Investment Market Update

Issue 57 – Winter 2015

Message from the Manager

It's now two years since we started merging Pentad in Melbourne with Capricorn Investment Partners in Rockhampton. We have created new roles to improve client service levels and embarked on a project to improve reporting and review processes for Melbourne clients in particular. Recently the board signed off on a complete revamp of our computer systems to improve client's access speeds, and enable broader and more consistent service levels across both offices. Following the separation form ILH Group, we are excited about our ability to implement these initiatives for the good of clients, staff and the firm as a whole.

Our regular seminars in Rockhampton and Melbourne are well attended, and we love the opportunity to talk and mingle with our clients. This coming October we will be talking about how companies raise capital and in Melbourne we have a special treat - musician Jane Cameron will be performing. Jane raised money for her new album through Pozible, an internet based crowd-funding platform. Jane's success in raising money for her album points the way to the future – there will be many, many more small businesses, many will be in the arts, and they will find funding from the community at large. Like Uber and Airbnb, such initiatives are forcing the hand of regulators, in altering rules which have over time made it extremely expensive to raise equity capital. It's a fascinating time for small business. We hope you will join us for the discussion and the music.

David French
Managing Director

How much is enough?

One question commonly asked by clients is "how much do you need to retire?" Advertisements, financial planners and well-meaning parents all admonish us to save for retirement; the fact is that by the time you are retired it's too late to worry about how much you have! Frankly I think the issue is bigger than this. What sort of a life do you want to have before you retire? More than once we have seen people putting all their energy into getting ready for their "later years" when it is snatched away from them by something unforeseen. Of course looking forward to retirement is a great thing, but so is living life now. Time with kids and grandkids can't be recovered once that part of life is passed, and neither can time spent travelling and visiting friends or following a passion when you are healthy, alert and active…. ***Youth is said to be wasted on the young, but sometimes retirement is wasted on the old.***

Back to the topic "How much do you need for retirement?" The figure I have always liked is $1 million, but as you will see below, it's purely arbitrary – so much depends on your own circumstances. The $1 million figure is appealing - it's a nice round number, and it's based on an idea that in retirement, we only earn investment income and we do not spend our capital under any circumstances. Of course clients want to preserve their superannuation and over the years I have told countless people that it's unlikely they will need to spend their capital. I like the idea that we might live a long time, and I like the idea that there might be something to leave to the kids. Our experience is that those goals are regularly achieved by people with much less than $1 million.

Take for example someone who would like to live on $60,000 per annum. You can get that in a portfolio with a mix of shares, fixed interest and cash, and after 60 its tax free. If you own your house, $60,000 is enough to do the shopping, visit the kids and have an occasional overseas trip. The Centrelink Assets test changes after January 2016 and on account of that you'll get no age pension but your portfolio will probably earn the $60,000 anyway.

Assessing the outcome for lower amounts is less straightforward, because factors like the age pension do come into play. With only $700,000 you will start eating into your savings, but from 65 the aged pension kicks in (if you were born after 1 July 1952, the entitlement age increases gradually to 67). With the new rules, the pension increases by $3.00 for every $1,000 that the value of your assets drops (double the existing rate). If you retired at 65, and based on some rough calculations, you'd still have $660,000 in the tin after spending $60,000 per annum for 25 years.

Finally, someone retiring at 65 with $500,000 will spend some capital, but at a much lower rate than you would think. The same sort of analysis shows they would still hold about $300,000 after 25 years.

Obviously these examples don't cover all possible outcomes. Many people live on less than $60,000 tax free (by way of comparison, the maximum age pension is $30,659 annually, plus concessions), so you mightn't need $60,000 to live on. Other people continue to work past 65 years old (did you know Bob Stewart in our Rockhampton office is over 80, and continues to be an important part of our day to day operations?). If you do work past 65, and you registered with Centrelink for the Pension Bonus Scheme before 1 July 2014, you might be eligible for Centrelink Payments of up to $74,300. Of course if you work you'll be earning income too and as I have said to many clients, for males in particular, finding something productive to do with their day is very important as they get older. Getting paid for it is better still.

