Investment Market Update

Issue 46 – Autumn 2012

Market update

Markets continue to be volatile, and management of portfolios in such an environment requires hands-on attention to client's affairs. CIPL was founded more than 12 years ago, on a fee for service philosophy that put clients first. Now on the back of legislative changes, the rest of the financial planning industry is playing catch-up. The industry is going through a seismic shift that CIPL recognised years ago. While many others are concerned for their future, it is business as usual for CIPL.

We are however not content to sit on our laurels and continue to invest heavily in the business. We have developed new service opportunities and continue to improve the services we already offer. All of this work occurs behind the scenes, and from day to day, some of it might go unnoticed. What is true is portfolio performances are benefiting from our work, and our ability to deal with client matters consistently improves.

We hope you enjoy our newsletter, to which we have added the names of most of the contributors. We hope that helps demonstrate the range of talents that go into making good on our belief that "our duty is your future".

David French
Managing Director
Senior Investment Advisor

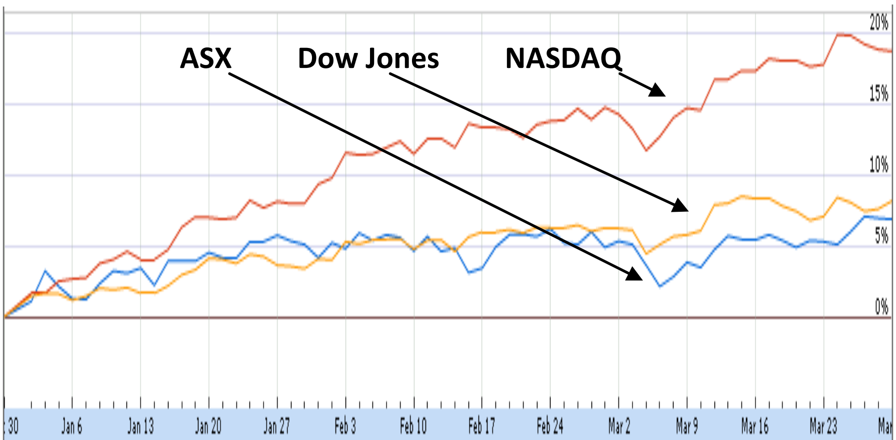
A new year: A new market?

2012 starts with a bang, but concerns remain.

The stock market doesn't believe in Santa, but investors could be forgiven for thinking that Christmas had come early this year, as the stock market made an exceptional start to 2012 with the ASX 200 index up 6.87% for the March quarter. The pick-up in the market was welcome following a very weak December quarter, where concerns over Europe negatively impacted the market.

The market growth was not restricted just to Australia, with most global markets ending the quarter near multi-year highs. In fact the Australian market was a relative under-performer for the quarter, with the US S&P 500 index up 8.14% and the technology-heavy NASDAQ index up 18.67% over the same period.

Chart 1: ASX, Dow Jones and NASDAQ Year-to-date ***Source: Google Finance***



Thank you Team America

The key driver behind the improved market performance was a continuing set of positive economic data out of the United States. Although the dominance of the US economy is undoubtedly diminished since the global financial crisis and spectacular housing market collapse, it is still the world's largest economy by some margin, and stronger US economic growth benefits every other economy in the world.

The most obvious sign of economic growth in the US was a continuing fall in the unemployment rate. From a high of just over 10%, US unemployment is now 8.2%. Still a relatively high level, and progress remains frustratingly slow, but the trend is in the right direction. Encouragingly, the private sector has been responsible for the majority of the recent jobs creation, which hints that businesses might finally be confident enough to start using their enormous cash hoards for investment and hiring (as of March 2012, US companies were sitting on $1.24 trillion of cash, money which could be more productively invested in existing or new operations).

