Investment Market Update

Issue 50 – Winter 2013

Message from the Manager

In this newsletter you will gain an understanding of the current reach of our business, a business that was conceived and funded predominately in Central Queensland. There is plenty to be proud of in what we have built. I like the way our staff always strive to be professional, and I like the long term relationships we have built with the vast majority of our clients. I like the way the staff care about their day to day activities, and the way we feel disappointed on the occasions we did not reach the standards we set for ourselves.

In this 13th year of running CIPL, we have enclosed a letter discussing the acquisition of a much larger business in Melbourne, and a pending change of ownership for CIPL. CIPL will continue to operate independently under its new owner (a legal services firm) and will run the entire financial services arm. There will be no change in management and staff, no change in the way we run portfolios and no change in our fee structure. What it will mean is a more robust business in the face of increasing costs and market volatility, and opportunities for clients and staff alike.

The new arrangements are expected to be announced to the Australian Stock Exchange on 31 July, and to be fully in place from 1 September. We look forward to a continued long and fruitful future, and as usual we welcome your feedback.

David French
Managing Director
Senior Investment Advisor

A Balancing Act

Portfolio Structuring Flexibility

One of the advantages we have at CIPL is our flexibility in structuring portfolios. This flexibility contrasts with 'Index Hugging', which occurs when a fund manager holds so many companies comprising a particular index (the ASX 200 (XJO) for example) that the portfolio just mimics the performance of the index. Index Hugging can be an inscribed mandate for managers to blindly follow with the choice sometimes being 'how much' of a certain company should be held rather than the question of if it should be held at all. Another portfolio management technique commonly embraced by fund managers is "Benchmarking". This is the comparison of performance against a certain benchmark such as the ASX 200 index. Benchmarking might be OK when markets are rising but it can also significantly detract from performance when markets are falling.

At CIPL we are not confined to mantras such as Index Hugging or Benchmarking and instead prefer to choose from a more concentrated number of companies. We believe this has advantages such as sharpening our focus to a basket of around 25 companies (predominately listed on the ASX 200) whilst also giving us the option of *when* to be in the market. There are times when we believe certain companies are too expensive, so we hold an underweight position. This can carry across the portfolio when a basket of companies is viewed as too expensive which in turn makes us underweight equities against the market.

Equity markets are by their very nature volatile. We are fully aware of this when managing portfolios and as a result only recommend companies that we see as good value. More emphasis is given to a company's valuation than to its index weighting. Two critical elements of managing portfolios are managing risk and attempting to mitigate volatility.

The advent of the Small Caps Fund in the CDIF has given us the opportunity now to house all small/mid-caps within the Fund whilst sharpening our focus on the companies within our Approved List (the companies approved by our internal Investment Committee and consequently the only companies recommended in portfolios). This also has the effect of transferring higher beta (more volatile companies) out of direct holdings in portfolios.

Another way in which we manage risk is to match the asset mix of your portfolio with your risk profile. This is not index-hugging, it is a deliberate attempt to keep the portfolio performance and volatility in line with the returns you require and the risks you are prepared to take. It is the main reason behind the regular reviews that we send out for all portfolios.

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At CIPL we are always looking at ways to improve the performance of portfolios whilst managing risk and history shows that by not blindly following the acts of Benchmarking and Index Hugging we can achieve outperformance, without incurring significant additional risk.

David French
Managing Director CIPL

Business Update

Financial planning

From 1 July 2013, the new Future of Financial Advice reforms become active. These wide-ranging reforms include the abolition of commission based payments for financial planners, and more focus on what financial planners provide for the money they receive.

CIPL was established as a fee for service financial planning business more than 12 years ago. At the time many said it would not succeed, and in one particularly funny encounter, a staff member was hounded out of an industry function for not sticking to the industry (commission) line. We'll send a posse round they said (watching too many John Wayne re-runs I'd say!).