Most people shouldn't stress about outliving their savings. Certainly it's possible, but it's not probable.

David French
Managing Director

Some thoughts on recent market performance

With news reporting verging on mania, it's quite possible that you have noticed that equity markets globally and in Australia have, of late, been extremely weak.

Recently we wrote to clients to communicate our thoughts on the following issues:

- What is happening in markets;
- What is happening to your portfolios which we advise on;
- What we think may happen in future; and,
- What actions, if any, we believe you should be taking.

What is happening in markets is a concerted fear that the Chinese economy, which approximately carried the world through the GFC in 2008-2010 through an astonishing flood of infrastructure projects, is slowing. Combined with weak economies in Europe this will likely impact Australian and global growth. These matters have already been discussed at length in earlier newsletters and client seminars.

There has long been a perception that considerable elasticity surrounds Chinese economic data, corporate reporting and lending structures. A downturn of any magnitude would expose or exacerbate these issues. As the Shanghai Composite Index has fallen by 42 per cent since June 2 there is considerable exposure coming through that market. The concern is thus two pronged: a slowing economy and the risk of a credit contraction.

This has seen equity markets fall sharply.

It is also impacting global commodity markets. It is important to note that China as a consumer of basic commodities is much, much bigger than the size of its economy suggests. Because China is such a large exporter, it has over the past decade, consumed more steel and cement (for example), than the US has since the country was founded.

The portfolios that we advise you on have been impacted by falling equity markets. The ASX 200, the benchmark index, rose from 5152 in mid-December 2014 to 5,938 on April 27 2015, a post GFC high.

As at 24/8/15 (i.e., as this is being written) the market has fallen by 15.4% to 5001. Thus all the gains of the past 12 months have disappeared. The average equities holdings in CIPL advised portfolios have fallen by 11.9%.

We believe that this outperformance in a weak market is a residue of design. We try to buy well run businesses that have strong balance sheets, excellent market positions and reputable management. These businesses tend to be less volatile than the market generally (they have low beta) and they tend to pay out higher dividends.

It is also extremely important that you understand that the average CIPL advised portfolio is underweight equities. On average 49 per cent of portfolios are invested in domestic equities and 6 per cent in international equities.

The 45% of funds invested in cash and debt instruments have been essentially unaffected by turmoil in equity markets.

The funds invested in global equities have benefitted from the decline in the A$ over the past few months. Assets like Capricorn Diversified Investment Fund are affected only modestly.

Further, income generated by investments (dividend payments for example), is typically much less volatile than the market, and we expect little near term change to the income generating capacity of portfolios.

We have no particular capacity to foresee the future. What we do know is that volatile share markets are far from unusual. Since 1950, the S&P 500 a very broad US index, has experience 100 days when markets fell by more than 3%, roughly 1.5 times a year. There have been 24 days when the market fell by more than 5%, roughly once every 30 months. There has been one day (October 1987) when the market fell by more than 20%. In general these events are like cyclones, they tend to cluster rather than being normally and predictably distributed. In addition they tend to be relatively short lived, with the market ultimately recovering well over time.

It's also worth taking note of some real-world observations that support the idea that this volatility is part of normal market movements:

- the US economy is 70 per cent larger than the Chinese economy and continues to grow strongly.
- China generally imports raw materials and exports finished goods. While a downturn in China hurts countries that rely on commodity exports (like Australia), it effects countries like the USA far less.
- Globally, reserve banks have shown a willingness to be proactive in creating liquidity in the face of market volatility. Even China has reduced interest rates.
- The overall debt position of the corporate sector is far stronger than prior to the GFC.
- As discussed in the past, automated trading is exacerbating volatility to a far greater degree than has historically been the case.

In general the best advice in every other period of volatility has been to increase ones exposure to equities, particularly to higher quality businesses at what have become relatively attractive prices.