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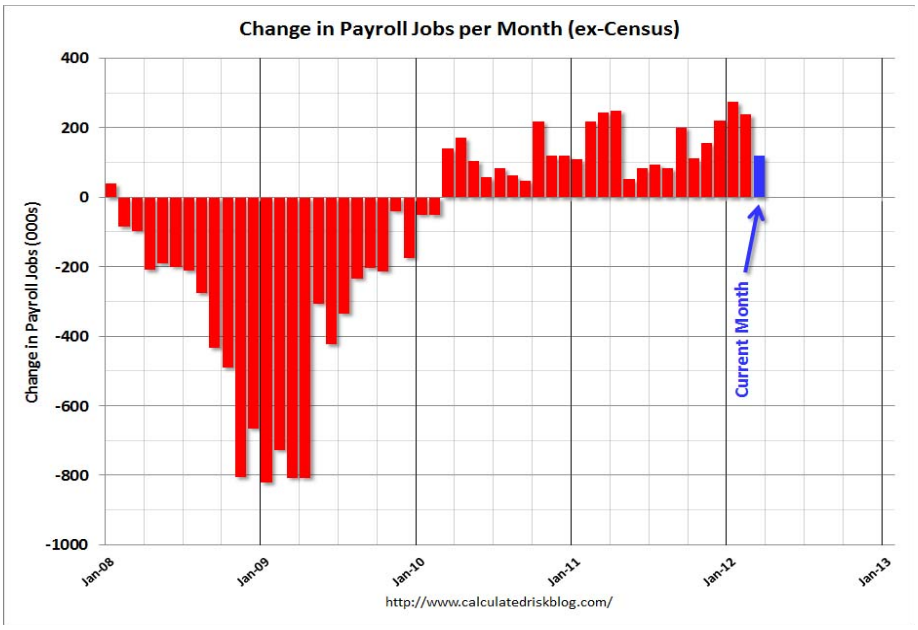
Chart 2: Jobs Added/Lost per Month in the US
Source: CalculatedRisk/US Bureau of Labor Statistics



On the downside however, the US housing market has continued to struggle, with house prices still falling, albeit at a slower rate. A struggling housing market impacts the rest of the economy, particularly the construction sector. The US was building more new homes in the 1960's than it is now, despite the population nearly doubling over the same period. Immediately prior to the GFC, the US construction sector employed over 11,000,000 workers, equivalent to 7.7% of the working population. By 2010 this had fallen to around 8,500,000 workers, which meant that nearly one in four workers in the construction industry lost their jobs during the GFC.

While the bottom of the housing market has been called before, it does seem as though there is some stabilisation of property prices in key US markets. Rising property prices are likely to still be some way away, but even a period of flat prices will encourage homeowners and raise both consumer and business confidence levels.

Pain in Spain, peace in Greece

In somewhat of a counterfoil to events in the US, the situation in Europe has continued to be of concern. The March quarter saw the long-awaited Greek debt default, which appears to have had only a minor impact on financial markets. We probably haven't heard the last of Greece and it's likely that another Greek default will occur at some stage in the future as the country struggles under a debt to GDP ratio of 160%, even after the most recent debt restructuring and default.

The focus in Europe has now shifted to the other highly-indebted countries, with current concerns focusing on Spain. Spain's predicament was brought about by the collapse of the Spanish property market, which required the bailout of the Spanish banking system by the federal government. Despite a stronger and more diverse economy than that of Greece, Spain finds itself in the same predicament as bond investors demand an ever-higher rate of return in order to invest in Spanish government bonds.

Recent action by the European Central Bank (ECB) has helped to ease the threat of a Europe-wide banking crisis, as the ECB lent over 1 trillion Euros to European banks at 1% for up to three years. This was similar to action taken by the US Federal Reserve during the GFC – the so-called quantitative easing. Both initiatives helped to pump liquidity in the banking system, reducing the possibility of the collapse of a major bank or the freezing of inter-bank lending. At some stage however this liquidity will need to be withdrawn without causing severe financial ructions – this is a challenge that the current crop of central bankers will no doubt be hoping to leave to their successors.

Australia – OK but not great

The March quarter provided further evidence that the Australian economy was slowing, despite consecutive interest rate cuts by the Reserve Bank in late 2011. Large sections of the

Chart 3: 10-Year Spanish Bond Yields – Increasing to danger levels
Source: Bloomberg

