Investment Market Update No. 19

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Editorial

March has been a strange month for the Australian share market. Following an above average reporting season we have seen most stocks sold off quite heavily of late. Rather than panic selling, astute investors see this as a way to increase exposure to quality stocks at a discount.

In this issue we cover:

1. Market sentiment; and
2. Investment briefs.

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Market sentiment

Since the beginning of March 2005 the Australian share market, represented by the All Ordinaries and the S&P/ASX 200 have fallen by 1.7 per cent and 1.86 per cent respectively. Since their highs (both achieved on 18 March 2005) the indices have each fallen by 3.6 per cent.

One of the reasons quoted for the recent decline are fears of higher interest rates. As anyone who had a mortgage in the 1980's can attest, current interest rates are low by this measure. Table 1 shows a selection of interest rates over the past fifteen years. Analysing this data indicates the current official interest rate of 5.50 per cent is neither much higher nor lower than official rates over the last decade or so.

The 1990s in Australia were characterised by strong economic growth and low inflation. Usually strong economic growth is accompanied by higher inflation, but the RBA has managed to keep inflation under control. Two inflationary threats to the Australian economy at the moment are higher oil prices and wages growth. As the cost of oil cannot be manipulated by the RBA, further significant increases may lead to higher domestic interest rates (unless global growth slows too).

Prior to rates increasing on 2 March 2005, they were last increased on 3 December 2003. The doom and gloom portrayed by the media following the March rise of 0.25 per cent rise was uneducated at best and just plain old scare-mongering at worst. The RBA has much more information about the state of the economy than any other body in the country. With their main goal being containment of inflation they acted in what they thought was the best interests of the economy.

New home owners who were only too happy to buy in at the top of the market with minimal deposits are now crying foul. Expecting interest rates to remain at 5.25 per cent was unrealistic, and perhaps the rush to buy property using the first home owners grant as the only form of 'savings' will come back to haunt many people.

Table 1: Historical interest rates

Date of change	Cash rate (%)
02-Aug-90	14.00
04-Apr-91	11.50
08-Jan-92	7.50
08-Jul-92	5.75
24-Oct-94	6.50
11-Dec-96	6.00
02-Dec-98	4.75
02-Aug-00	6.25
05-Dec-01	4.25
02-Mar-05	5.50

It is interesting to note that in the period from 30 July 1993 to 14 December 1994 interest rates increased by 2.75 per cent (from 4.75 per cent to 7.50 per cent) and the All Ordinaries fell by only 1.35 per cent. Perhaps this indicates a short-term over-reaction by speculators given current interest rate movements. However, between the period 31 January 1994 to 31 January 1995, the All Ordinaries fell by 20.5 per cent. It was not until 30 April 1996 that the All Ordinaries recovered to the same level achieved in January 1994.

Both investors and homeowners should be prepared for further interest rate rises in the short to medium term. To that end we are currently predisposed to allowing cash to build up in portfolios – or at least not make new investments unless there is something compelling. Our portfolios are designed to withstand the market's ups and downs. They all generate substantial income, which helps to offset volatility, and they all have a mix of assets that behave differently in different market conditions. For instance, all portfolios have at least some hybrid securities or property/infrastructure assets, with generally low volatility. More aggressive portfolios have more direct shares, which while more volatile, have the potential for significant capital growth. Even with shares however, we focus on quality assets that are likely to pay high levels of dividends.

Currently we are working on ways to improve our reporting of portfolio returns. The data shows that by and large client portfolios are behaving exactly as you would expect – the aggressive ones show the highest returns in a strong market, the conservative ones a lower but stable return, and the balanced portfolios fall mid field.

Some clients might be wondering why we don't always sell investments "at the top". There are a number of reasons. First, there are so many factors that influence investment prices each day, that even if you have got a good idea of fair value (which we always try to ascertain), it can be difficult to know where the top is. Second, what do we do with the money if we do sell? Often all investments have increased in price. If we were getting an 8 per cent yield on the original investment, is it sensible to reinvest it in something equally expensive that is now yielding 5 per cent? Sometimes it is, sometimes not.

While any investment carries some risk, the academic literature and our own experience supports our approach for the accumulation of wealth, and the funding of retirements.

Naturally if you are ever concerned about any part of your portfolio, please contact us for a review.

Investment briefs

National Australia Bank (**NAB**): NAB have announced its intention to make 1,700 jobs in the UK redundant as part of its restructure. No word has been provided about potential job losses in Australia.

Telstra (**TLS**): The federal government has appointed UBS and Caliburn Partnership to undertake a scoping study for the sale of the government's remaining stake in TLS. The study is expected to focus on ways to maximise the value of the sale.

Colorado Group (**CDO**): Bucking the recent trend for retailers, CDO announced a 54 per cent increase in profit and a doubling of its pace of expansion (*source: Macquarie Equities*).

Australian Infrastructure Fund (**AIX**): AIX is another stock that has been sold down heavily recently, especially in the lead up to its rights issue (which is being used to fund the purchase of stakes in the Athens, Dusseldorf, Hamburg and Sydney Airports). This remains a quality, well-run company with a high and sustainable yield.

Sydney Futures Exchange (**SFE**): SFE gets hurt more from sentiment rather than earnings as its earnings are a function of risk, volatility and interest rate differentials, not the direction of equity markets (*source: UBS*). Hence the recent price movements. Over the past six weeks SFE hit a (record) high of $10.17, only to fall to a low of $8.54 (a loss of 19.08 per cent). The stock has since recovered to $9.17.

Seven Network (**SEV**): Due to changes in international accounting rules SEV have announced they will be redeeming their SEVPA and SEVPB hybrid securities and issuing a third tranche. We will provide more details about the implications of this to affected investors as they come to hand.

Challenger Financial Services (**CGF**): CGF have announced the acquisition of HSBC Asset Management for $21.9 million. History says integrating the two business will take longer than expected and disaffected staff will be poached by competitors.

Macquarie Bank (**MBL**): MBL announced their intention to acquire Canadian aged care provider Leisureworld for A$558 million (*source: UBS*). MBL is expected to report strong numbers when its results are released on 17 May.

Hastings Diversified Utility Fund (**HDF**): HDF have announced they are seeking to raise $110 million from the issue of Trust-issued Adjustable Preferred Securities (TAPS). The TAPS are being used to repay bridging finance provided by Westpac for the purchase of Mid Kent Water. Mid Kent Water is the fourth largest (of thirteen) Water Only company in England and Wales.

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