Around the time of the GFC, it became clear that simply relying on the underlying honesty that is fee for service wasn't enough. We realised that you can be technically very competent, but that many clients wanted regular personal contact. We had always assumed that people knew we would drop everything for them if required, but in the uncertain environment during and following the GFC, it wasn't enough. This realisation led to the implementation of our new Financial Services Guide, which allowed clients to choose their service level, and through that decide how much personal contact they wanted over a year. We set different fee scales, and we invested the money derived from that into a full-time Client Services Manager (Rose) and a dedicated advisor to continuously review portfolios (Lachlan).

The result has been much better interaction with clients, less stress for both clients and advisors and continued excellent portfolio performance, even in choppy markets.

Well 10 years later, here we are. By law, all financial planners now have to be fee for service, and have to justify what they do for the money. They will need in-house portfolio systems, and will come to realise the value of having an in-house managed fund (where more diverse assets are managed by the same people that always looked after your portfolio).

The important point is that CIPL has always been ahead of the curve. We are already set for the new era, and because of that we can concentrate on delivering for clients rather than worrying about the impact of regulation on our business.

Business consulting

The consulting side of the business continues to grow both in terms of staff numbers and clients. Michael Peet, an experienced industry analyst joined CIPL in April, focussing on consulting tasks for professional services and law firms. Roger Cameron continues to work on projects for private developers and engineering firms, and Stephen Moss has been travelling the world linking up buyers and sellers in all professional services sectors.

Perhaps surprisingly CIPL's business consulting arm (Eaton Capital Partners) is a good fit for the firm's financial services activities. There are two reasons for this. First, financial planning (in the manner it is undertaken at CIPL) is itself consulting work, and many of the skills and disciplines required to build and manage portfolios and to advise individuals, are also core to advising small business. Second, ECP's focus is on small to medium size businesses, and behind each of these are real people – the business cannot be considered outside the effect or the advice on the people.

Importantly the work of ECP isn't about just buying and selling of businesses – although that is a key part of it. Almost always there is a significant structuring component, and in conjunction with a sale or restructuring, consideration for personal finances.

If you do run a small or medium sized business, feel free to have a chat about the range of value-adding things we can do for you.

David French
Managing Director

Business Consulting

The consulting arm of CIPL has been exceptionally busy over the last quarter. From the Sydney and Rockhampton offices the consulting team has been advising a range of international, national and local Rockhampton clients on a range of projects in Australia and throughout Asia.

Currently consultants are working for two international law firms to design their respective Asia Pacific business strategies. Both firms are trying to position their practices for the massive growth in the region. Historically, global law firms have focused mainly on Hong Kong as the primary market in emerging Asia. Over time the broader growth in the region and particularly China has seen firms open practices in Singapore and mainland China. The main constraint in the Chinese and Singapore markets is the fact that foreign firms can't practice local law in these jurisdictions. Our expertise in the legal services market is helping guide these firms to the growth sectors of the market including the possible entry into the Australian legal market. Eaton Capital Partners (a wholly owned operating unit of CIPL) has a long history in the legal services market and has several additional mandates with legal firms in Australia and Asia covering strategy, mergers and acquisitions.

Consultants are assisting a local Rockhampton based disability service provider to implement a range of recommendations that came from a whitepaper CIPL wrote earlier in the year (a project we are very proud of). The National Disability Insurance Scheme (NDIS) has just been introduced in several launch sites throughout the country and will be gradually rolled out around the whole country. The NDIS will change the entire disability sector and impact the way service providers operate. After months of investigation and research, CIPL put forward numerous recommendations to this local service provider to prepare it for the NDIS and allow it to capitalise on the opportunities that will arise. We are now assisting the organisation to implement these recommendations so that it is ready to take advantage of the NDIS and better serve people living with a disability.