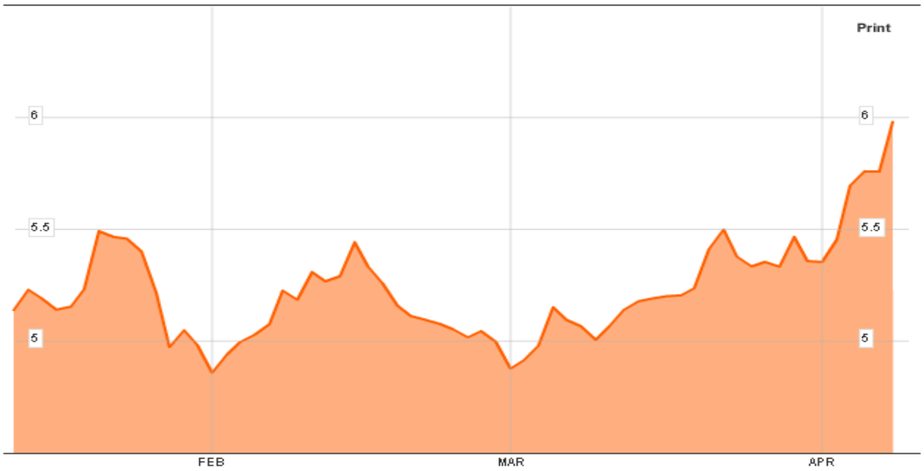


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Chart 4: The Aussie dollar/US dollar chart for the year-to-date
Source: IRESS

economy can be said to be operating at close to stall speed, with some sectors such as retail and manufacturing actually in reverse. As has been the case for the past two years, the strong Australian dollar is the primary headwind faced by many businesses. It is possible that further interest rate cuts through 2012 will assist in lowering the value of the Aussie dollar relative to the US dollar, which should provide some relief to struggling businesses. A number of our preferred investments have significant overseas exposure and should benefit from any weakness in the Aussie dollar (QBE and CSL are two examples).

The Australian housing market has also continued its slow and gradual decline, though some areas have defied the trend (mainly those towns nearby or adjacent to large mining projects). We expect to see further residential property market weakness, although interest rate cuts may assist in propping up the industry to some extent. From an investment perspective, our preference is for high-grade commercial property, which is still recovering from the negative impact on valuations during the GFC.

The next few months are likely to set the tone for the rest of 2012. There is evidence that the commodity boom has eased off slightly, which gives the RBA scope to lower interest rates. In an ideal scenario the slowing in the mining industry would be matched by a corresponding pick-up in the weaker sectors of the economy: retail, manufacturing, agriculture, and travel and tourism. This is a delicate balancing act and may be difficult to achieve. Fortunately however, stock market valuations in Australia are not stretched, with many profitable and well-run companies trading at very undemanding multiples. Prudent investment selection and a focus on quality earnings and manageable debt levels will position client portfolios appropriately for the year ahead.

Justin Baiocchi
Tamworth Regional Manager

Business Update

CIPL's client seminars in April were well attended in both Rockhampton and Tamworth, and provided an excellent opportunity to provide clients with more detail about CIPL's view of markets and where they are headed. It is always quite uplifting to have our clients put time aside for such briefings, and we appreciate the questions that often come from such interaction. Feedback suggests that the majority of attendees get something positive from these seminars, so please come along if you can see your way clear.

Many clients perhaps do not realise the extensive work constantly going on behind the scenes in relation to their affairs. Lachlan and Bob, in conjunction with Sue, Justin and David are constantly trawling markets to identify opportunities or to rebalance portfolios, and such efforts have been clearly adding to portfolio returns. This was a strategy implemented in conjunction with the roll-out of our new Financial Services Guide a couple of years ago, and we are pleased to report not only generally excellent returns compared with the market, but some very positive comments from clients.

CIPL's portfolio system has been operating for about 10 years. While it is already quite a tidy piece of work, it is continuously being improved. Besides day to day reporting, that ongoing investment by the firm ultimately helps keep fees reasonable and allows staff to add value by identifying opportunities and acting quickly on recommendations. Lately we have added a module that allows us to calculate overall returns for groups of clients or even clients as a whole. This will better help us identify portfolios that might be lagging and that require additional attention.

Another area of interest is the roll-out of a book-keeping service. Earlier in the year Christine King joined CIPL as a part time book-keeper. Working under Sandra French (Sandra was formerly a scientist and she has become very skilled with QuickBooks and commercial book-keeping in general), we responded to the needs of a couple of clients who wanted such a service. This week, one of these clients said that having CIPL manage their cash flows was probably the best thing they had ever spent money on.

