Investment Market Update

Issue 42 - Autumn 2011

Welcome...

Now in the fourth month of the new year, markets have shown a resilience over and above what might have been expected with the succession of natural disasters that seem to have popped up all over the world.

The fact is however, markets are resilient. The desire to swap and trade is as old as humanity itself, and because of that they are one of societies' greatest institutions and social assets.

Prices determined by markets do move about. Seemingly capricious, it is up to market participants to gauge whether prices are accurately reflecting value or not. Experienced practitioners know that one off events (such as the tsunami in Japan) rarely have a long term negative impact on prices, whereas structural problems such as became evident through the GFC take much longer to wash through.

We hope you enjoy the contents of the newsletter, and as usual, please contact us if you have any queries or concerns.

Regards

David French
Managing Director
Senior Investment Advisor

NATURAL DISASTERS A FEATURE OF THE START OF 2011

Stock markets challenged by global events but perform strongly

People who are in the business of making predictions would have made a poor start to 2011. It's unlikely that even the most skilled observer would have predicted the wave of major events which have occurred in the first quarter of 2011. The severity and disparate nature of recent events was quite staggering.

Major flooding in Queensland, New South Wales and Victoria; Cyclone Yasi; earthquakes in New Zealand and Japan; political upheaval in North Africa; and the financial bailout of Portgual.

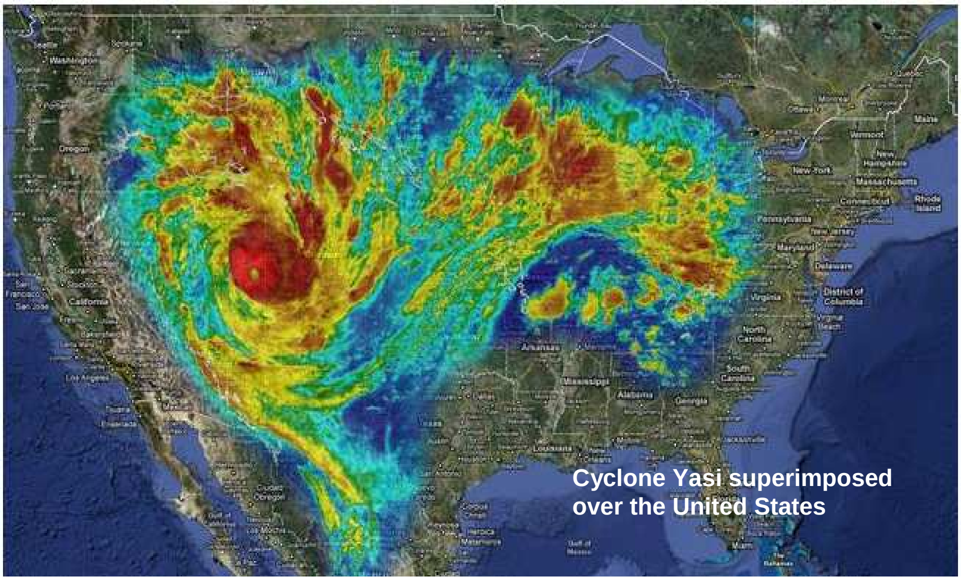
Floods, earthquakes, nuclear accidents, revolutions and unrest…it certainly has been an eventful few months.

Somewhat contrary to what might be expected however, the stock market put in a relatively strong performance over the quarter, with the key ASX/S&P 200 Index rising 1.94%.

There are a number of key reasons why the market was able to record a solid result despite the severity of the various incidents.

Firstly, the US economy has continued to recover from the recession of 2008/09. Unemployment in the US recently fell below 9% for the first time since the global financial crisis erupted.

Company profitability is rising as cost-saving measures and cutbacks during the recession act to increase the profit margins of many major organisations.