Every Australian Counts

NDIS | revolutionising disability services

CIPL consultants are also providing strategic advice to a group of Rockhampton investors to assist in creating a multimillion dollar residential development. The development will aim to utilise the Australian Government's National Rental Affordability Scheme (NRAS) that provides a tax free incentive to owners of dwellings that are rented to approved tenants at affordable rates. Consultants have provided advice on the overall feasibility of the project and are now working on getting the development off the ground.

Roger Cameron
Business Consultant / Analyst

Superannuation

Trustees of a self-managed superannuation fund

Self-managed super funds are required to have at least two trustees, or a company as trustee. There are minor differences from a day to day operating perspective, but under certain circumstances, the difference can be major.

Firstly, if an individual trustee becomes mentally incapacitated, that person can no longer be the trustee of a self-managed super fund. They may continue to be a member if they have provided another person with an Enduring Power of Attorney.

If you are the trustee of a SMSF as an individual, we recommend that you provide an Enduring Power of Attorney, either to another trustee of your SMSF, or to a trusted family member or friend. Please contact us if you have questions, or contact your solicitor to prepare this document for you.

The second circumstance is when the trustee of a fund dies. If the fund has two trustees and one passes away, that trustee must be replaced. This can be done either by appointing a trusted family member or friend to be the second trustee, or by replacing both individuals with a company as trustee.

A company may be established with one shareholder and director i.e. the surviving trustee, and the financial position of the SMSF will remain private, whereas a second trustee will also be privy to this information during the course of his/her duties as a trustee. There is an establishment cost if a corporate trustee is chosen, as well as annual registration fees for a company.

Fees

Fee Disclosure Statements

All clients paying ongoing fees will receive a Fee Disclosure Statement (FDS) from us, within 30 days of the anniversary of inception of the portfolio. Some clients with two portfolios may receive the FDS on a different date if the portfolios were established at different times.

The provision of a FDS is a new requirement imposed on all financial services businesses where clients are paying an ongoing fee, commencing from 1 July 2013.

CIPL has been ahead of the game as we have been disclosing the amount of fees paid in our portfolio reports for at least 3 years! The format of the new FDS will be slightly different from our reports so that it complies with the regulations, but contains all the fee information currently available in portfolio reports. When you receive your FDS, please contact us if you have any questions and please sign the acknowledgement and return that to CIPL for our compliance records.

IMPORTANT: Fees on investments purchased with borrowed funds

Another change from 1 July 2013 is that no financial services business may charge ongoing management fees on investments purchased with borrowed funds.

This change will affect only those portfolios where there is a margin loan or the client has redrawn funds against their home loan or taken out a loan specifically to purchase investments. In the main, this will apply to portfolios held in **personal names, family trusts or companies**. It will not apply to any self-managed superannuation funds unless the fund has a Limited Recourse Borrowing Arrangement in place.

We have included a letter with these reports and we ask that **all clients sign and return the letter**, indicating whether borrowed funds have been utilised or not, and if so, the current amount of the outstanding loan.

We are already aware of many portfolios where borrowed funds are used. Where a margin loan exists through Leveraged Equities, CIPL is updated on a daily basis as to the outstanding balance of the loan. For other borrowings, it is in your interests to keep CIPL updated as to the outstanding loan balance.

Risk Profile Questionnaires

Many clients have already completed new Risk Profile questionnaires in the last few months. All our investment recommendations are based on your identified risk profile which is based according to your responses to the questionnaire. You originally completed a risk profile assessment when you became a client of CIPL.

It is important that we keep your Profile updated as typically your tolerance to risk will reduce as you age. Market fluctuations may cause you some anxiety, particularly if your portfolio is based on a profile that is no longer a good match. If your Profile hasn't yet been updated, feel free to contact us to obtain a questionnaire – we will be presenting these anyway at future review meetings.

Sue Dunne
Financial Advisor

Feature Article

The dangers of mental accounting

Behavioural finance is the study of how human behaviour (and psychology) actually drives financial outcomes in a range of situations, often with counterintuitive results that are not flattering to us when revealed in the light of day.

