Investment Market Update

Issue 41 - Summer 2011

Welcome...

The flood events in South-East Queensland were indeed tragic, but regarding Rockhampton, the similarity between reporting on the floods and reporting on the GFC was notable. Low lying areas of Rockhampton flood regularly. Residents are completely aware of the drill, but media chose to portray a disaster. Similarly the GFC, which while a very serious matter, was not the harbinger of the end of market economies or society as we know it.

Political commentary also displayed similarities. Anna Bligh seemed to handle the issues well, but Rockhampton was never isolated, as she claimed on national TV. Similarly, during the GFC Kevin Rudd claimed that (despite thousands of years of evidence to the contrary) markets could not be trusted, and governments would have to take over markets' distributive role.

A large part of CIPL's value to clients is in cutting through noise which obscures truth, value and welfare. Enjoy the newsletter and please contact us if you have any queries or concerns.

Regards

David French

Managing Director

Senior Investment Advisor

DUSTING OFF THE CRYSTAL BALL FOR 2011

A look back at 2010 and some thoughts regarding the year ahead

In our first newsletter of the year, it's customary for us to take a quick look back at the year just past, as well as consider some likely developments over the next twelve months.

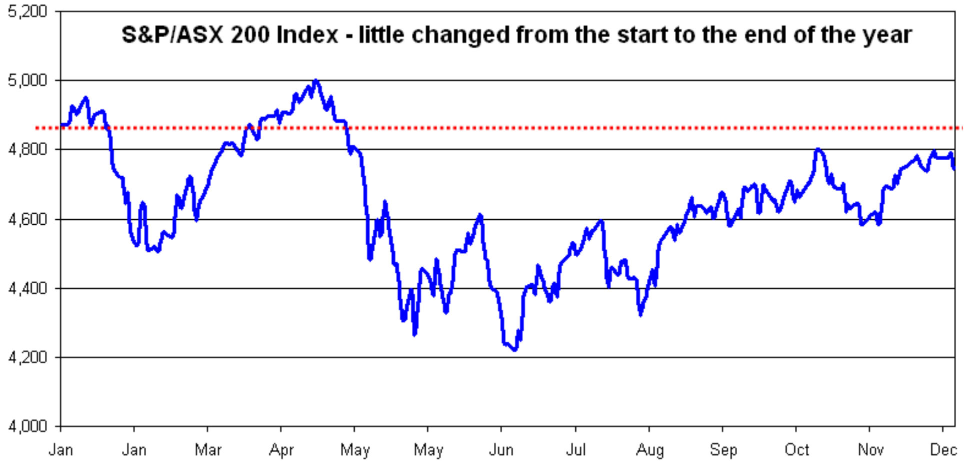
2010 was an eventful year, but not one which rewarded investors to the manner that would reasonably be expected. The ASX All Ordinaries finished the year down 0.73% from the start of the year, while the widely followed S&P/ASX 200 Index fell 2.6%.

This rather flat performance masked some significant swings in the market however, with the S&P/ASX 200 index for example, ranging from being up 2.7% to down 13.3% at various stages during the year. Clearly the market volatility that we experienced in 2008 and 2009 remains a factor, albeit in a diluted form.

The year was largely dominated by the still unresolved sovereign debt problems in Europe, with the most recent development being the acceptance by Ireland of a bailout package of over $113 billion. We weren't surprised by the problems surrounding the over-indebtedness of the European nations, having noted in our Summer 2010 newsletter that...

"An additional challenge the global economy will have to deal with in 2010 is the significant levels of government debt incurred by OECD countries over the past 2 years"

Although the state of some of these heavily indebted 'fringe' European nations will continue to be an issue through 2011, we consider it unlikely to lead to a full-blown financial crisis.



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A strong Aussie dollar is not always a good thing

The past year was also notable for the strength of the Australian dollar, which spent much of the year hovering close to or above parity with the US dollar. While this to some extent reflects the weakness of the US dollar, it also indicates the relative strength and performance of the Australian economy versus that of most other industrialised economies.

