Investment Market Update

Issue 43 - Winter 2011

Welcome...

Lacklustre markets have been going on for two years now, but over this time, there have been many changes that will ultimately set store for widespread recovery. Recent concern about employment in the US ignores the improvement that has already taken place, and the fact that it is holiday season in the Northern Hemisphere. Concerns about US debt ignore the fact that at 65 per cent of GDP, the US debt is perfectly manageable. Greece is a problem because it is linked to the Euro, but it is a long time since Greece was an important economic state, and Germany and France are unlikely to allow the European block to be put at risk. At home the carbon tax debate, high interest rates relative to the rest of the western world, and a soaring $A is crimping economic growth, and depressing consumer and business sentiment.

Against the dark background consider this: Last reporting season, corporate profits in the US increased by around 24 per cent. Increased corporate profits are a precursor to higher employment. Yields on many franked Australian shares now exceed 10 per cent, and most companies have long put their debt problems to bed. Takeover bids for Fosters Group, Macarthur Coal and Spotless Group suggest that corporates are doing their sums, and the numbers are stacking up.

The current situation indicates a peak in the domestic interest rate cycle. If that is accepted, money will chase the higher yields available on listed securities, and the market will rally substantially.

David French
Managing Director
Senior Investment Advisor

Déjà vu all over again

2011 resembles 2010 as global concerns dominate markets

Exactly a year ago, in Issue 39 – winter 2010, of our quarterly newsletter, we led with the following paragraph:

"The continuing economic recovery story in Australia however, proved no match for the pessimism which has swept global markets over the past 3 months. Driven by continuing concerns over the debt levels of the US and European nations, the selling also appears to be motivated by a growing anxiety that the US economic recovery was slowing."

Sounds a bit like today, doesn't it? After a strong start to the year, just as in 2010, global equity markets have been roiled by concerns over slowing economic growth in the US, and the re-emergence of sovereign debt concerns, particularly in Europe.

In Europe, initial concerns a year ago regarding the high levels of government debt, were dealt with by the establishment of a European bailout fund worth over $1 trillion. The reasoning behind the establishment of the fund was such that heavily indebted nations (such as Greece, Ireland and Portugal) could borrow from the fund at low interest rates, while they enacted steep government spending cuts at the same time, designed to reduce or eliminate the government deficit and allow the eventual repayment of their loans.

It all sounded very plausible in theory, but as the great baseball player Yogi Berra reportedly said, *'in theory there is no difference between theory and practice. In practice there is.'* And in practice, the bailout plan fell short of market expectations, and only brought temporary respite for indebted European nations, in particular Greece.

The problem facing Greece, is that the stiff spending cuts which the government had agreed to as part of the continuation of its bailout funding, have helped to push the Greek economy into a deep recession, which means that government tax revenue is falling almost as fast as the Greek government cuts spending.

A new proposal for dealing with Greece, and one which has some merit, is to extend the maturity of some of Greece's loans, which may allow their economy to recover over time and for the eventual repayment of some of their debts.

The plan envisages rolling over half of the Greek government's debt into long term bonds at a 5% interest rate with a bonus tied to Greece's economic performance. A third of maturing debt would be repaid immediately in cash and just under a quarter of Greece's debt would be covered by the European bailout fund. However the plan needs the voluntary agreement of Greece's lenders, which is not guaranteed.

But why are we even worried about Greece? Why does an economy which is only a quarter the size of Australia's even matter?