A great example of how we deceive ourselves into irrationality in everyday situations is mental accounting. Mental accounting refers to the tendency for people to separate their money into different accounts based on a variety of subjective criteria, like the source of the money and intent for each account. According to the theory we assign different functions to each asset group, which can sometimes have an irrational and detrimental effect on our financial outcomes.

How do you deal with a found $20 bill or a win at the poker machines? For many people money that comes as a windfall gain is treated very differently than money perceived as having been earned. This interesting and predictable outcome is exactly why casinos have such lavish shopping options on site – people who otherwise would not think of spending thousands on jewellery or designer clothes will happily spend everything they have just won (assuming it doesn't go straight back onto the tables!).

Everyone falls victim to irrational mental accounting at some point, and generally they do not realise just how illogical this line of thinking can be. I know some otherwise very rational people who save money in a jar as a mechanism for saving for their annual holiday, while carrying substantial credit card debt! The money in the jar is not earning any interest, and the balance on the credit card incurs interest at as much as 19% pa – this is in effect a strategy to gear into a zero return asset! Clearly this is a suboptimal strategy. The study of behavioural finance seeks to understand, and potentially to address, these irrational behaviours.

It is important to note that in certain cases, mental accounting, when done effectively and for the right reasons, can contribute to positive outcomes. A good example of this strategy providing benefits is the establishment of an education fund for your young children. When done properly this type of segregation can help you achieve a specific and important goal by ensuring it does not fall by the wayside as a result of more immediate calls on your income. This is one way you can use mental accounting positively to structurally enforce saving for a vitally important goal.

So it can be seen that there are positive and negative aspects to mental accounting. Done right with awareness, it can be a driver of fulfilment of a

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particular critical financial objective. However, if you do not remain alert to the traps, what seems on the surface to be entirely reasonable and rational might end up undermining your financial progress. Being aware is the first step towards being effective in your personal financial behaviour.

It is important to remember that all money, regardless of its origins or intended use, is the same. With this front of mind it becomes easier to make effective allocations of your available money to the most productive use. Realising that saving money in a low or no interest account is counterproductive if you still have outstanding debt is a great place for all of us to start.

In a more formal and strategic sense, your adviser takes elements of mental accounting and uses them as a tool in your financial plan to guide you towards better financial outcomes. For example it is common for many people to see borrowing for investment as risky, but happily draw down against their home to pay for a holiday or new car or to use their credit card to pay for the holiday with the intention of paying it back later. Debt recycling, a strategy where money is deposited as extra repayments on a non-tax deductible home loan only to be immediately redrawn from a tax-deductible line of credit and invested, combined with budget planning is an example of us addressing mental accounting through strategic advice and ongoing coaching. This results in better tax outcomes and faster repayment of your home loan, the same overall level of debt and all accelerated by the benefits of investment portfolio returns.

By taking formal advice from us in the form of a financial plan with ongoing reviews, and combining it with an awareness of your own personal unproductive financial behaviours is the best way to combat the traps of mental accounting. With this knowledge in hand I encourage all our clients to put their next windfall gain straight into their bank account where it can form part of the overall wealth management plan.

Michael Blanchflower
Head of Strategy / General Manager

Investment Briefs

origin

ORG: In the last Quarterly Newsletter we discussed Woodside Petroleum (WPL) as a candidate for a core medium to long term holding in portfolios. With its Pluto project now being fully on line this has resulted in a significant boost in free cash flows. From a free cash flow yield perspective the company was (and continues to be) trading at a significant discount to the market. Its ability to finance solid dividends has significantly improved and the outlook is that WPL has now become a 'yield play' as well as offering growth opportunities.

Origin Energy (ORG) is a company possibly in a similar predicament albeit one slightly earlier in the development stage.