We believe that the recent decline and present volatility offer an opportunity to continue to increase holdings in high quality names. In particular we find CBA, CSL, WES, WOW, Aurizon, SYD, TCL and the unregulated utilities to be attractive.

Volatility also often creates selling opportunities. We continue to advise that people sell South 32 and any other low end mining assets they may have accumulated.

David French
Managing Director

Annual tax reports will not be ready before the end of October due to the necessity for CIPL to wait until all fund manager reports have been received and the details recorded in the system.

Insurance

Welcome to Scott

Morgen Harris, our dedicated risk protection adviser, will start maternity leave from Monday, September 14.

Morgen has been an integral part of the Melbourne office for more than 9 years and has been responsible for the wider risk protection needs of both offices in more recent times. Morgen is assisted by Amy Gill who will remain a central part of the risk insurance team moving forward.

Scott Plunkett will replace Morgen and commenced in our Melbourne office in late August. Scott is an experienced risk adviser and will be the key contact for insurance for both Melbourne and Rockhampton.

Morgen Harris
National Risk Protection Adviser

Financial Planning

Government moves goal posts on Age Pension Assets Test

Centrelink uses two tests to determine a person's Age Pension entitlement. One is an asset test and the other is an income test; Centrelink applies the test which results in the lower Age Pension entitlement.

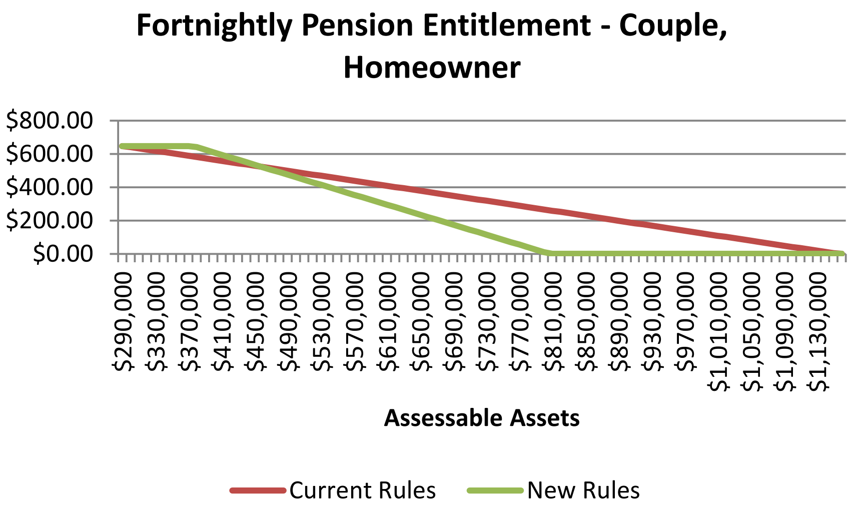
Legislation has now passed (taking effect from January 1, 2017) resulting in the following changes to the assets test.

- The level of assets that results in the maximum age pension entitlement (the "lower threshold") will increase.
- The rate at which entitlements decrease (as assets increase) will double from $1.50 for every $1,000 above the lower threshold to $3.00 for every $1,000 above the lower threshold.
- The maximum level of allowable assets (the "upper threshold") will decrease.

As a result of these changes, some people (with lower assessable assets) will receive a higher entitlement, some will receive a reduced entitlement, and others will lose their entitlement altogether.

The table below shows the new minimum and maximum thresholds applicable from January 1, 2017:

The chart below shows the expected impact of the changes for varying asset levels (based on members of a couple who own their home) and highlights that whilst some pensioners will benefit from the changes, others will be worse off:



Pensioners with assets above the new upper thresholds are likely to feel the biggest effect of the changes as they will lose their entire age pension entitlement.

It is important to note that if you are not eligible for the age pension you may still be eligible for the Commonwealth Seniors Health Care Card which provides a number of concessions and benefits.