I would also like to warmly welcome Jake Brown and Jaimi Summerton to our growing team. Jake is studying Economics at the University of Queensland and is working part time for CIPL between study. Jake has been a fantastic resource for our advisors in data analysis and collection for the portfolios and other projects we're currently undertaking. Jaimi started with CIPL three months ago after graduating from the Rockhampton Grammar School in 2011 and has been a welcome young face in the office. Jaimi is responsible for our reception area handling all of our incoming calls and mail along with the multitude of tasks that go with a busy office. Jaimi has taken to the role like a duck to water and we are very pleased to have her on board.

Over the past few months, we have been commissioned to participate in a project investigating the feasibility of a commuter train running between Rockhampton, Gladstone and Bundaberg (David was a transport economist and analyst for a number of years), and we have been appointed to assist another organisation build their own managed fund. We continue to look for acquisitions and other growth opportunities that benefit clients, staff and shareholders alike.

CIPL IT Services

These days, with the security features that are built-in to Windows 7, it is getting rare for a virus or some other form of malicious software to "just appear" on a computer. Generally you need to click something to give permission for the software to install.

A common one I've seen recently are toolbars. These are semi-legitimate programs that show up as a toolbar in your browser window. They aren't *usually* dangerous, but they can slow down your machine, hijack your searches, and reduce your privacy by reporting back to their "home" on what sites you visit. The creators of toolbar software make money from the advertising and by selling the data they collect. They are notoriously difficult to remove - even if you stop the toolbar from showing they can still send data back and hijack your searches - and sometimes **really bad stuff** get installed along with the toolbar. Obviously not something you want on your computer.

Toolbars are usually bundled with another program that you are installing. Much of the time, especially with the higher-quality programs, you can even opt out of installing the toolbar. Most of the security programs you have installed, such as anti-virus, anti-malware, spam and scam blockers, are powerless to protect you because you are the one pressing the buttons. It's like the $600 electronic rust-proofing on my car - completely useless if I blindly follow my GPS and drive off into the sea.

The advice I give is simply to read what you are being asked to do, and think about what you are doing and why you are doing it. Does it make sense to have to install some random program, just to open a website or download a document? You're far less likely to break things if you are aware of what's going on.

If you suspect that your computer has a virus or is acting strangely, take it to a good technician to have it checked out immediately. If you need IT advice for your business, give me a call. If you're hungry, tacos are nice, I prefer soft.

Ben Scott
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Insurance Matters

Death Benefit Pensions

One of the key advantages when including insurance through superannuation is the ability to pay death benefit pensions to certain dependants.

While many people take a lump sum following death and seek to invest outside of superannuation, a death benefit pension can be a tax-effective solution that provides regular income to cover ongoing living expenses.

A death benefit pension is generally an account based pension paid to a beneficiary following death. Eligible beneficiaries include a spouse, or former spouse, children under the age of 18 (or disabled), financial dependants and anyone in an interdependency relationship.

At least once a year, payments are received from the pension and the underlying account balance reflects the transactions made, fees charged and investment returns. The total payments in a year must be at least the set minimum.

A death benefit pension can be tax-effective as earnings within the pension are tax-free. Pension payments are taxed in the hands of the recipient based on the age of the deceased and recipient:

- Where the deceased or beneficiary is under the age of 60, the tax free component of the payment is tax free and the taxable component of the payment may be eligible for a 15% tax offset.
- If the deceased or beneficiary has reached age 60, the payments are tax free.

This concessional tax treatment of the death benefit pensions compares favourably to other investments where income receives little or no tax concessions.

Source: One Path Life lines, issue 7, 2012.
Jason Fagg
Life Risk Advisor

Investment Briefs

Corporate actions for the March quarter

It has been a busy period for corporate transactions with a number of hybrid issues coming onto the market in the quarter. Due to the plethora of new issues, we see a good opportunity to either participate in these issues and/or take advantage of price favourable price movements in the secondary market. QBE Insurance successfully raised $600m worth of new equity and Beach Energy have plans to raise new equity to assist the financing of its capital expenditure programme in the Cooper Basin, Egypt and Tanzania.

AGL Energy:
AGK announced a $650m floating rate Subordinated Notes hybrid issue (AGKHA) to assist in the financing of its proposed Loy Yang A Power Station. The notes are trading at a rate of 3.8% above the 90 day bank bill rate and are currently selling at a discount to face value.