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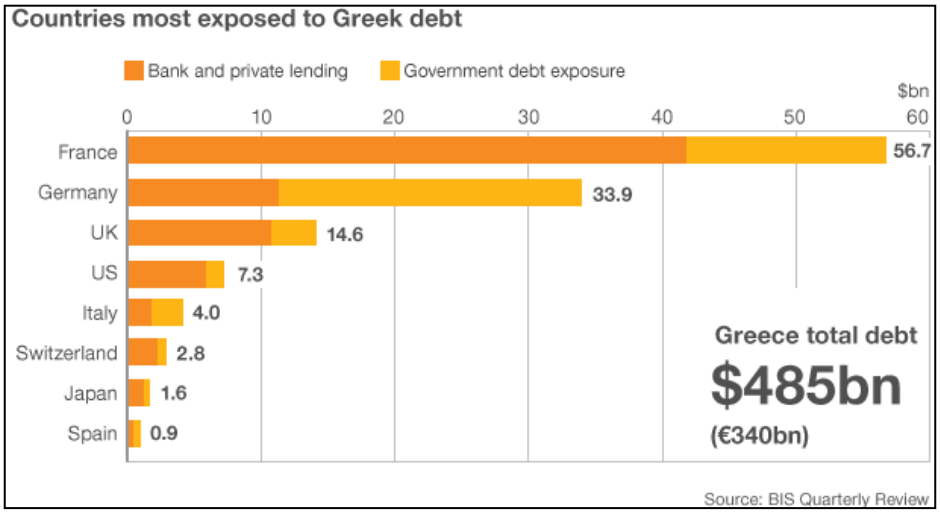
The real concern is not really Greece itself, but for the banks which have lent to Greece.

Policymakers (and bankers) in Europe are worried that some European banks would be placed under severe stress if Greece were to default on its debts, which would require writing down the value of their Greek loans. Such an outcome could potentially lead to another credit crisis as liquidity and bank funding dries up across Europe, similar to the GFC, although most likely less severe and mostly restricted to Europe.

The chart below shows the countries, through their banks, which have the most exposure to Greek debt.



Unsurprisingly France and Germany are leading the efforts to ensure that Greece does not default on its loans.

Slowdown in the US

Coinciding with the concerns over government debt levels and Greece specifically, has been the emergence of signs that economic growth in the US is slowing.

At this stage it's too early to judge whether or not the US economy is simply in a 'soft patch', or if it is more serious than that. Unemployment in the US, already at high levels, has increased in the past few months, and housing prices have fallen again, although the declines have been somewhat limited.

It has been argued that some of the slowdown is simply weather-related, as the data reflects a period of poor weather across much of the US, and there is some truth in this. It's likely that economic fallout from the Japanese earthquake earlier this year has also played a role, as despite a stagnant economy for over a decade, Japan is still the world's fourth largest economy.

30 June also marked the end of the second round of quantitative easing by the US Federal Reserve. This strategy, which is generally referred to as 'money printing' in the press, was designed to keep interest rates at very low levels, a goal which was partly achieved. It remains to be seen whether or not the Fed will be required to take further action if the US economy continues to struggle, which would probably take the form of another round of quantitative easing.

The state of Australia

As would be expected, the global issues already discussed have had an impact on Australia, and most directly on our stock market. As a relatively small player in global financial markets, Australia will always be subject to global events to a certain extent. We do however have a number of home-grown challenges to deal with.

Chief among these is the continued strength of the Australian dollar. We have written about this extensively in previous updates, so we will not go into it in any detail, except to say that it continues to act as an anchor on the Australian stock market. At the same time households have continued to tighten the purse strings, with little inclination to spend money. The property market is also feeling the pinch as households focus on lowering their overall debt levels, as opposed to gearing up into ever more expensive houses.

While households are struggling somewhat (including a rising cost of living) and some sectors of the economy are weak, we are buffered to some extent by the continued expansion of the resources sector. Even this however, presents some problems as it exposes us more directly to events in China, in addition to pushing up wages and denying scarce capital and labour to other sectors of the economy.

Impact on the stock market

Given all the global uncertainty and the set of circumstances specific to Australia, it is not surprising that the stock market has remained flat, trading in a band of between 5,000 and 4,300 points on the ASX All Ordinaries Index for much of the past 18 months.

There are some catalysts however, which may be identified as a source of possible strength for the stock market, though their timing is debatable.

A successful resolution of the debt crisis facing Europe would certainly be of benefit to all global stock markets, not just in Australia. Given the depth of the problems facing Europe however,

it's likely that the full resolution of these problems is still some time away, and cannot yet be expected to provide lasting assistance to the market. A short-term rally is possible however, as an outright Greek debt default becomes less likely.

Another potential catalyst is if the Australian dollar was to weaken against the currencies of our major trading partners, in particular the United States. However, given the soft economic growth of the US, it's doubtful that the Federal Reserve will act to increase interest rates for some time, which means the US dollar is likely to remain weak. The same case can be made of Japan, the UK and Europe, although the European Central Bank is one which has indicated it is willing to increase interest rates as required.

