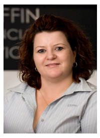

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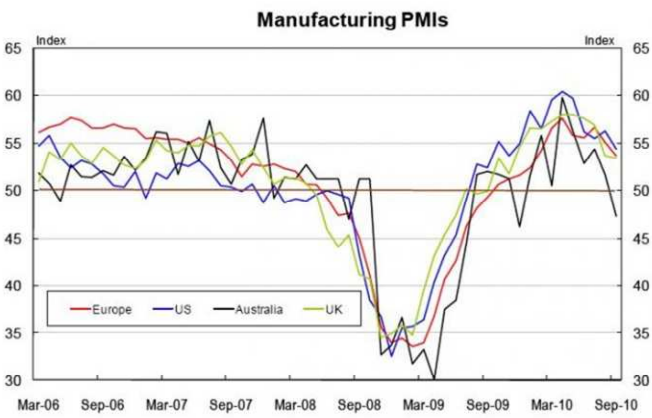
Senior Administrator

Kayla Oakley
Office Administrator

CHART PACK

***Information at a glance** (sources: RBA, Evans & Partners, OECD)*

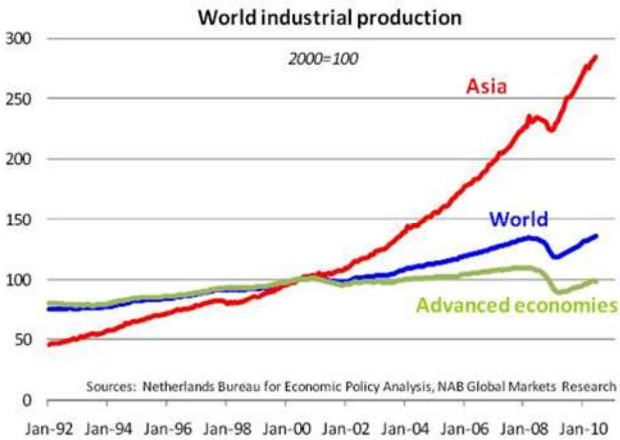
PMI - Purchasing Managers Index points to slower economic growth in 2011 as inventory restocking ends



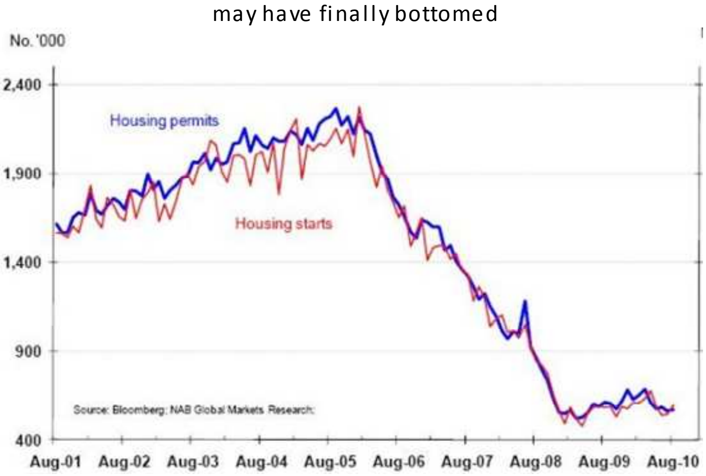
Shop Online - take advantage of the strong Aussie dollar and shop online for your Xmas presents this year

Product	Australia	United States
Nike Air Max Shoes (Men)	A$200	US$100
iPad	A$629	US$499
Levi Jeans	A$120	US$32
Jadore Perfume (100ml)	A$160	US$95
Ray Ban Sunglasses	A$299	US$139
Samsung Series 7 46inch LCD TV	A$2,799	US$1,699
Callaway FT-iZ Driver	A$519	US$399
CD: Lady Gaga - Fame	A$22	US$8.99
Dell Inspiron 17' laptop	A$1,249	US$699
Chanel Rouge COCO lipstick	A$43	US$30
John Deere Ride-on Mower (LA115)	A$3,789	US$1,699
Johnny Walker Blue label 750ml	A$220	US$160

Asian Economic Strength - economic growth in Asia continues to outshine more developed economies



US Housing Market - hopes rise that the US housing market may have finally bottomed



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