ORG is an integrated energy company focusing on energy markets in Australia & New Zealand. Primarily the company is an energy retailer however it places emphasis on its vertical integration model whereby it attempts to source gas and renewable energy directly. The company has languished over recent years due to the development of the massive Australian Pacific Liquefied Natural Gas (APLNG) project based in Gladstone. Such a project is historically unprecedented (in Australia) and as a result there have been logistical issues and intermittent cost increases in the process of finally getting the project on line.

There have been concerns regarding ORG's ability to build the APLNG project without incurring significant cost blow outs and as a result requiring an equity raising. This fear was compounded at the recent 1H 2013 results announcement when the company disappointed the market by announcing lower than expected earnings as a result of regulatory changes affecting its energy retail business. We believe this is a short term blip and are prepared to look through such an announcement and instead anticipate the APLNG project.

We believe ORG like WPL is a candidate for a core long term holding in portfolios due to the expected significant surge in free cash flows once the APLNG project is on line. CEO Grant King has so far been able to balance the significant operation of financing APLNG through operating cash flows and external debt whilst still managing the company's core retail operations. APLNG is expected to be producing through its first train in 2015. ORG can be bought with a current dividend yield of 3.87% fully franked.

Woolworths
Australia's fresh food people

WOW: Earlier this month, Woolworths (WOW) management announced to the market that its Masters big box home improvement business is not performing as expected. Lower than expected foot traffic, a low conversion rate (high number of tyre kickers at this early stage) and higher costs had all impacted the business. The company's share price fell as much as 2.7% on the day of the announcement.

It is important however to put the Masters business into context whilst remembering that it is still in its infancy. When establishing a business such as this the expectation should not be of absolute smooth sailing. Inevitable teething issues such as establishing right product mix are needed to be worked out when a business such as Masters is operational. We believe

WOW management's decision to directly compete with Bunnings is a valid one due to the inflated margins within the hardware/home improvement industry and room for another major player (we believe) in the big box home improvement market. The current market structure affords this due to the dominance of Bunnings and the highly fragmented nature of the remainder of the industry. WOW is being assisted by US big box operator Lowe's Group (part owner of Masters) and we have faith that management can make the business break even by 2016 (as stated on the 18th of July).

Any further sell off in the WOW share price due to lingering concerns over the Masters business may present an opportunity to purchase WOW shares.

The Masters business represents around 2% of WOW as a whole and consequently investors are still purchasing predominately a leading supermarkets business. WOW enjoys a very high return on equity of 29% (and growing over the last nine years) and consistently high (and also steadily growing) operating margins both of which are testament to management especially in light of the increasing competition from direct competitor Coles. We see long term value in the WOW share price at current levels.

BHP: On the surface the resources world appears to be vastly different now compared to the years preceding 2011. It appears the catchcry 'stronger for longer' has been replaced with sayings such as 'end of the boom'. We have seen mining services companies decimated in this new environment, one of a normalisation in capex of which resources companies have not escaped. We believe the best way to play the downturn in the resources sector will be to turn to the best quality major. With the onset of a new prudent and operationally savvy CEO, world class low cost mines and forecast favourable free cash flow profile, BHP may be the company for investors to turn to.

New CEO Andrew MacKenzie has wasted no time in his efforts to improve the productivity of the company whilst divesting any underperforming assets in an attempt to increase cash flow. The recent sale of its 15% stake in the Jimblebar iron ore operation in the Pilbara, WA is a case in point that netted $1.5bn for the company. BHP has now sold approximately US$7.5bn of assets over the past 18 months at or above net present value. This is not an insignificant feat in the current climate.

MacKenzie has been forced to deal with a number of legacy projects that were committed to at the peak of the commodities cycle. As a result, the company's free cash flow profile this year is expected to be lower than what was witnessed during the commodities boom cycle. However, it is estimated this dynamic will change from FY 2014 onwards. From then, BHP should offer an attractive 5.4% free cash flow yield rising to 6.5% in FY 2015. Furthermore, if the $AUD can continue to depreciate, this will have positive flow on effects for BHP which reports earnings in $US and have the effect of reducing local wage costs.