Cyclone Yasi superimposed over the United States

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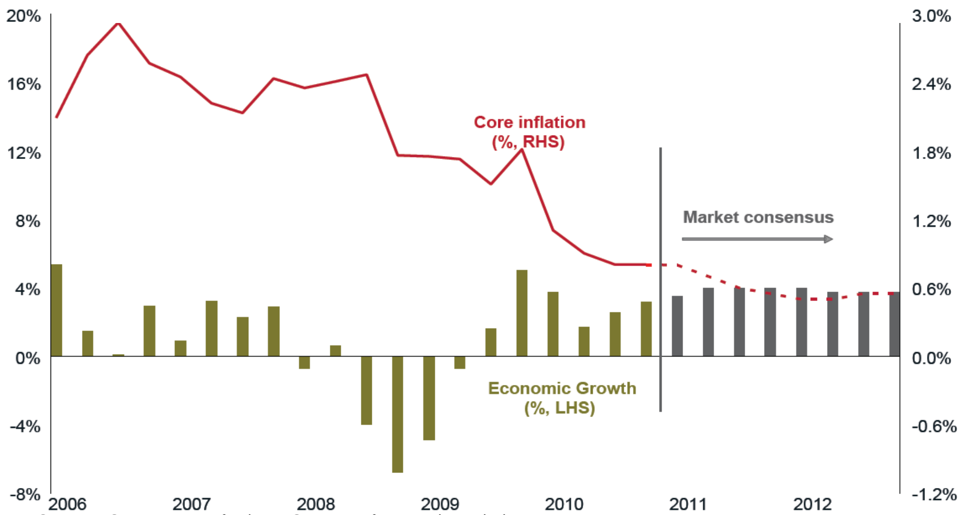
Furthermore, US exporters are gaining a significant benefit from the weak US dollar, which allows them to compete with, and undercut, exporters based in Europe, Australia, Canada and elsewhere.

Importantly, both fiscal and monetary policy has continued to provide support to the US economy, evidenced by the extension of tax cuts and interest rates at near zero levels (homeowners in the United States can borrow at interest rates Australian mortgage-holders can only dream of – imagine locking in a 30-year home loan at a fixed rate of 4.50% for the entire life of the loan).

US inflation & economic growth forecasts are both positive



Source: US Department of Labor, US Bureau of Economic Analysis

As the United States economy makes up nearly a quarter of total global GDP, a sustained economic recovery in the US is a key requirement for ongoing global economic growth.

It's not all good news for the US however, with house prices tipped to fall by a further 10% in 2011, despite very attractive interest rates as mentioned earlier. There are currently around 3.49 million homes in the US for sale, with another 1.8 million either in a state of loan default, foreclosure or owned by the lender.

This oversupply of housing for sale will continue to push housing prices lower, although the good news (if it can be called that) is that new home construction has fallen to such a low level that it may not take as long as expected for the demand for housing to significantly reduce the large number of houses for sale.

A second reason why the stock market has been able to withstand the uncertainty caused by recent global events, is that the world remains locked into the ongoing commodity boom.

On many occasions we have pointed out the vulnerability of the Australian economy should the boom end abruptly, but in the meantime the Australian stock market, which is heavily dominated by resource companies, continues to benefit from near-record prices for most commodities.

To some extent many Australian companies may actually stand to benefit from the recent floods and the earthquake in Japan.

Rebuilding and construction work associated with both events results in increased demand for construction and housing related materials and the raw materials required to rebuild damaged transport infrastructure.

While the short-term impact would certainly be negative, we do expect to see an increased level of demand for raw materials in the medium term as the rebuilding process gets underway.

The dark side of the ongoing commodity boom however, is the rise and rise of the Australian dollar (AUD) against our major trading partners. While it's not the sole cause of the strength of our currency, the boom has played a significant role in pushing up the value of the dollar. The AUD finished the quarter at $1.033 compared to the US dollar, and has since risen above $1.05.

These are historically high levels – since the dollar was floated in 1983 it had never reached more than $1.02 versus the US dollar, and the average value since 1983 has been only $0.72 versus the US dollar.

It is important to remember however that there are two sides to exchange rates: while it is true that the Australian dollar is strong relative to our major trading partners, it is also true that the US dollar is conversely very weak against most other global currencies.