A final potential catalyst to push the Australian market higher, and one which is probably most likely, is simply that valuations have fallen to a level where the market now offers excellent relative value. Many well-run and profitable industrial companies now command valuations which make them attractive investment opportunities.

Some of the companies we consider to fall into this category include the following:

- Telstra: high dividend, less uncertainty following NBN deal, wide range of future growth options.

QBE Insurance: high dividend yield of around 7.5%, extensive overseas operations and will benefit from a weaker A$.

Woolworths: well-run defensive stock with less volatility than the market, respectable dividend yield of 6.14%.

There are also a number of opportunities in the fixed interest (listed interest rate) sector, where an ongoing and reliable income stream can be locked in at interest rates ranging from 7 – 11%, which we consider to be very attractive.

Under current market conditions, with a sideways trending market, an astute and deliberate approach to security selection and portfolio management will still enable clients to achieve good returns.

Business Update

Small business advice

Do you know that CIPL has the capability to raise capital for small and not so small businesses? For many years we have provided small business advice, often in conjunction with clients' accountants. We have some notable success stories to our credit, in particular underwriting a Share Purchase Plan for The Rock Building Society Limited, helping to restructure a leisure related business and a primary producing business which also operated a mine, and succession planning and expansion advice for a successful consulting company. We have also raised more than $5 million through a number of capital raisings.

CIPL's experience, excellent contacts in financial markets, and access to a range of solicitors and accountants can be extremely helpful in advising small businesses, through expansion, selling or putting succession planning measures in place.

Australian Small Scale Offers Board

CIPL's sponsorship of the Australian Small Scale Offers Board complements our small business advisory activities. Through ASSOB we can help raise up to $5 million without a prospectus. The ASSOB platform keeps track of money raised, and facilitates buying and selling of investments that are not traded on a stock exchange.

By restructuring companies in a manner such that they can accept money from the public, CIPL's sponsorship of ASSOB can reduce reliance on debt, and prepare companies for expansion or succession. Many companies have successfully raised money on ASSOB, and now CIPL can assist in that process.

Getting the most from CIPL

Are you getting the most from your relationship with CIPL? CIPL is very much focused on building and managing client portfolios, and we were one of the first to offer Individually Managed Accounts and assistance with self-managed superannuation. Just as importantly we look after clients' Centrelink issues, and work with accountants on tax matters. We negotiate term deposit rates with banks, and step in with assistance in the event that you are laid up in hospital or on holidays and you cannot attend to your affairs.

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Over time, it has become obvious that the best relationships are the result of a two way street, so please use our full range of services, let us know if your circumstances change, and let us know what we can do for you.

Federal Budget Update

2011/12

Flood levy

For the first time in a number of years, there were no personal tax cuts in this year's budget. The key changes from a taxation perspective were the imposition of a flood levy on taxpayers with taxable income over $50,000. The levy is an additional 0.5% on taxable income between $50,000 and $100,000, and an additional 1% on any income over $100,001.

Removal of low income tax offset on unearned income of minors

From 01 July 2011, people under 18 will no longer be able to use the low income tax offset to reduce tax payable on unearned income. Unearned income may be dividends, interest or distributions from trusts. This will impact on family trusts where part of the trust's income is normally distributed to their children.

Dependent spouse rebate for spouses under 40

The dependent spouse rebate for non-working spouses under 40 (persons born on or after 1/07/1971) is to be phased out from 01 July 2011.

ATO supervisory levy

The supervisory levy imposed on all self-managed superannuation funds will rise from $150 per annum to $180 per annum, effective from the 2010/11 financial year.

Superannuation co-contribution

Indexation on income thresholds for the co-contribution will be frozen until 2012/13. Employed persons with taxable income of less than $31,920 making personal superannuation contributions of $1,000 will again be eligible to receive a matching contribution from the government. A partial co-contribution payment is available to employed persons with income between $31,920 and $61,920.

Superannuation pension drawdown relief

Those drawing superannuation pensions have again been afforded some relief from drawing the statutory minimum pension for their age. For the past couple of years until 30 June 2011, the pension draw downs could be reduced by 50%. In 2011/12 the reduction in minimum pension drawdown is 75% of the statutory amount.

