Investment Market Update

Issue 45 – Summer 2012

Market update

On markets, the coming year is likely to see a continuation of uncertain times. Political considerations mean that the European issue is unlikely to be resolved at the stroke of a pen - rather than a definite "cure", piecemeal patchings are more likely.

Indeed, the "cure" when it comes, is likely to be the result of continuous economic improvement in the USA. In the meantime, domestic interest rates are falling. This will help broaden economic growth outside of the mining sector, but means that deposit rates will fall. CIPL's role will be to ensure that income is protected while managing volatility.

In this issue we look at...

- *CIPL Business Update*
- *CIPL IT Services*
- *The power or compounding interest*
- *Insurance Matters*
- *Investment Briefs*
- *Using the client portal; and*
- *Prepayment of annual fees*

David French
Managing Director
Senior Investment Advisor

Tous pour un, un pour tous

All for one, one for all?

Lachlan McKenzie-McHarg
Equities Advisor & Dealer

Amidst a backdrop of escalating problems in Europe, signs of a slowdown in China and a stubbornly high US unemployment rate, our market finished down 13.2% in 2011. Although most of the damage had been done from 2007 -2008, it has been a frustrating period for clients as they have had to ride through uncertain times choreographed at times by partisan politicians. However, there are signs that the worst may be over or at least nearing an endgame which will most likely be characterised by a normalisation in European bond yields. Although we may usher in some more volatility this year with a possible early downside bias, we believe the remaining part of 2012 should be an improvement on what we have experienced over the last 12 months.

With our market effectively split into three major subsectors being S&P ASX 200 Industrial, Materials and Financials it would be prudent to analyse these sectors when making a forecast for 2012. Starting with the Industrials, a major component of this sector is related to the engineering and mining services businesses such as Leighton Holdings (LEI) and QR National (QRN). Despite reports of a sharp drop off in Chinese demand, this has yet to materialise. Instead what we are seeing is a controlled slowdown in an effort to counter inflationary pressures. We continue to hold both LEI and QRN in certain client portfolios and are in fact adding to LEI in portfolios underweight the stock, a strategy reaping rewards with the recent FY2012 profit upgrade.

The landscape for the Financials sector has changed somewhat since the early part of 2008. Credit growth has stagnated to historically low levels making the job of generating increasing profits that much more difficult. Potentially the two interest rate reductions will help in boosting credit growth however; we remain sceptical that we see a return to the high levels of credit growth experienced during the last decade. This is not to say the banking sector is to be avoided. Management are now placing a strong emphasis on reducing costs such as reductions in headcount numbers and other discretionary costs. Furthermore, there has been a realignment of strategy placing more emphasis on higher growth markets such as what is being seen in Asia currently. ANZ Bank (ANZ) is one proponent of this; another appears to be Commonwealth Bank (CBA). For the foreseeable future, it appears banks have resorted to being lower growth high yielding companies fit for a place in portfolios due to their focus on returning capital to shareholders.

The Resources index comprises mainly BHP Billiton (BHP) and Rio Tinto (RIO). Certainly not immune to the events of last year, the sector was

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down 22.4% over the year. Copper has fallen 21% from its peak in February last year, whilst iron ore has fallen 27% in the same period. Importantly we did see some strong support come into both of these markets, evidence that Chinese buying was capitalising on the lower prices to build up inventories.

Although Chinese growth may slow to below 8% this year we see some good buying opportunities especially in BHP at these lower levels. The company is aggressively pursuing opportunities in the US natural gas market however, we are slightly concerned by the premiums paid for acquisitions and would prefer a return of capital to be made. Regardless, the share price has fallen by 28% since April last year; we see an opportunity at these levels.

Regarding our market, we see the possibilities of another move lower in the first half of 2012 (possibly panic selling) followed by a strong completion to the year. From a historical perspective, the market is trading at a 35% discount a figure that also closely aligns to our technical upside target. Direction will most likely come from a stabilisation in European bond yields which will almost certainly stem from an improving economic situation. The devalued Euro as a means of stimulus to export markets of troubled economies in tandem with important reforms from interim Greek PM George Papandreou and Italian interim PM Mario Monti may be the antidote the markets are looking for.