Nevertheless, the end result as far as Australia is concerned is the same – reduced competitiveness in global exports markets, while domestic sectors such as tourism, manufacturing and agriculture are squeezed by ever-cheaper imported products.

Looking ahead to the rest of the year, it's clear that the recent natural disasters both within Australia and abroad have provided food for thought for the Reserve Bank (RBA). It now seems likely that interest rates in Australia will be on hold until perhaps September or October.

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The Australian Dollar versus the US Dollar since 1983

Source: IRESS

The only foreseeable condition which could lead to a sudden increase in interest rates by the RBA, is a breakout in wage inflation.

Until now, wage increases have been largely within the RBA's band of tolerance, but increased investment in mining projects, infrastructure and continuing falls in the unemployment rate will be carefully scrutinised by the RBA for any sign of inflationary tendencies.

Just to make matters even more complicated for policymakers and our elected officials, the Australian housing market is slowing dramatically. On an annual basis house prices in Australia increased by 0.8% for the twelve months to February. After taking inflation into account, house prices are actually cheaper than they were a year ago on a national basis.

Juggling a weak housing market, an over-valued currency and an over-reliance on the commodity boom are just some of the challenges facing us as we enter the second quarter of 2011.

BUSINESS UPDATE

Changing times

Recently David was interviewed for an article in Financial Planning Magazine, which is the official Publication of the Financial Planning Association of Australia. Many of the questions focused on what makes CIPL different from traditional forms of financial planning businesses.

Perhaps the most important of these is our establishment as a fee for service business more than 10 years ago. This client focused initiative created a lot of angst at the time. Competitors felt we were undermining their business, and it was much more expensive to set up that way than under the normal commission based model. Within about 15 months however, all financial planners will have to become fee for service because of recent legislative changes banning commissions.

There are also other changes occurring in the industry. An announcement made last week by Bill Shorten means that many financial planners will need to obtain formal tax qualifications.

CIPL staff members are already well experienced in tax matters, and we refer more complex matters to some well-respected accountants. This is the flip-side of rules that mean accountants cannot provide advice on self-managed super funds, without an Australian Financial Services Licence.

On balance the new rules are likely to see much closer relationships develop between financial planners and accountants. Recent conferences we have attended suggest that the new rules are already encouraging a higher level of professionalism and client focus across both financial planning and accounting. Forward looking participants seem genuinely excited about the changes, and CIPL has devoted much of the last five years to working on the basis that clients were best served by a fee for service model, offering personal contact and choice. We have invested heavily in IT infrastructure, providing more and more information at our fingertips.

Acquiring the business in Tamworth resulted in a larger business that could afford systems, services and staff out of reach to either business alone. The new Financial Services Guide, managed fund, and further recent investment into share trading and life insurance services are all examples of a business committed to providing clients value for money services, and choice.

We always like to hear your feedback. Please don't hesitate to contact David, Justin, Sue or any of the other knowledgeable and helpful staff.

INSURANCE MATTERS

Cover or Protection

It seems as though you can buy life insurance at every turn these days. Sometimes it seems every second TV commercial is about how you can get life insurance 'for as little as a cup of coffee per day', or 'what would you do if your main income earner was unable to work?'

You all know the ads - like the one where six middle age men are happily playing a game of volleyball on Bondi Beach, and their mate is watching on, his leg in a brace from the knee surgery he just had. That's where the bloke from the TV series 'The Block' comes in and tells us how important it is to have insurance. It then pans out to the token picture of the bloke from 'The Block' sitting on a picnic blanket – the golden retriever runs up an licks his face, and his wife and kids laugh in joyous rapture.

Or do we remember when Billy Connolly was trying to get us into the life insurance craze. Billy is riding his motorbike around Sydney and spruiking the XYZ direct product, about how it has changed his life forever, and now, for as little as ... I am sure you know the rest. Personally, I (Jason) didn't even find Billy funny when he was being funny, but does it make me want insurance more because he is now being serious?