There are also strategies we could help you implement in order to reduce your assessable assets, such as:

- Gifting assets (within allowable limits).
- Renovating the family home.
- Superannuation fund contributions on behalf of a spouse who is below the Age Pension age.

If you have any questions regarding your entitlement we invite you to contact us.

Client Focus

Cambodia – it is a majestic kingdom

Mark and Mary Roberts, long time clients of Pentad, were met at Tullamarine airport by sixteen keen travellers including Russell and Sue Warmington, eager to board the plane for their tour to Cambodia. Mark is the tour leader for this wonderful adventure. Over the years Mark has developed a keen interest in Vietnam, and in recent times this has spilled over to Cambodia as well.

Mark, a pharmacist by profession, first visited Vietnam in 1992 with his wife Mary. This visit ignited a love for Vietnam, its people and culture, so much so that in 1994 Mark started studying Australian Vietnam Relations during the period 1983 to 1996, the Hawke/Keating Prime Minister Years. Mark sold his Melbourne Pharmacy business in 1995 to pursue his thirst for knowledge on Vietnam, and finally completed his Doctorate in 2005. During this time Mark travelled to Vietnam many times.

In 2005 a group of Mark and Mary's friends, including Russell and Sue Warmington persuaded Mark to host a tour to Vietnam, little did anyone know that this would lead to Mark having a retirement hobby of tour leading. To date Mark has lead 11 tours to Vietnam and this is his second to Cambodia.

Along the journey Mark and Mary have also spent a year in Hoi An, Vietnam, working for Lifestart, an organisation helping underprivileged children. With all this experience and his natural enthusiasm for the region, Mark is well equipped to lead tours to the area.

Most of the travellers on this tour have been on one of Mark's Vietnam tours before, and are looking forward to Cambodia and the river cruise down the Mekong to Saigon on the river boat The Jahan.

We arrived in Siem Reap, Cambodia and our first full day was taken up with visiting the fantastic ancient temples of Ta Prohm, Angkor Wat and Angkor Thom. It is hard to believe that these large majestic temples could have lay hidden and unused in the jungle for so long. There is a lot of restoration work under way to preserve these wonderful structures for generations to come.

During the 9th to 13th centuries the Khmer Empire prospered and this was certainly evident in the amazing structures before us. In a number of the buildings the magnificent roots of the trees have merged over the centuries with the temples' huge stone blocks, that emphasised a "forgotten feeling". On our next day we were hosted by HUSK, an NGO, and spent the day in Kom Pheim village, located about 25 minutes from Siem Reap. This was a typical Cambodian country village surrounded by rice paddies. We went to the local school and saw the children in the classroom and then we were transported by ox and cart to a local house where we got involved in making thatched roofing material and planting trees for a local villager, who HUSK is helping to be self-sufficient. What a delightful experience was had by all.

Our next day we were transferred to our boat for the 7 night cruise to Saigon. That is another adventure. If you get a chance to come to this part of the world take it. The people are wonderful, the food is fantastic and the scenery so different.

Investment Briefs

Sydney Airport (SYD)

Earlier this month, Sydney Airport (SYD) announced it had completed (in the most part) important pricing negotiations with its international airlines. This deal cements passenger pricing for the next five year period and is dependent on certain service levels being met. It was above consensus expectations and once again underlined the quality of the Kingsford-Smith Airport asset.

SYD derives its revenue predominately from three areas – aeronautical, retail, lease rental and car parking. The importance of the recent deal is that aeronautical fees make up close to half of total group revenue and revenue from international passengers makes up three quarters of total aeronautical revenues. The average price increase of 2.9% compounded annually over the next five years is combined with average projected traffic growth of between 2.5%- 3%. This is a powerful combination set to place SYD on a continued growth projection.