In general however, a strong Australian dollar acts as a drag on economic growth – while overseas holidays, imported goods and online shopping are all cheaper under such circumstances, major sectors of the Australian economy such as agriculture, tourism, manufacturing and even the resources industry, are all negatively impacted.

As we have discussed in previous newsletters, coping with a strong Australian dollar, largely caused by our relatively high interest rates and Asian demand for our raw materials, will be one of the more important challenges facing Australia over the next few years.

Proper portfolio construction proves its worth

The past year has also been a period which rewarded portfolios which were properly constructed. In periods such as 2010, when capital gains are muted and the market trends sideways, the income earned by your portfolio plays an even more important role than usual.

While the market was broadly flat, client portfolios have benefited from a regular and substantial income, earned through dividends, bank or mortgage interest and fixed-interest payments.

This reflects a deliberate strategy at CIPL to construct and manage portfolios such that we are not wholly reliant on capital gains. While we expect and do achieve capital growth over longer periods, there are occasions (such as 2010) when the bulk of a portfolio's return will be attributable to income received from investments.

This strategy allows retired clients to continue to receive an income from their investments without having to sell assets, and it allows younger clients to accumulate cash for re-investment into the market.

Some thoughts on 2011

And so, a few thoughts on the year ahead.

As already mentioned, the ongoing debt issues in Europe will continue to cause volatility in global financial markets. However, this shouldn't overly detract from the Australian economy, which we expect will record another year of positive economic growth.

It is also usual for the third year following a market downturn to generate above average returns for investors – history has shown that the year immediately following a downturn experiences significant gains (as did 2009), the second year is a year of consolidation (as was 2010), while the third year generally shows positive growth (although not as high as we saw in 2009).

There are a number of risks however, specific to Australia, which may negatively impact market returns for the year ahead. Our reliance on demand from Asia (and China specifically) for our raw resources ties the state of our economy very closely to that of our trading partners.

China will likely need to act quite decisively to slow its economy, which is starting to exhibit an increasing inflation rate, and this would impact Australia directly.

Reduced demand for our resources will translate into weaker economic growth, lower tax revenues and a possible rise in unemployment. Having said that, some cooling of the resources sector may not be wholly negative, and may help delay future interest rate increases by the Reserve Bank.

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A further risk we face is the state of the residential property market in Australia. By most measures, property prices in Australia are significantly overvalued, and this places significant financial strain on households due to their high debt levels.

Already we have witnessed a slowdown in property construction and modest falls in property prices over the past few months. The challenge for policymakers will be to prevent property prices from collapsing, while still keeping a lid on future price increases, a difficult balancing act.

Nevertheless, the Australian economy enters 2011 in relatively good shape. Unemployment is low, interest rates are not yet too restrictive, GDP growth is forecast to be around 3.4%, stock market valuations are reasonable, and high commodity prices are providing a boost to national incomes.

While the year ahead will be filled with the usual range of unpredictable events and market volatility that we have come to expect, we remain confident that client portfolios are well positioned to benefit from the ongoing recovery from the global financial crisis.

REVERSION TO THE MEAN

How investment bubbles follow a common pattern

A common phrase in financial circles is 'reversion to the mean'. It's a simple phrase but it captures a powerful dynamic.

In essence, it states that prices of financial assets (for example) can increase or decrease significantly over short periods of time, but over time they must always revert to their mean level of growth (that level of growth which they consistently exhibit over a lengthy period of time).

The more scientific definition is that *"the greater the deviation of a random variate from its mean, the greater the probability that the next measured variate will deviate less far. In other words, an extreme event is likely to be followed by a less extreme event."*

(source:http://mathworld.wolfram.com/ReversiontotheMean.html)