Australia & NZ Banking Group:
ANZ issued a floating rate Subordinated Notes hybrid issue (ANZHA) to the value of $1.5bn in March. The notes are trading with a margin of 2.75% over 90 day bank bills and are currently trading on the market at a slight premium to face value. The Notes have a first call date in 2017.

Beach Energy:
In an effort to fund future capital expenditure plans, BPT has launched a 1 for 8 $195m equity raising as well as a $150m unsecured Convertible Notes Issue due in 2017. The offer price for the retail component of the equity raising is $1.40 and it is unlikely we will be participating due to the offer price premium.

Commonwealth Bank:
Wholly owned subsidiary Colonial Group have issued $1bn worth of hybrid Subordinated Notes at a price of $100. The Notes are trading with a margin of 3.25% over 90 day bank bills and currently are priced on the market at close to face value. The Notes have a first call date in 2017 and we expect them to be repurchased at this date due to the incentive of Colonial Group to do so.

IAG Insurance:
Due to the June 2012 maturity of IAGPA Reset Preference shares and current Mandatory Preference Share offer, holders of IAGPA have been given the option to rollover the existing IAGPA into the new IAGPC. The offer was an attractive one due to the lucrative 4% over 90 day bank bill rate on offer as well as the opportunity to secure the last dividend payment available in the IAGPA issue.

QBE Insurance:
QBE have successfully issued $600m worth of new shares in an institutional ($450m) and retail ($150) offer. The new shares were issued at $10.70 and we applied for new shares on behalf of existing applicable clients. Due to the large discount, the offer was heavily scaled back.

Westpac Banking Corporation:
Another to enter the hybrid security market was WBC during the quarter. The company launched a $1.19bn Mandatory Converting Preference Share offer (WBCPC) with a margin of 3.25% over 90 day bank bills. The Notes came onto the market at a slight discount and have a first call date of 2018 and there is a likelihood they will convert to equity at this time.

Woolworths:
Woolworths is a retailer with primary activities in Supermarkets (food and liquor), merchandise (Big W), consumer electronics (Dick Smith and Tandy) Hotels (ALH Group) and home improvement (Masters). Since relisting in 1993, the company has performed consistently through the adoption of the “Fresh Food People” strategy with “Everyday Low Prices” being matched by “everyday low costs” to the extent that cost savings of $8BN have been achieved in 10 years.

NPAT for the full year 30/6/11 was up 5.1% to $2.12BN with the full year dividend coming at 122c. On 1/3/12 however, the company reported NPAT for the half year 31/12/11 down 16.8% to $966M and anticipated that results for the full year will be subdued due to extreme conditions. Against this, Woolworths has plans for future growth in to the $40BN home improvement market with start up costs for the “Masters” programme calculated at $100M for full year 2012.

This is shaping up to be an interesting recovery situation and at $26 the stock is presenting itself as a buy.

AP Eagers limited:
AP Eagers Limited is an automotive retail group focusing on owning and operating dealerships which provide full facilities covering new and used vehicle sales, service, spare parts and consumer finance. The main areas of operation are South East QLD, Adelaide, Darwin, Melbourne, Sydney and Newcastle/Hunter Valley. The company is active in acquiring commercial properties in association with its dealership and franchising operations.

Through an efficient strategy of acquisition, marketing and cost control, AP Eagers has optimised its margins. Earlier this month the company provided guidance that net profit before tax for the first half year 2012 would be up 20-25% on the previous corresponding period implying growth in earnings for share of 7.1% in FY12, 9.3% in FY13 and 9.9% in FY14. With a very strong outlook prevailing, the group trades on undemanding fundamentals –

- FY12 P.E. 9.2x
- Yield FF 6.6%
- Asset backing $8.37

The stock is presently trading at $14.12 and has a target price of $17.43. It carries a buy recommendation.

Cromwell Property Group:
Cromwell Property Group is an internally managed Australian Real Estate Investment Trust with Australian property valued in excess of $1.4BN and a funds management business which promotes and manages unlisted property investments. It has two key business units which form on property investment activities from property capital raising to property management and leasing. The company reported operating profit for the first half 2012 of $37M (+13% on PCP) which was entirely secured from recurring income. Revenue rose to $86M (+8% on PCP) while gearing was held at 50% and interest cover at 2.3x. Forecast for full year 2012 are strong with the EPS calculated at 7.3cps and dividend at 7cps.