The beauty of Sydney Airport is its proximity to the Sydney CBD. It is only 8 km from the city and due to the significant footprint of an airport combined with the hugely expensive nature of building a competing airport means that SYD should enjoy a continued regional monopoly. Furthermore, aviation is afforded a 'light handed' regulation model, meaning that SYD can generate attractive returns over its invested capital. This type of investment-regulatory mix is an ideal combination that we seek out as investment managers.

We see significant growth potential for SYD to be captured in the growing Chinese middle class. We don't see a risk in the utilisation of the airport given the increasingly optimised operations combined with the usage of larger aircraft with the advent of the A380. Sydney's second airport (65 km from Sydney CBD in Badgery's Creek) does not pose much of a direct threat and regardless SYD itself has first right of refusal to own this airport. We certainly like the longer term investment potential of SYD and are recommending the company in certain client portfolios. We believe SYD currently is trading around fair value and the company offers an unfranked dividend yield of 4.5%.

Syndicated Loans Fund (CSA0046AU)

With term deposits at 2.7% investors have flocked to riskier parts of the market to seek out higher income levels. We have witnessed the significant appreciation of bank stocks whilst in some parts of the world negative yields have taken place. This is an unprecedented time in credit markets. As investment managers we need to evaluate client's income requirement objectives but we must balance that in the context of risk. Our main objective is to minimise the risk of permanent capital loss. As a result, we seek out the best investment managers that we can find.

Bentham Syndicated Loan Fund, is a fixed interest fund focused on syndicated loans diversified across various geographies, issuers and industries. Although investments are made in companies whose credit rating is generally below investment grade the investments themselves are generally made in senior loans. As a result of investing high in the capital structure the recovery rate in the event of default is high. This means that in the case of default, Bentham recover a significant amount of their investment due to the recourse against the invested in company's assets. The best litmus test for this was the greatest credit slump in modern times - the Global Financial Crisis. Bentham 's total default rate was only 2.7% of the portfolio given that 70% of its outstanding defaults were recoverable. As a result, despite the initial move lower in unit price, the Syndicated Loan Fund soon recovered.

However, the Bentham Syndicated Loan Fund is not for every investor. Due to the nature of the fund holding generally lower credit rated investments we should expect more volatile fund unit pricing. The fund is generally held in lower weightings in investment portfolios for this reason. It does however, provide a good income return paid monthly. The current yield to maturity of the portfolio is 7.92% with a running yield of 7.21%. Furthermore, the fund holds very little duration meaning an adverse move in interest rates will have little impact on the fund's return from a unit pricing perspective.

Ramsay Healthcare (RHC)

For some time we have been attracted to investments in the healthcare space. We view the ageing population as an opportunity due to the increasingly unaffordable nature of healthcare for Governments. As a percentage of GDP, healthcare expenditure has increased from around 6% in 1986 to around 10% today with no signs of abating. This increasing burden has meant governments have been forced to incentivise private health insurance to push the expenditure on to the private sector.

This is where private hospitals provider Ramsay Healthcare (RHC) plays its role. The company has been one of the best performing on the Australian market over the last 15 years. We have been rewarded with an investment into RHC since 2012 seeing the investment increase significantly. However, we believe the outlook for RHC is still favourable.

We like RHC for a number of reasons. It has for some time earned a sizeable return on invested capital against its weighted average cost of capital. This is derived from its scale of operations as RHC is the largest private hospital provider in Australia. This enables the group to have efficient procurement, lowering its cost of doing business. Furthermore, scale plays into its advantage. When negotiating with the comparably more fragmented private health insurance market scale affords RHC with reasonable pricing power. We consider RHC to have an economic moat due to the above reasons.

A future plank for growth is found in RHC's global expansion programme. The group moved into the UK market in 2007 with its acquisition of Capio UK. It has since prospered. Its culture of cost control and high levels of customer service have translated overseas seeing a material lift in UK Return on Invested Capital. The UK now represents 15% of total group revenue. RHC has also targeted France for expansion due to favourable industry dynamics such as a high level of private insurance participation coupled with the currently fragmented market. Management have an excellent track record of integrating assets and we believe this will continue with the group's reach into Europe.