However it gets worse - you can now go and see your local chemist and they can sell you life insurance. You can shop at your local Priceline pharmacy, and whilst you're there throw in an extra $100,000 to top up your life insurance. I can see you all running out now to stock up.

These insurance policies get you in with their advertising propaganda and cheap up front monthly payments, but what happens when it comes time to make a claim? Can you call the person who sold you the policy and ask for them to assist you with the claims process? No - in most cases you don't even get their name. Are you provided thorough advice to ensure loved ones have no burden if the worst was to happen? Again the answer is NO!

Speaking to a reputable financial planning firm about your overall life insurance needs gives you peace of mind that you are receiving the best cover for your budget, and for your family's needs in the event of an untimely death or disability. At Capricorn Investment Partners we also offer a brokerage service free of charge, which means we have the ability to tailor an insurance package using up to six different insurance companies.

INVESTMENT BRIEFS

Here are some ideas for our trading clients:

BRICKWORKS LIMITED (BKW)

The Company is principally a brick manufacturer with operations in all Australian states and is identifiable by the trade names Austral Bricks, Austral Masonry, Bristile Roofing, Auswest Timber and Sasso Prescast Concrete. In addition, it is seriously involved in land sales, property trusts and waste management. It owns 42.85% of associate Washington H. Soul Pattinson Ltd. (SOL).

BKW reported net profit after tax of $61m for the first half 2011. This was ahead of a forecast $57m and up 7.0% on the previous corresponding period. Building products EBIT rose 2.8%, negatively impacted by wet weather, whereas property EBIT rose by 67.5%.

The outlook for building products is steady with demand varying from state to state. Property is difficult to forecast but the change in Government in NSW could contribute to an improvement in land supply and affordability. With a strong balance sheet and earnings diversification BKW has a favourable long-term outlook. Brokers suggest a target price of $14.24. The current share price is $11.02.

TRANSURBAN GROUP (TCL)

Transurban's principal activity is the development and management of electronic toll roads in:

Australia:
City Link, Melbourne (100%), Hills M2, Sydney (100%), Westlink M7, Sydney (50%), Eastern Distributor, Sydney (75.1%) and M5 motorway, Sydney (50%). In May, 2010 it acquired the Lane Cove Tunnel, Sydney.

North America:
Pocahontas 895, Virginia (75%), Capital Beltway HOT Lanes, Virginia (67.5%).

At a recent briefing on current projects, the Company updated performances as follows:

City Link:
The upgrade is delivering benefits, as expected, with increased capacity producing strong traffic and revenue growth. The company reaffirmed its expectation of 7% traffic growth by 2016.

M2:
The upgrade is due for completion in 2013. The work involves additional lanes and on/off ramps with expectation of a 16% uplift by 2016. Tolls on M2 will increase 8% on completion and the overall concession will be extended to 2046.

M5:
The widening project appears to have the commitment of the new LNP Government but fresh discussions are planned. Completion remains 2014.

USA:
Both projects are receiving government support and projections are for strong revenue and valuations.

TCL is in a position to produce strong earnings and distributions in coming years. The stock has a target price of $5.80. The current trading price is $5.25.

OZ MINERALS LIMITED (OZL)

Oz Minerals Limited (formerly Oxiana Ltd. and Zinifex Ltd) is primarily involved in the production of copper and gold from the Prominent Hill mine in the Gawler Craton of South Australia. It is an open pit operation employing conventional grinding and flotation plant with an 8mt.pa capacity. There is potential for underground operations.

Since commissioning, Prominent Hill has consistently outperformed projections and has supported an aggressive exploration programme involving the existing tenement of 4,000 sq. km.

An important acquisition has been made in the form of Carrapateena, a long mine life, moderate cost, copper asset. It is situated 250 km from Prominent Hill. Given its size and potential, it is expected to generate NPV of 4X acquisition cost.

Based on current commodity prices, the company's cash flow is building at approximately $600m/annum ensuring a more than adequate supply of funds to develop Carrapateena.

Net profit after tax for the 2010 year was $398m., and given reasonable conditions, OZL has the capacity to generate a fully franked yield of 4% from 2013. Brokers value OZL at $2.11 per share and it is currently trading at $1.68.