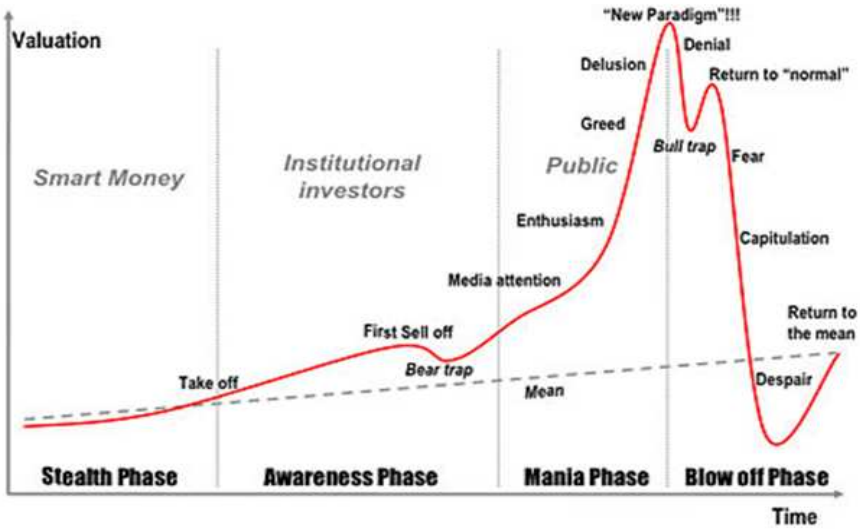
The stock market in particular is subject to mean reversion. Each time we experience a stock market boom and then a bust, we are effectively experiencing reversion to the mean.

The chart below, which shows the various stages of a bubble, quite clearly illustrates how over time the market reverts to trend. It can overshoot on the upside as well as the downside, but it will eventually return to its trend level of growth.

A handy method of judging when reversion to the mean is imminent is to keep an eye out for phrases such as *'this time it's different'* or *'new paradigm'* or any other description which intends to convey that we have entered a period which is different from any that we have experienced before.

The simple truth is that most stock market (and other asset) bubbles are very similar to each other – there is very little that is 'different' on each occasion. As noted by the legendary investor Sir John Templeton who remarked that *'"the four most dangerous words in investing are: 'this time it's different'"'*, words that are still relevant today.

Stages of a Bubble



The same concept can in fact be readily applied to cricket teams, rugby league teams and a host of other real-life situations.

The recent poor performance of the Australian cricket team in the Ashes series is a good example of this – for many years the team was all but impossible to beat, but such a run of results is ultimately unsustainable and the team has now well and truly fallen back to the level at which most of its competitors operate.

PROPERTY AND SUPERANNUATION

Owning property in your self-managed fund means taking care

One of the benefits of establishing a self-managed superannuation fund is the flexibility it allows in choosing which investments to hold within the fund.

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For example, it is quite common for self-managed funds to own one or more investment properties, both residential and commercial.

Recently however, the Australian Tax Office (ATO) has issued a warning to trustees of self-managed funds who hold business real property in their fund, that they have obligations to keep the property free from faults or risk being sued.

The warning stems from a recent legal case where the trustees of a self-managed superannuation fund were found to be liable for the death of an electrician who was engaged to remove an old hot water system at the property.

The ATO has warned that "if you own business real property in your SMSF you should make sure you are aware, to the best of your ability, of any hazards on your business real property. If any hazards exist you should have them fixed".

The ATO has also recommended that SMSF trustees consider taking out public liability insurance for any business real property in the super fund.

If you own property in your super fund, and you have any questions regarding this matter, please feel free to contact us.

BUSINESS UPDATE

Managed fund hits the streets

CIPL's managed fund, The Capricorn Diversified Investment Fund was launched in November and December to a gathering of more than 100 people in Rockhampton, and more than 30 in Tamworth. Early indications are that the fund has strong support, and CIPL is proud to have been able to build and develop it from a regional base.

Some people have queried the need for a fund. Put simply, many investment opportunities cannot sensibly be accessed through direct investment in the amounts we typically see. For example, bank bills and bonds are generally denominated in amounts of $500,000 or $1 million, properties are almost always significant investments on their own, and some listed investments might be quite suitable for inclusion in a large diversified portfolio, but too risky to include in a modest sized individual portfolio. In addition, as we have mentioned before, we now have a vehicle such that smaller investors can gain access to a good quality diversified portfolio at a reasonable price.

Clients who include the CDIF in their portfolio will not be charged portfolio management fees on that asset.

New service levels

Sometimes I think we assume that we know what is good for clients, when perhaps a little more discussion would have revealed that a different approach might be suitable. Of course such deep and meaningful discussions require trust, and trust generally takes time to develop.