Age	Minimum 2010/11	Minimum 2011/12	Minimum 2012/13
Under 65	2%	3%	4%
65-74	2.5%	3.75%	5%
75-79	3%	4.5%	6%
80-84	3.5%	5.25%	7%
85-89	4.5%	6.75%	9%
90-94	5.5%	8.25%	11%
95 or over	7%	10.5%	14%

Limits on superannuation contributions

Two types of contribution may be made to superannuation – those on which a tax deduction is claimed (for example, salary sacrifice and employer contributions), called concessional contributions, and those on which no tax deduction is claimed (simply a contribution made with after-tax dollars) called non-concessional contributions.

For 2010/11 the concessional contribution limits were $25,000 for a person aged under 50 and $50,000 per annum for a person aged over 50. The under 50's limit will be unchanged at $25,000 per annum, but the limit for over 50's will be changed as from 01 July 2012. The change will be that anyone who has over $500,000 in superannuation will be limited to $25,000 in concessional contributions per year.

Excess contributions tax

From 01 July 2011, the government will allow a one-off option to request the return of up to $10,000 excess concessional contributions. When these excess contributions are refunded, the individual will be taxed at his marginal tax rate on the returned contribution.

There is no ability to refund excess non-concessional contributions and the relief does not extend to anyone exceeding the concessional cap by more than $10,000.

Reduced HECS discounts

Effective from 01 January 2012, the discount available to students electing to pay their Higher Education Contribution Scheme (HECS) student contributions upfront will be reduced from 20% to 10%, and the bonus on voluntary payments of $500 or more will be reduced from 10% to 5%.

Contribution Type	2010/11	2011/12	2012/13
Concessional - under 50	$ 25,000	$ 25,000	$ 25,000
Concessional - 50 & over, (with **less** than $500,000 in super)	$ 50,000	$ 50,000	$ 50,000
Concessional - 50 & over, (with **more** than $500,000 in super)	$ 50,000	$ 50,000	**$ 25,000**
Non-concessional *	$ 150,000	$ 150,000	$ 150,000

* Persons under 65 can make up to 3 times the non-concessional limit over a three-year period)

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Insurance Matters

To Age 65 in the mining industry

Australia's mining industry just keeps going from strength to strength. The ad on TV, "previously Australia rode out of tough times on the sheep's back, nowadays we are riding out in the back of a dump truck" really rings true.

Finally an insurance company sees things from this point of view. The industry has some of the most stringent safety standards going. From your first site induction to stepping into your first truck or lifting your first box in the store room. Personal Protective Equipment (PPE) must be worn at all times, these include fluorescent vests, safety helmets, glasses, ear protection, steel cap boots, and that is to walk from the smoko room to the toilet, on your break.

So why have insurance companies not recognised the safety standards these companies possess? The simple answer is they look at the industry as a whole - Chile, New Zealand, South Africa, Indonesia, Russia and PNG to name a few. None of these countries offer the same safety standards as that of their Australian cousins. Insurance companies are re-insured by global companies, who look at the doings of the other 'mining' professions around the world and automatically a red light flashes up, saying NO!...until NOW.

We have had win for the mining profession. An insurance company that has taken it upon themselves to assist the miners and offer them an income protection insurance that can ensure their future if something happens today. The price of the insurance is competitive with the rest of the market, but the biggest factor is they will insure a miner for income protection to age 65. Previously we were lucky to get a benefit payment for 5 years. For a 45 year old miner that only gave them an income until they were 50. Imagine their delight when I call them now and suggest we can get them cover for an extra 15 years for a similar premium.

This product is very new to the market, so not everyone is aware of it - if you know someone who works in the mining industry and has some form of personal protection insurance; get them to give me a call to review it. It costs them nothing for me to review, but the savings to their hip pocket and to their families if they are injured could well be priceless.

Jason Fagg
Life Risk Advisor

Investment Briefs

Here are some stocks we are currently looking at:

Telstra Corporation Limited (TLS)

Telstra is nearing the end of a five year transformation where revenue from traditional services is falling and revenue from mobile phones and internet services are affecting the deficiencies. The transformation strategy involves a cultural change towards next generation networks – Next G and NBN – and will change TLS from a telecommunications company to a media and communications company.