RHC management typically pay around 50% of earnings out as dividends due to its investment strategy into acquisitions and brownfield projects. This places the stock on a 1.4% dividend yield inclusive of franking.

Staffing update

Welcomes and Farewells

We have a number of new staff to welcome to our team since our last newsletter in both our Rockhampton and Melbourne offices and a few to farewell.

A very warm welcome to the following staff…

Ian Maloney – Manager – Share Trading (Melbourne)

Ken Khoo – Paraplanner (Melbourne)

Tamika Albon – Senior Client Services Officer (Melbourne)

Boden Abell – Graduate Trainee Rockhampton

Cheryl-Ann Walton – Analyst / Paraplanner Rockhampton

Scott Plunkett – National Risk Protection Adviser Melbourne

Congratulations to…

- **Jodie Thompson** who welcomed a beautiful baby boy in August. Jodie is on maternity leave until early next year
- **Morgen Harris** who is heading off for her maternity leave break in September, we will keep you posted on Morgen's news in the next edition

Farewell and good luck to…

- Michael Azzato
- Supriya Kamat
- Michael Roberts
- Colleen Staun

We thank you for your efforts and hope your future employment opportunities are fulfilling.

Client system update

The client services team is currently working on the role out of a new system for managing client reviews. Our new system will provide a more streamlined approach to communication and will allow for text message and email reminders, improved formatting of communication to all clients.

Our offices Rockhampton / Melbourne

Rockhampton – 1800 679 000 or enquiries@capinvest.com.au

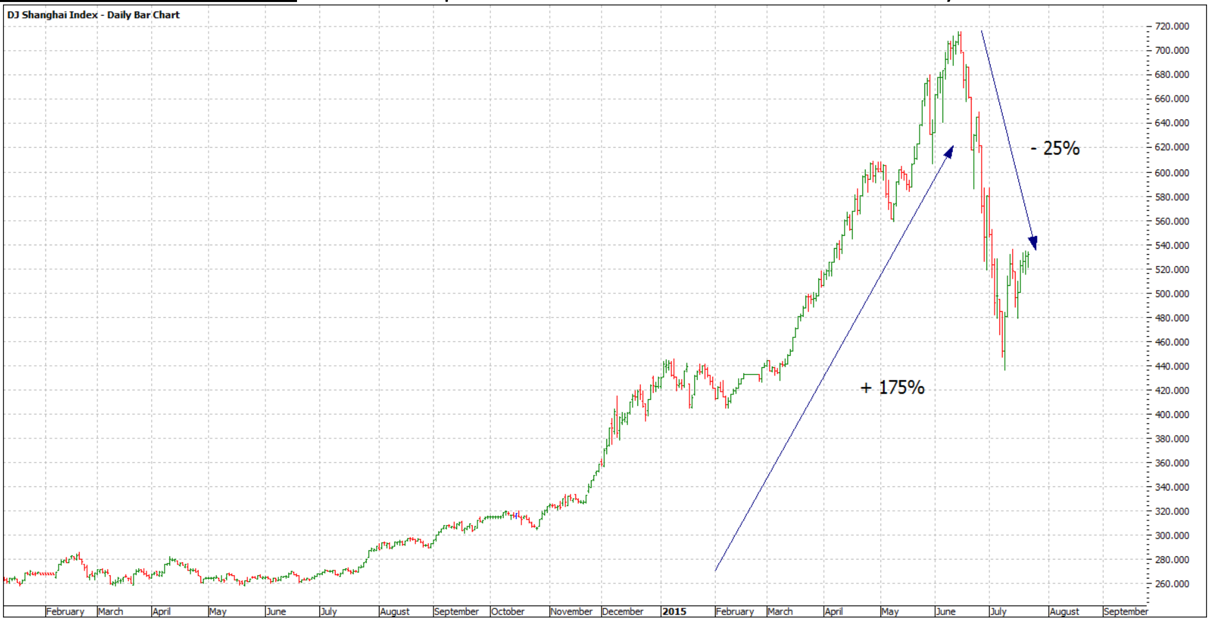
David French	Managing Director
Sue Dunne	Senior Financial Adviser
Bob Stewart	Senior Financial Adviser (Equities Dealings)
Jaimi Summerton	Receptionist/Administration Officer (casual)
Ashleigh Green	Receptionist/Administration Officer (casual)
Boden Abell	Undergraduate Trainee
Rose Sladden	Client Services Manager
Julie Rush	Compliance Manager
Adrian Cahill	Consultant / Analyst
Katrina Tearle	CHESS Administrator
Natasha Kuhl	Portfolio Administrator / CHESS
Cheryl-Ann Walton	Paraplanner / Analyst
Christine King	Bookkeeper
Sandra French	Bookkeeper