Across the board, we understand that different parts of our service are important to different clients, and we want to put some effort into understanding what you value, and in doing that well. To that end CIPL is undergoing a process of establishing clear service levels with clients. This includes organising meetings well in advance, and finding out what you expect from the meeting.

By arranging these meetings in advance we can make sure we are well prepared, and we can address any issues you raise before you come in. While setting out a schedule of meetings for the year may seem a little strange, it does allow us to plan and make resources available, so maximum attention is paid to client matters.

Tamworth clients have enjoyed regular meetings for years. We hope formalisation of meetings in Rockhampton and small changes to the Tamworth meeting format will yield excellent results for clients.

INSURANCE MATTERS

Business class for an economy price

Most buildings are started by getting the right foundations in place. After all, if we didn't have the right foundations, what would happen when there is movement in the soil, strong winds or flooding rains? The answer to that question is quite simple: your house may very well fall to the ground, exposing a shortfall in setting the right ground work.

It is the same when it comes to investing. If you haven't got the right foundations in place, your entire investment dream could come crashing down around you.

So you have your superannuation, your own home with a mortgage and a young family going to a private school. Suddenly you receive the news that you have an aggressive melanoma that is will require intensive treatment. The treatment is expected to last at least six months, with side effects such as nausea, chronic fatigue and loss of memory. How is this likely to affect your superannuation, your home mortgage and your children's school fees?

The right foundations can help mitigate financial adversity. By having a relevant insurance policy you are protecting yourself from those unforseen events. Income protection insurance will pay 75% of your income, including contributions being made to superannuation; it will cover your mortgage payments; and it will even keep your child in their same learning environment and with their friends. In some cases, if you have Critical Illness insurance you may be entitled to receive a lump sum payment on the diagnosis of a melanoma, depending on the specific grading of the policy.

Many of us see our house as our biggest asset, and we ensure that the foundations are laid down correctly prior to commencing construction. We often don't look at our income as being an even bigger asset when positioning ourselves to repay our home, or to retire earlier. You need to ensure that the foundations of your income are just as strong as those on your house.

INVESTMENT BRIEFS

Here are some ideas for our trading clients:

NUFARM LIMITED (NUF)
Nufarm is a global agrichemical operation involved in the manufacture and marketing of crop protection products. Encouraging end of year reports were based on a strong first half 2011 performance and improving industry fundamentals. NUF's first half guidance for an operating profit of $10m – $20m was greater than expected and, while no earnings guidance was given for the full year 2011, management is confident that improved results will be achieved. Successful debt refinancing and an improved operating environment are important contributing factors. Rising soft commodity prices and improved seasonal conditions are supporting a strong demand for agricultural chemicals. Brokers suggest a target price of $5.45.

CARDNO LIMITED (CDD)
Cardno owns a group of companies operating in the consulting engineering services industry, the primary focus being on planning and design of new communities and infrastructure. The company has announced the acquisition of J.F. New and Associates, a U.S. based environmental consulting firm for $12m. It is expected that this addition will fit well with CDD's other U.S. businesses (Entrix and ERI) which, together, are generating revenues of $150m. The J.F. New acquisition has resulted in an increase in forecasts for the U.S. operation of 1% for 2011 and 3% for each of 2012 and 2013. Consolidated NPAT is expected to rise from $37.6m (2010) to $53.6m (2011). Brokers suggest a target price of $5.70.

GWA GROUP LIMITED (GWT)
The company is a supplier of building fixtures and fittings in four divisions - bathrooms and kitchens; heating and cooling; door and access systems; commercial furniture. Hallmark brands include Caroma bathroom fittings, Dorf Clark taps and sinks, Sebel commercial seating, Gainsborough door fittings, Dux hot water units and Rover lawn mowers. The company recently announced the acquisition of Gliderol (doors and openers) for $42m. Gliderol generates around EBIT of around $7.5m and seems a perfectly sensible acquisition for GWA. GWA has stated that it plans to create a door and access equipment division based on Gainsborough, Austral Locks, Hillaldam and Gliderol. The expanded business is expected to increase revenues from $656.8 million (2010) to $774.2 million (2011) and $835 million (2012). Brokers suggest a target price of $3.25.