The signing of an agreement between TLS and the NBN Company has removed much of the uncertainty surrounding Telstra's future in recent years and it is accepted that consideration would be needed before a final agreement can be put to shareholders for approval. The terms of agreement are comprehensive and uncertainty exists as to what will remain for TLS if there is a change of government and the arrangements with NBN are dismantled. Either way, it is expected that the 28c fully franked dividend will be delivered over the forecast time frame of 5 years.

Perhaps the most underrated aspect of Telstra relates to the NBN deal. Once complete it will substitute a government guaranteed income stream for a declining copper wire business. This is a Godsend for the company, which we believe will underpin capital management initiatives such as share buybacks or special dividends, and consequently renewed interest in the stock.

Woodside Petroleum Limited (WPL)

The company produces liquefied natural gas, domestic gas condensate, crude oil and liquefied petroleum gas from facilities situated in the North West shelf in joint ventures and Pluto in Western Australia. In addition, it was producing assets in Algeria and the Gulf of Mexico and exportation in Brazil, South Korea, Peru and Sierra Leone. The basic strategy is for the marketing of gas and oil from Australia, the Americas and Africa.

Of major importance in recent months have been the delays to completion of the Pluto development in Karratha. Originally estimated to cost $12 billion, the figure was recalculated at $14 billion in May 2011 and more recently at $14.9 billion. The completion date has been pushed out to March 2012 due to commissioning delays and bad weather. This is clearly bad news for WPL but it doesn't change the big picture. The company is well positioned for significant earnings and valuation growth over the next five years as it's suite of LNG development options are brought on line. The bigger near term driver of the Woodside share price should be the Pluto expansion.

DUET GROUP (DUE)

DUET Group is the owner of energy utility assets in Australia with the key interests being:-

- Combined Energy Distribution (66%)
  Electricity Distribution / Victoria
- Multinet (79%)
  Gas distribution / Victoria
- Alinta Gas Networks (25%)
  Natural gas and LPG / W.A.
  Dampier and Bunbury natural gas Pipeline (63%)
- North West Shelf in Perth (29%)
- Electricity distribution in Pennsylvania

The company is jointly managed by AMP Capital Investors and Macquarie Capital Group and focuses on developing a portfolio of regulated and contracted utilities with stable and predictable revenue streams. While current emphasis has been on delivering organic growth, DUE has entered into a conditional agreement with ATCO to swap assets if AET & Co is successful in trading for ATCO. Indications are that the ATCO acquisition might be close to finally proceeding. If it is successful, the transaction will be very beneficial for DUE given its strong accretion and corporate governance benefits. It will firm up DUE'S 20c distribution and clear the way for the company to be more appropriately valued.

Leighton Holdings limited (LEI)

Leighton consists of six operating companies and has significant interest in others including al Habtour Leighton, Devine and Sedgeman. It operates in countries across Australia – Pacific, Asia, India, the Middle East and Africa. The key focus areas are engineering, infrastructure, property development, building construction, contract mining and telecommunications.

The company's well considered business model focuses on diversification, project transparency and risk assessment which have become significant problems for senior management particularly on large scale infrastructure projects. In response to significant overrun problems in Queensland and Victoria and a serious credit collection problem in the Middle East, the company has changed its approach to risk management and tender assessment.

A reported reduction of 25% in NPAT for the half year ended 31 December 2010 shook investor confidence and this will only be restored in the short term if the new strategic focus is having an impact on lowering the company's risk profile. With the recent acquisition of substantial hospital contracts in Adelaide and Perth it is believed that the turnaround has begun and a more streamlined and efficient operation is emerging. It is expected that medium – term opportunities will eventually outweigh short – term headwinds and the share price will turn upwards. The stock is trading at $20.80 and the target price of $26.35.

Welcome To New Staff

We have made some important staffing changes that are expected to improve business efficiency and client service.

Delvean Steadman commenced at the Rockhampton Office in February 2011 as Front Office Administrator, Delvean is your first point of contact for the firm and will be able to point you in the right direction for any queries you have. Delvean has a wealth of knowledge in customer focused administration with 12 years in Administration and 16 years prior to that in Sales.

Rose Sladden is our new Client Services Manager, and she is responsible for ensuring that we meet the commitments we make to clients as regards service levels, and general interaction with the company. Rose has a longstanding history in client service including time with Local Government and the Australian Breastfeeding Association.