Business Update

David French
Managing Director

In February CIPL will have completed 12 years running as a fee for service financial planning business. Early on this was frowned upon by competitors resulting in some fiery exchanges in the media. How times have changed. From July all Financial Planning business will be fee for service, and all financial planners will have to work hard to demonstrate value for money. CIPL's continued investment in systems and staffing has meant we have been able to improve service levels in the post GFC period. Indeed over the past year, many, if not most, of the portfolios we look after have significantly outperformed the All-Ordinaries index, while providing income at a rate better than bank interest. These are the results of a team that cares for its clients.

CIPL's managed fund, Capricorn Diversified Investment Fund has been searching for opportunities, and will soon announce its first major project. The project is related to the redevelopment of the Grand Hotel in Rockhampton, and involves a well-known brand name tenant taking a long term lease for much of the site. It is true that in the past, we have not been keen on the use of managed funds, but that is because they have had high entry fees, high ongoing fees and we have had no control as to how the money was invested. Having our own fund means that clients can gain exposure to a much broader range of investments (over and above the normal listed securities), while still having their assets managed by the team they know and trust. A managed fund (whether alone or in a superannuation environment) is the only avenue available by which most retail clients can gain exposure to bulky assets, and over time we expect that CDIF will become a cornerstone of investment outperformance.

Sallyanne Cook, who has been training in Rockhampton for the last 18 months, is returning to Sydney in mid-January to run a CIPL office in North Sydney. This office is a Joint Venture between Archangel Wealth and Accounting, the principal of which is Theo Kotselas. Sallyanne's office will be integrated with all of CIPL's software and systems, providing a seamless service. We are fortunate to have met a joint venture partner with Theo's skills and drive, and have every reason to expect that the Sydney office will attract genuine and interested clients such as we have in Rockhampton and Tamworth.

In the coming year we'll be doing more of the same, and some extra. We'll be maximising income in portfolios, while managing volatility. We'll be organising clients' affairs to get the most from Centrelink, and we'll be keeping up to date with superannuation rules to get the most of the concessions offered by that investment environment. We'll be looking for new investment opportunities for CDIF, and helping small business through providing advice on growing businesses and retirement, and offering our new bookkeeping service.

To finish its worth noting some of the new and interesting projects that have come CIPL's way over the last few months. We are involved in securing the sale of a business in PNG, providing advice regarding a forest products business, and the development of a new coal terminal. The fact that CIPL is considered for such projects is proof of the calibre of the staff at CIPL, and the importance that we place on the various roles you task us with.

CIPL IT Services

We have started an IT services and software development company, headed up by our long-term IT manager, Ben Scott.

Over the last five years, Ben has managed our computer networks and designed and developed a number of internal software systems which allow us to operate effectively with a relatively small number of staff.

Ben is experienced with a number of technologies to develop web, mobile, desktop and server applications. As the only IT person in CIPL, he is comfortable working one-on-one with staff of different skill levels to find

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solutions to their individual requirements as well as developing systems and processes. CIPL IT Services aims to provide custom software development and support services to businesses. Please visit the website (under construction) at **www.ciplit.com.au** for more information. For a confidential discussion please contact Ben:

Email: helloworld@ciplit.com.au
Ph: 1800 679 000
Mob: 0447 741 927

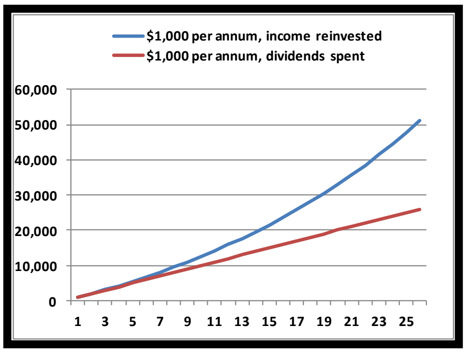
In your best 'Interest'

The power of compounding

Sue Dunne
Financial Advisor

'Compounding' simply refers to the addition of any interest or dividends earned on an investment, to the principal. Once the interest is added to the principal, then interest is earned on the whole amount for the next interest period. In terms of a portfolio of shares, this means that dividend income is used to purchase new shares rather than drawing the income out to be spent.