Melbourne – 1800 804 431 or clientinfo@pentad.com.au

Russell Warmington	Senior Financial Adviser
Chris Heyworth	Senior Financial Adviser
Lance Livermore	Senior Financial Adviser
Robert Syben	Senior Financial Adviser
John Robson	Senior Financial Adviser
Joshua Scipione	Financial Adviser
Morgen Harris / Scott Plunkett	National Risk Protection Adviser
Lachlan McKenzie-McHarg	Adviser Equities Dealing and Research
Ming Hou	IT Manager
Tamika Albon	Senior Client Services Officer
Under recruitment	Client Services Officer
Ian Maloney	Manager - Share Trading
Paul Young	Manager - Client Services & Paraplanning
Ken Khoo	Paraplanner
Stephen Coniglione	Investment Research Officer
Jaben Heyworth	Client Support
Amy Gill	Technical Support Officer
Janice Vass	Reception / Administration
Rebecca Gough	Administration Assistant

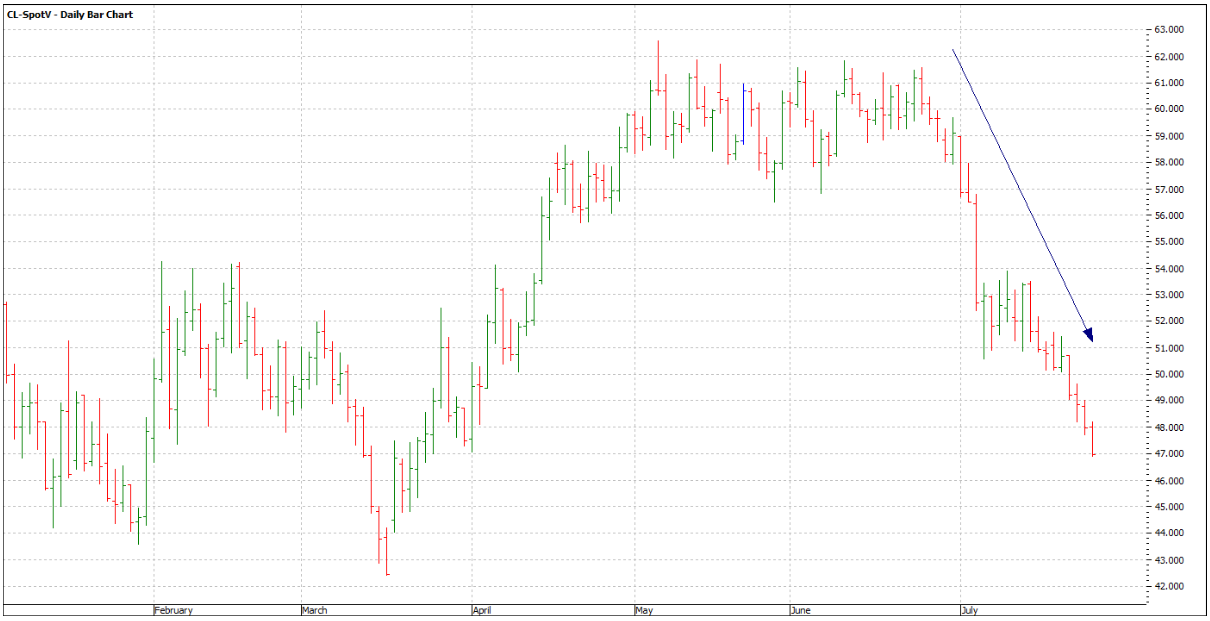
CHART PACK *Information at a glance*

<u>Chinese Market – 'Lunar' Park</u> - Chinese equities have faced a wild ride over the last year



Source: *Profitsource*

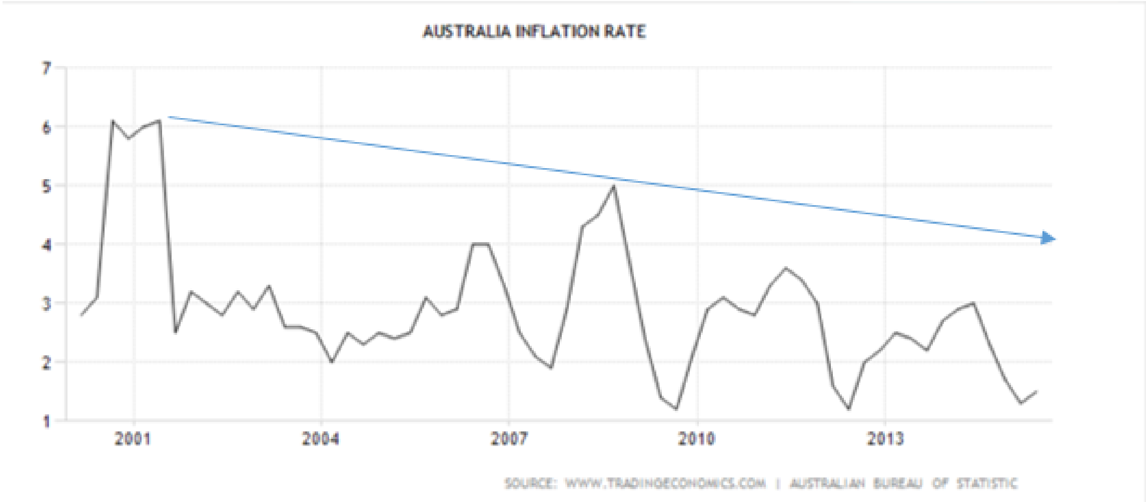