Chris O'Brien joined us this month as General Manager. Chris is taking on most of the administrative tasks for the firm, which means that David will become more focused on assisting with advice provided to clients (particularly on more complex issues), and on growing CIPL as a premier regionally based provider of advice on personal finance.

In Tamworth we have two new staff. Margot Wentworth-Brown is completing a Bachelor of Business and has extensive experience in the financial aspects of running a small business. She and her husband, built the successful Farmer Brown Eggs from scratch, and this complements existing expertise in advising small businesses.

Nigel Campbell is completing a combined Business/Arts (International Studies) degree at University of New England. Both Margot and Nigel are participating in a trainee program which we expect will significantly add to the capabilities of the Tamworth office.

Annual portfolio reports

The annual tax statements will be prepared as soon as we have all the information that is required. It is usually not until the end of September before we receive the information from the fund managers that we require before we can prepare your tax reports. As soon as we have this information we begin the task of printing, posting and emailing the reports. Thank you for your patience.

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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Senior Administrator

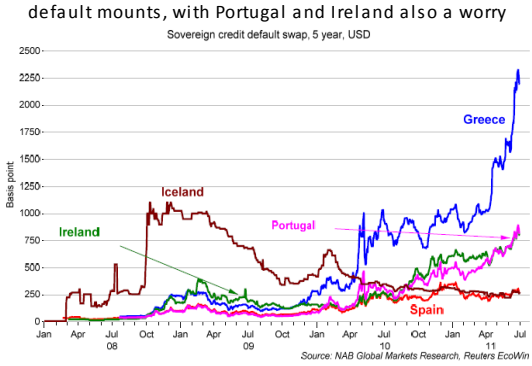
Nigel Campbell
Trainee Financial Advisor

Margot Wentworth-Brown
Trainee Financial Advisor

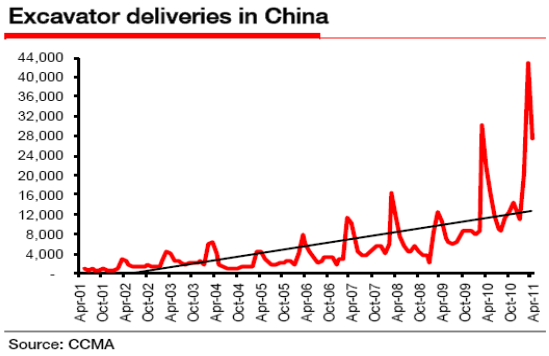
CHART PACK

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

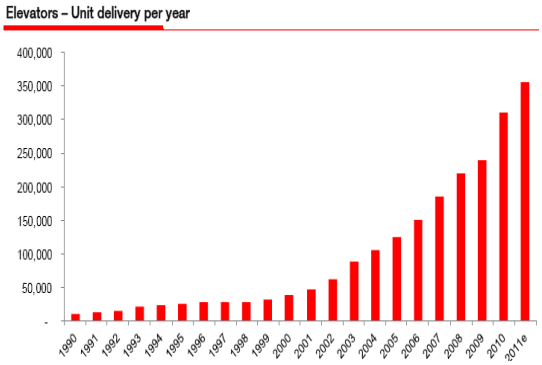
Expensive - the cost of insuring against a Greek debt default mounts, with Portugal and Ireland also a worry



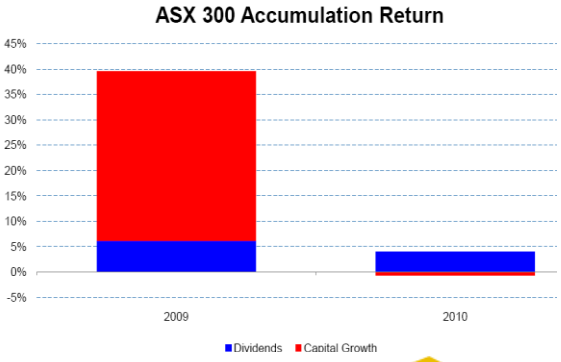
Construction in China - boom times for machinery suppliers in China but is it sustainable?



Going Up - elevator sales in China soar as new building construction continues apace



Dividends - the importance of a reliable income return on your investments hasn't changed



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