Reinvesting your dividend income, coupled with the duration your investments are held, are two keys to creating wealth. For example, a savings plan commenced with $1,000 plus $1,000 saved every year, with interest reinvested annually would be worth around $51,000 in 25 years' time, compared to $26,000 if the interest income was spent. The latter is worth almost 50% less.



The example below assumes that the annual income is 5% and does not take into account any fluctuation in the market value of the investment, or any taxation implications.

The table also illustrates that in the early years there is little difference between the value of the portfolio where the income is reinvested and the portfolio where the income is spent. It is not until around Year 7 that the gap widens and the first portfolio begins to visibly outperform the second.

A quick lesson in adding to your investments, adding back the income and leaving it alone to grow!

Insurance Matters

Go ahead, make my day!

Jason Fagg
Life Risk Advisor

Isn't the festive season a great time to catch up with family and hear stories of the year that was. With my family it is about breakfast with my parents-in-law (Hi Rod and Jane) and then lunch with my Mum and Dad (Hi Mum and Dad). We talk about sport, the kid's toys, how they don't make them like they used to etc etc. But this year my brother-in-law asked me why I sell insurance, because it seems the less serious the injury the more likely the company will pay. He gave an example of one of his mates who needed surgery to repair some discs in his back, he was covered by insurance however the company would not pay. He then gave an example where a workmate of his broke his hand and could not work, the insurance company paid up.

These two cases are probably true, but I am guessing the guy with the discs in his back didn't have the right manager on the case.

The very first insurance policy I wrote when I started at CIPL, recently went through the claims process. Our client phoned us saying he was unable to work as he had ripped his shoulder apart and was unable to continue his job as a tiler. We sent through the appropriate claims paperwork and in no time we were receiving calls from the insurance company asking for financials, why we quoted this, reasons for that etc. We were able to provide all of those details to the insurance company quite easily.

After 3 months of consideration by the insurance company we received a letter in the mail from the insurance company. Dear Client, we have assessed your claim please find a cheque in your favour of in excess of $600,000, oh and by the way we have also refunded you all of your premiums that you had paid from day one.

I immediately picked up the phone and phoned my client. He knew it was me straight away, he was blown away; he initially expected to receive a cheque for $10,000 - $15,000 but to get a cheque for over $600,000, and this has now made his life so much easier.

If you have the right cover in place and know the person you are speaking with things do tend to go in your favour. I now have a client for life, because they know I will do what it takes to get the claim over the line.

I told this story to my brother in law, just letting him know insurance companies do pay.

Investment Briefs

From the Share Trading Division

Here are some stocks we are currently looking at:

Lachlan McKenzie - McHarg
Equities Advisor & Dealer

NHF: NIB Holdings Limited (NHF)

NHF is a national provider of private health insurance and related health care activities to more than 800,000 people. NHF's strategy is to provide innovative, low cost health insurance products. NIB Holdings (NHF) continues to comfortably lead the private healthcare insurance (PHI) market in policyholder growth, with figures over double the industry average growth since 2006.

NHF is operating in the fast growing PHI market a fragmented market that may provide acquisition opportunities in the future. NHF is capitalising on the supportive dynamics within the PHI market and is seeking to capitalise on the emphasis by government on PHI. One possible risk to future earnings is the Government's proposed means testing of the current PHI rebate. However, not only has this change not passed through both houses of parliament but NHF Management have stated that the risks to earnings from a change is minimal.

NHF is conservatively managed with no debt and it employs a defensive investment position for surplus funds. Furthermore, NHF offers a very competitive fully franked dividend yield of 6.75% and can be purchased for around 11.5x FY2011 earnings. We are currently purchasing NHF in a number of portfolios due to its defensive earnings stream, excellent Management, solid dividend yield and attractive valuation.

SMX: SMS Management & Technology Limited (SMX)

SMX is a consulting, technology and systems integration company. SMX specialise in improving operational performance and IT delivery by addressing everything from business integration to compliance, process improvement to change management and technology strategy to systems integration and application development.

SMX is a fundamentally sound company with forecast earnings growth, strong balance sheet and healthy margins. Furthermore, SMX has no debt, has an average Return on Equity of 30% (extending back to 2006), has experienced 8 consecutive years (bar 2009) of EBITDA growth and has reported solid operating cash flow for years. Another positive aspect is the reluctance of management to dilute shareholders with very few equity raisings – shares on issue have increased only slightly in the last few years. Also, the company is currently holding around $25m in excess cash, so there is some scope for capital initiatives such as a buy-back of shares if merger and acquisitions don't materialise.