BREVILLE GROUP LIMITED (BRG)
Breville imports and distributes electrical consumer products to a number of substantial markets including Australia, U.S.A., Canada, N.Z. and Hong Kong. It owns the Breville, Kambrook, Ronson and Goldair brands and has full distribution rights to Phillips in Australia and N.Z. The strong message coming out of the AGM was "we are well positioned to deliver increased earnings in the 2011 financial year."
It is understood that the company is trading to plan for full year 2011 and that the favourable AUD/USD situation is contributing to a strong recovery in sales and profit. Forecast EBIT of $48.3 for full year 2011 is encouraging and, taking a 12 months view, brokers have increased the target price from $2.75 to $3.15.

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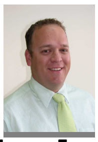

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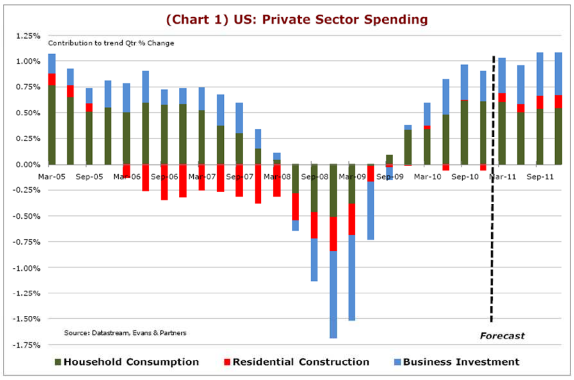
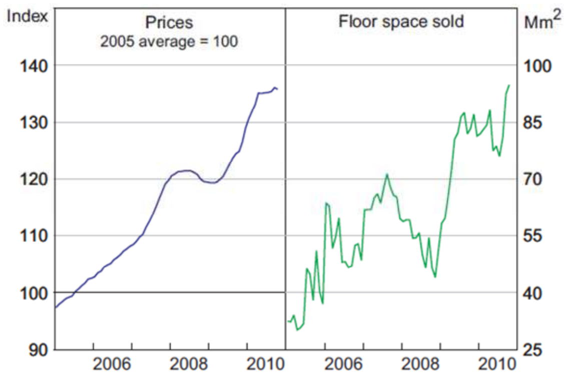
CHART PACK

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

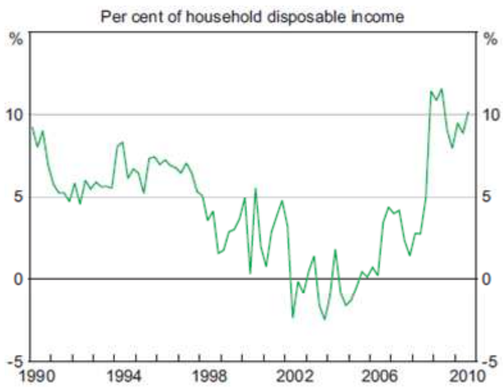
US Consumer spending - consumers in America are still wary after the financial crisis, but businesses are investing



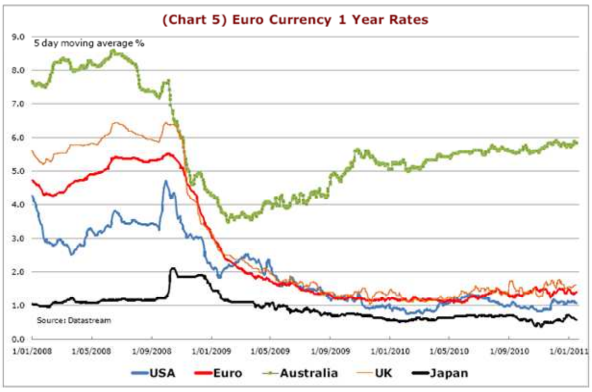
China's property market - the rapid increase in property prices in China has sparked concerns of a price bubble



Australian household saving ratio - savings reaches record levels as we remember tosave for a rainy day



Interest Rates - interest rates in Australia are still much higher, hence the strong Aussie dollar



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