The portfolio stands at $1.73BN with 99% occupancy and 85% of income being sourced from government or listed company tenants. The focus for the time being is maintaining portfolio quality rather than growth. The share price is currently 72c and the target price 77c. It carries a buy recommendation.

Lachlan McKenzie - McHarg
Equities Advisor & Dealer, and

Bob Stewart
Senior Advisor

Fixed Income – ASX Hybrid Instruments

What are they and how do they benefit portfolios?

Due to the recent spate of Fixed Income Security issues on our local market and the prominent place of Fixed Income Securities in many portfolios, we thought it prudent to provide an educational article articulating what Fixed Income Securities are, how they work and why we choose them as an investment choice in portfolios. With relatively low interest rates currently and a stagnant share market the Fixed Income Security sector can provide good income and (in some cases) capital growth prospects.

What are Fixed Income Securities? Fixed income securities are defined as investments that pay a defined distribution (the coupon) for a given period of time (the term). Some repay the face value of the security at maturity while others have no maturity date and are considered perpetual.

Fixed Income securities are a loan from the investor to the issuer of the security with the implied guarantee of the receipt of a regular dividend payment and the return of capital at maturity. Fixed Income Securities rank ahead of ordinary shares meaning any distributions will be paid to holders of the issued Fixed Income Securities.

What types of Fixed Income Securities are there? We focus on two types of Fixed Income Securities being Fixed Rate Hybrids/Bonds and Floating Rate Hybrids/Bonds. Each have different characteristics and are explained below:

Fixed Rate Hybrids/Bonds - Securities which pay a set rate of interest for the duration of the investment term. These securities tend to perform better in a falling interest rate environment as they provide a more predictable dividend than Floating Rate

Hybrids/Bonds - Upon maturity of the investment these securities are redeemed by the issuer of the security at face value normally $100.

Floating Rate Hybrids/Bonds – Securities which pay a rate of interest set at a predetermined margin over the 90 day bank bill rate. The yield on these securities will fall in a declining interest rate environment and conversely rise in an increasing interest rate environment. These investments may either be:

- Redeemed (purchased back by the head company) at the maturity date
- Converted to equity (usually at a slight discount to the prevailing market price of the head stock) or;
- 'Stepped up' (if not redeemed or converted to equity) meaning the margin (over the 90 day bank bill rate) will increase by a predetermined amount.

Why invest in Fixed Income Securities?
Fixed Income Securities are an investment of choice as they provide many benefits not found in ordinary shares. As the main purpose of Fixed Income Securities is to provide a low risk reliable income stream with the aim of preserving capital, they tend to be a more defensive lower risk investment than underlying shares. As there generally is a predetermined expiry date (repayment at face value or conversion to underlying equity subject to the capability of the issuer to meet this requirement) they tend to provide lower volatility and greater capital stability than underlying shares.

Furthermore as Fixed Income Securities generally pay a regular coupon they are a good source of income for portfolios. They also play a diversification role helping spread the investment across a range of maturities, industries and risks. Fixed Income allows diversification away from the two most highly cyclical asset classes – equities and property.

In some cases, good opportunities arise in Fixed Income Securities trading at a discount to face value. These investments can be acquired with the prospect of being repurchased or converted into underlying equity at a premium to the current market price. Recent new issues onto our market have depressed the price of some hybrids already trading and this has created opportunities to purchase existing securities at a discount to face

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value. The effect of this is increased yield and the potential for capital growth.

We believe Fixed Income Securities will continue to provide an important role in the structuring of portfolios due to their generally reliable income stream and less volatile characteristics, and this has created opportunities to purchase existing securities at discount to face value. The effect of this is increased yield, and the potential for capital gain.

If you have any questions or are unsure of anything in this article, please feel free to contact us and we will be happy to assist.

Client Services Update

Keeping in touch... are your contact details up-to-date?

At Capricorn Investment Partners we are flexible with how you like to keep in touch. Throughout the year we correspond with you for client meetings, reporting, seminars and trades and we understand you like to be able to contact us easily as well. Whether you prefer post, email, phone or fax we can accommodate to suit your needs and to ensure your enquiries are met promptly.