However, despite the number of positives, the SMX share price has suffered to the tune of 37% since reaching a high of $7.44 in November last year. As a result, SMX is now on offer for 10.4x trailing earnings, 8.1x EV/EBITDA and is offering a very healthy 6.5% Fully Franked dividend yield. Taking a look at the risks surrounding the sector and a slow down due to a possible worsening in economic conditions, it is important to put this in perspective. At the depths of the crisis in 2009, SMX's EBITDA fell by a very small 4.8% and soon recovered in 2010. With the share price down by 37% it appears most if not all of this negative sentiment is now baked into the stock. At this stage it would be unlikely for economic conditions to be as bad as what was experienced back in 2008 – 2009.

APN: APN News and Media Limited (APN)

APN is involved in publishing, radio broadcasting, online, transit & outdoor advertising in Australia and New Zealand. Its share price has been absolutely punished since the peaks of the GFC, falling 88% from $6.04 in late 2006 to a low of $0.695 in December this year. Readers may recognise APN from the large advertising boards found in cities across the country. However, as it is a diversified media business the company also has ownership of a number of news publications, including the *Rockhampton Morning Bulletin.*

APN is a classical cyclical business. As it operates in the advertising market, its earnings are heavily skewed to the health of the economy. With advertising spend currently at historically low levels this has directly impacted upon the company's earnings. However, there is the possibility investors have become too pessimistic. The stock now trades at a forecast 12.5% FY12 dividend yield (partially franked) and forecast FY12 price earnings ratio of 5.9x.

Management reported 1H11 EBIT at A$66.5m, below guidance of A$67-72m. The result was affected by a number of one off items such as a non-cash impairment of A$156m from its NZ mastheads and A$10.3m for redundancies. Furthermore, APN was adversely affected by the Queensland floods and Christchurch disaster. Nevertheless, the result was not all doom and gloom. Management are targeting 2H11 EBIT of A$118m on the back of some encouraging results in its outdoor division. Outdoor revenue grew 11% on the preceding period and EBIT by 80%. Furthermore, there was some growth in the radio division also with a solid ad market and improved ratings whilst the A$7m in savings from redundancies should hold the company in good stead when it reports its FY11 result. APN's net debt of A$657m was steady on the preceding period with management opting to instead pay dividends rather than pay down debt from existing cash flow. This may be another reason why investors have shied away from the stock, as its gearing level now stands at 55%. However, as APN is a highly cash generative business it is able to cover interest payments by four times through its net operating cash flows. APN may be a worthwhile turnaround story for a patient investor willing to ride out the current tough conditions.

Client Services Update

Did you know you can access your portfolios from the CIPL website?

Rose Sladden
Client Services Manager

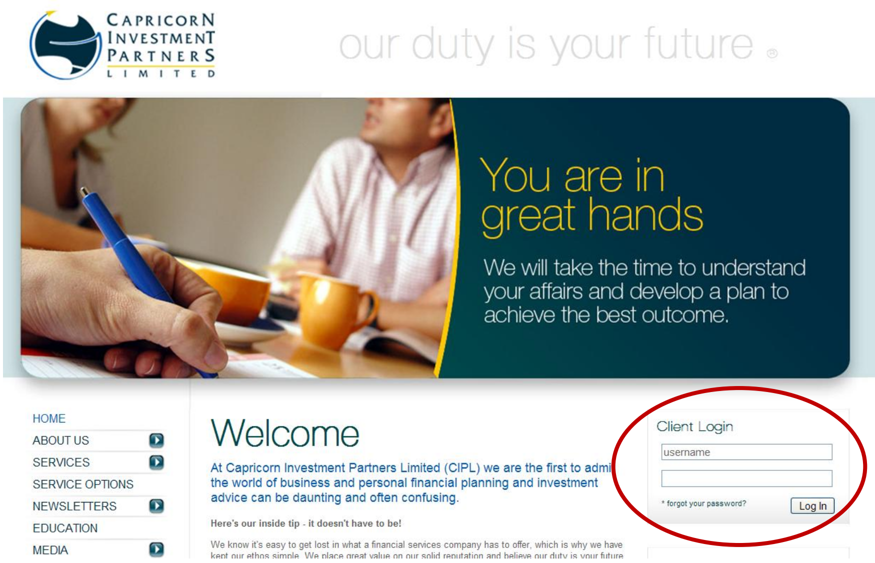
Accessing your portfolio information is now easier than ever! Simply go to our website - www.capinvest.com.au and log in to the client portal with your unique username and password.