NEW HOPE CORPORATION LIMITED (NHC)

New Hope Corporation produces coal for the international and domestic thermal coal markets from the New Acland and New Oakleigh Minesin S.E. Queensland. NHC is majority owned by Washington H. Soul Pattinson Ltd. and has an interest in a coal shipping port operator. The company explores for coal in the Bowen Basin and in the Darling Downs. From the sale of its interest in Arrow Energy Ltd., the company maintains substantial cash reserves.

NHC reported first half 2011 net operating profit of $81.1m - at the upper end of profit guidance of $74m - $81m.

NHC also reported its expectation that 5.2mt – 5.5mt of sales would be achievable for the full year 2011 against a target of 6.0mt. This shortfall is less than the 30% was expected due to wet conditions in early 2011.

NHL is tending to outperform its more leveraged peers with a resulting share valuation of $5.35. Brokers suggest a target price of $5.62 for OZL and it is currently trading at $5.05.

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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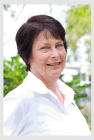

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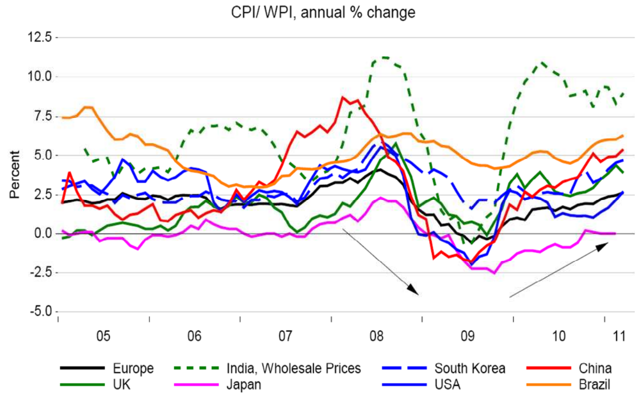
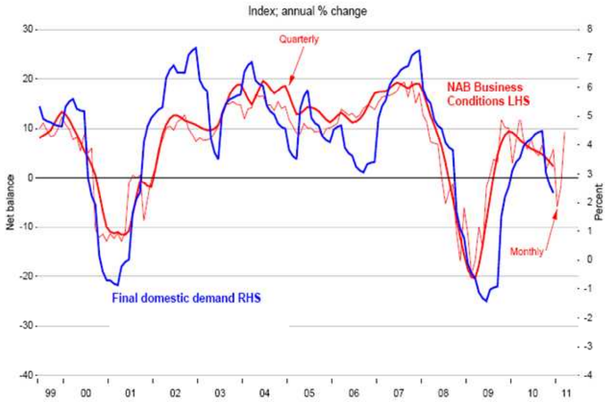
CHART PACK

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

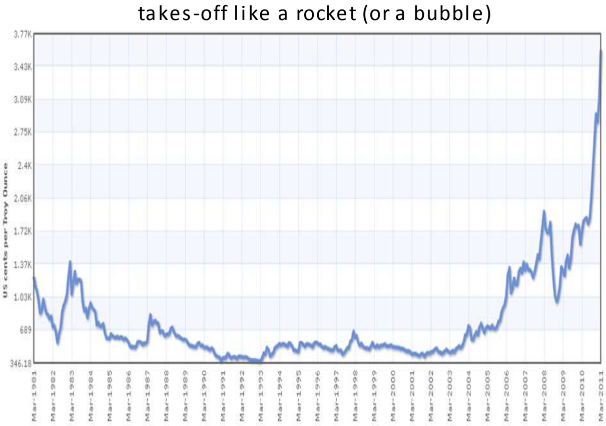
World Inflation - rising prices may be the next challenge for global markets as inflation starts to bite



Business Confidence - the floods early in the year not yet reflected as business confidence jumps higher



Silver outshines them all - the 30 year chart of silver prices takes-off like a rocket (or a bubble)



Australia Housing Market - a fall in demand for new home loans is likely to lead to lower home prices

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