Often the best investment decisions are made when they are the least popular. Investing in resources companies is far from fashionable at the moment. But, an investment in BHP may be a good long term move because much of the negative sentiment may already be priced into the company.

Lachlan McKenzie-McHarg
Equities Advisor & Dealer

Client Services Update

Have your details changed

Have you recently moved house, changed your email or mobile numbers or has your personal situation changed? If yes, please contact CIPL on 1800 679 000 or email your changes to enquires@capinvest.com.au.

Prepayment of Annual Fees

Don't forget 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. This can be done at any time throughout the year.

Word of mouth

We'd like to extend a huge thank you to those clients who have recommended our services to friends and family. Word of mouth is by far the best form of advertising for our business and we're always delighted to hear about it when we've met all of your expectations.

On the flip side we're also eager to hear how we can improve our services. Please keep the lines of communication open so we can continue to grow our customer relationships and provide you with the best service possible.

Client Portal

Would you like some extra help using the client portal? We have staff available to help you in accessing your information online, changing usernames or passwords or simply running or accessing reports. Whether you're brand new at using a computer or well versed we can run you through the parts you need to know. We're here to help you however we can. You can opt for some help at the end of your client review throughout the year or over the phone. Feel free to give us a call between 8:30am and 5:00pm week days.

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.

Your team at Capricorn Investment Partners Limited

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Amy Gill
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Christine King
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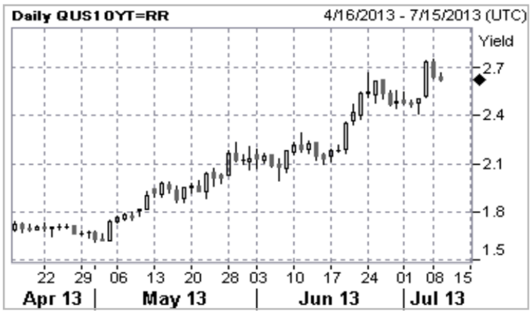
CHART PACK

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

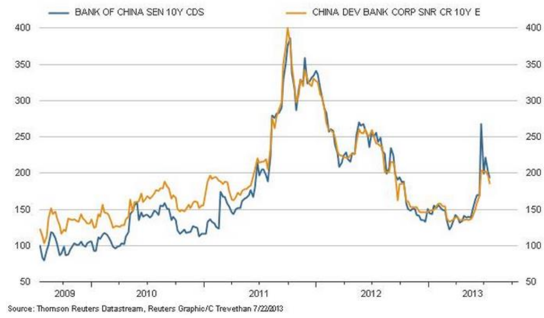
US Bond Yields on the rise

Post Bernanke's tapering comments, US treasuries have sold off and yields have risen. This most likely has **positive** longer term implications for the state of the US economy.



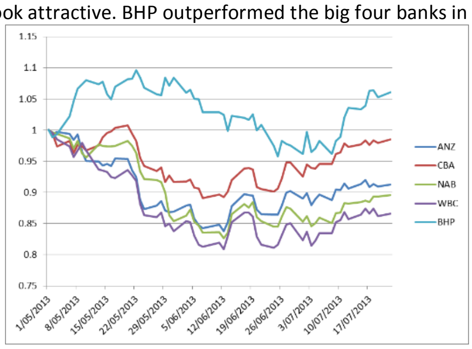
Spike in Chinese short term bank lending rates

Chinese authorities attempt to reign in a burgeoning shadow banking system causing a spike in short term rates. Chinese borrowing needs to be watched closely for any signs of a bubble.



BHP leads the banks in the quarter

As the 'yield trade' cooled off, the banks lost some favour and resources started to look attractive. BHP outperformed the big four banks in the quarter.



Bad for overseas travel, good for our economy - $AUD down 11% in last quarter

In what should be a much needed dose of medicine to the Australian economy, the depreciating $AUD should give a kick start to the domestic economy including manufacturing.

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