If you do not have a username and password or have forgotten or misplaced them – no problem, please feel free to call or email and we will set up your access over the phone and run through how the client portal works.

Once logged in you can see your portfolio summary along with the following reports...

- *Portfolio Valuation*
- *Income and Expenses*
- *Income Summary*
- *Mark-to-Market*
- *Investment Transactions*

Capricorn Investment Partners Limited website homepage



- *Cash Transactions*
- *Distribution Summary*
- *Investor Movements*
- *Realised Gain/Loss*
- *S/F Member Movements*
- *Unrealised Gain/Loss*

To save time you can also accept share recommendations at the click of a button from your secure client portal.

Please contact the office on free call 1800 679 000 or email us on enquiries@capinvest.com.au for any questions or to set up your access.

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.

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.

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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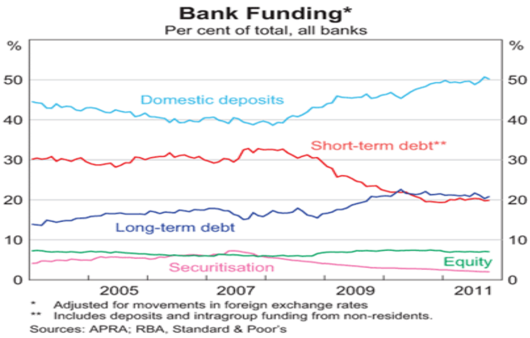
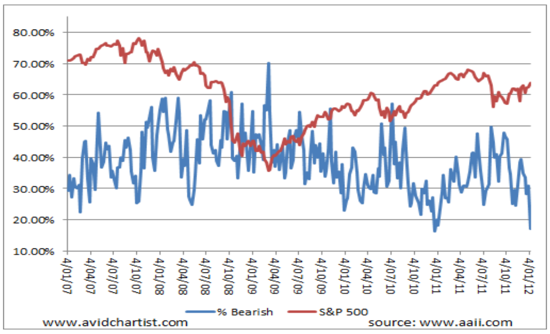
CHART PACK

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

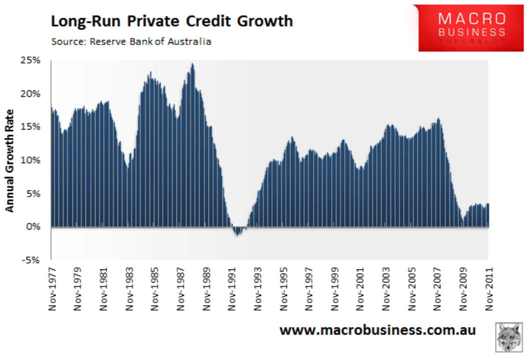
Bank Funding - Domestic deposits became more important for Aussie banks from 2007-2008 & onwards



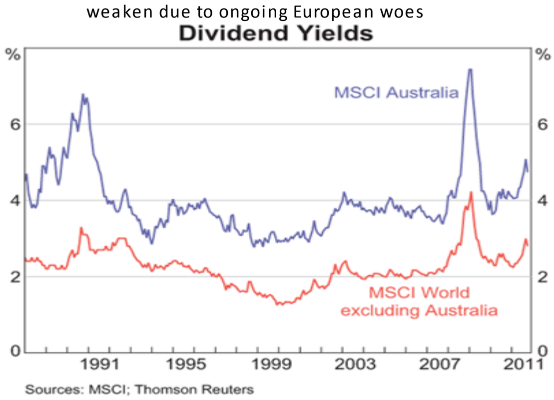
US Bulls? - Bearish sentiment in the US is at a five year low



Credit Growth - The days of double digit credit growth seem gone. Not good for banking jobs.



Dividends - Dividend yields are rising as share prices weaken due to ongoing European woes



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