If your details have changed or you'd just like to double check, please contact us and we will make any necessary changes.

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Staff Development Training

On April 19, 2012 all staff from Capricorn Investment Partners travelled to Rockhampton from Tamworth and Sydney to attend our Staff Development Day. This is a vital part of the ongoing improvement of CIPL where we can ensure our services are second to none. Staff were further trained on statutory compliance, internal system management, customer service, IT services and Insurance. A very informative day was had by all and a great opportunity for team building when geographically our staff work so far apart.

Website - Client Portal

Did you know you can access your portfolio information via the client portal on the CIPL website www.capinvest.com.au. If you have any queries about how to use the client portal or would like someone to step you through it, please feel free to call the office on 1800 679 000.

You will also find a booklet with this mail out with further information about the client portal for your perusal.

Prepayment of Annual Fees

Did you know you can prepay your annual fees and receive 10% discount on the total? To take advantage of this special offer, please phone or email us and we will send you all the information you need to save yourself what could be thousands of dollars each year.

Tell your friends

At CIPL we always appreciate it when our clients recommend our services to their friends or family. As a small but growing firm, client referrals are important to us, and if you know of friends or family in need of financial advice we would appreciate it if you mentioned our name. We are always open to new clients, big or small and are constantly striving to provide the highest level of service possible.

Rose Sladden
Client Services Manager

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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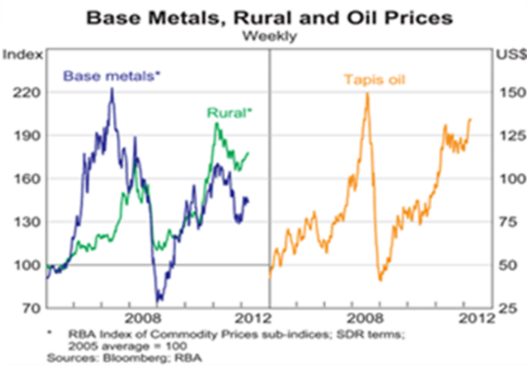
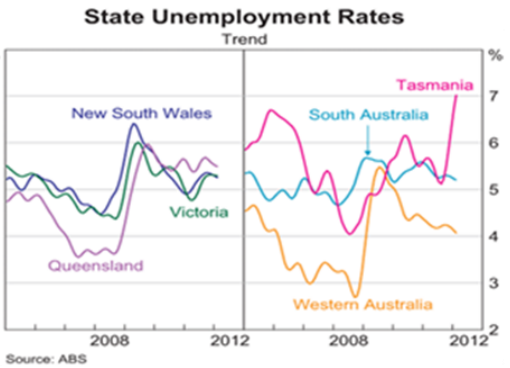
CHART PACK

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

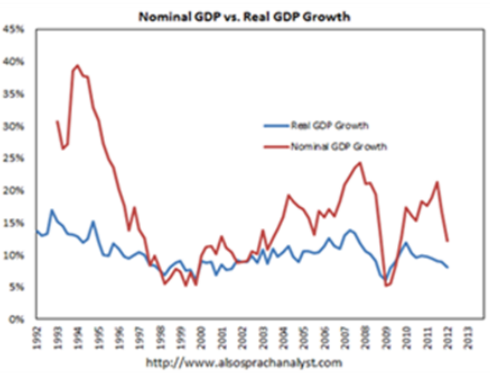
Commodity Prices - Not a great sign for our wallets? With oil rising



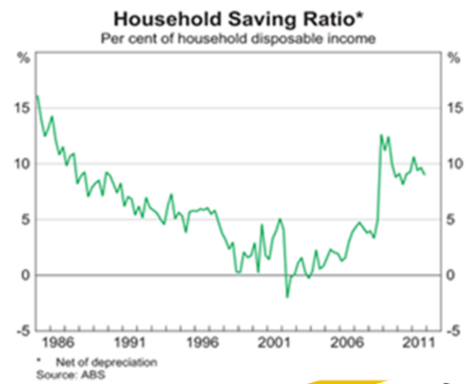
State Unemployment - Tasmania struggling compared to Western Australia. Queensland just ahead of New South Wales



China Slowing - How much puff left in the Dragon?



Aussie's - Saving more good long term sign



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