<u>Crude awakening</u> - Excess supply continues to impact crude oil. This should be a positive for global growth due to a decline in input costs



Source: *Profitsource*

CHART PACK *Information at a glance*

<u>Lower for longer?</u> - Declining inflation is dampening the lower yields realised from various asset classes



Source: *Trading Economics*

<u>Lift off?</u> – Debate around when the US Federal Reserve raises interest rates has ensued for some time. The futures market says this is a 45% chance of happening in September.

CME Group FedWatch

Last Update: 08/14/2015

September 17, 2015

Meeting Date: Thursday, September 17, 2015

Futures Expiry: September 2015

Futures Price: 99.8100

Probability of Rate Hike: 45%

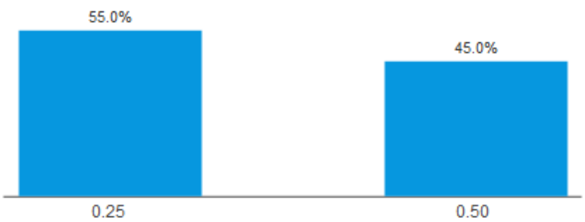
Previous Day

Volume: 8,998

Open Interest: 73,928

Target Rate %	Current Probability %	Previous Day Probability %	Previous Month Probability %
0.25	55.00	61.43	74.29
0.50	45.00	38.57	25.71

Implied Probability



Source: *CME*

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.