Investment Market Update

Issue 39 - Winter 2010

Welcome...

We hope winter is treating you well, and that you enjoy the contents of CIPL's 39th newsletter.

In this edition we look at the lingering concerns over world economic growth, the differences between trading and investing, interesting matters regarding CIPL's business and some of the recent changes to superannuation and tax rates. The insurance section looks at insuring children and we include some investment ideas for clients using Bob Stewart's Advisor Trading Service.

As usual we continue to work hard to meet or exceed client expectations, even in challenging times. Our overall view is that economic conditions are improving, but there will be bumps on the road. Our door is always open to clients so, please make sure you call us if you would like to discuss your portfolio or your financial affairs in general.

Regards
David French
Managing Director
Senior Investment Advisor

OVERSEAS CONCERNS WEIGH ON THE ASX

A poor quarter for the market as debt worries dominate

In the Autumn 2010 edition of our newsletter, we discussed the debt situation in Europe at some length, while pointing out the relative strength of the Australian economy when compared to the rest of the developed world.

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.

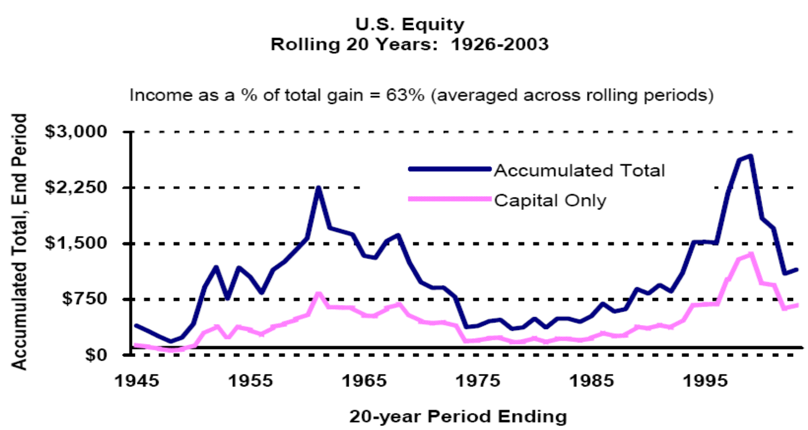
No major stock market was immune, including Australia, with the ASX S&P 200 falling 11.77% over the quarter.

While client portfolios have generally outperformed the market, June valuations are likely to be somewhat lower than reported for the March quarter.

As always, we stress the fact that while portfolio valuations will fluctuate over time, the income generated by your portfolio is just as important a determinant of long term returns, and all portfolios continued to generate a substantial level of income even as market values fell. Recently we calculated the average income return for a client of 8 years as 6.48 per cent, compared with the average term deposit rate reported by the RBA of 3.936 per cent.

Empirical research confirms the importance of dividends and interest income in overall long term returns. A 2004 study by The Brandes Insitute, '*Examining The Income Component of Total Returns*'[1], found that for investment periods of 10 years or more, the income component (i.e. the dividends and interest) made up a greater proportion of the overall return than capital appreciation, in all income-producing assets (see chart below).

[1]http://www.brandes.com/Institute/Documents/Income%20Components%20of%20Returns%20Paper%20071204.pdf



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Capricorn Investment Partners Limited

Incorporating Griffin Financial Services

The chart breaks down the total return to US equities over a rolling 20 year period since 1945, clearly showing the importance of income and capital return compared to capital appreciation only.

For clients who are still in the accumulation stage of life, reinvestment of dividends is a key contributor to long term returns, while clients who have retired are able to use the income generated by their portfolios to meet their living expenses and other needs.

This not to say that capital appreciation is to be ignored or neglected – we view the two components as working hand in hand to deliver superior returns over the long term. Short term valuation changes however can often mask the internal workings of the portfolio, where a steady stream of dividend and interest payments accumulate in the cash account, ready for reinvestment or to be drawn-down to meet spending requirements.

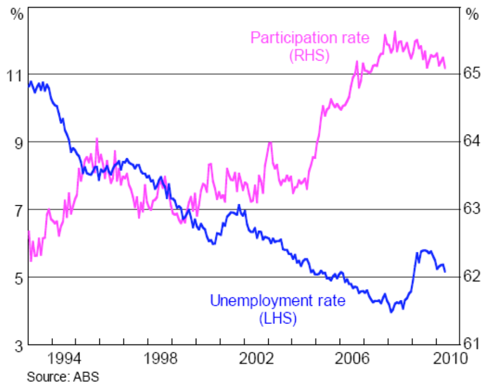
Looking ahead to year end

With regards to the rest of the year, we expect the market to continue to be volatile, despite the continued improvement in the Australian economy. The most recent indication of the strength of the economy was the surprising June unemployment report, which revealed unemployment dropping to an 18-month low as an extra 45,700 employees were hired during the month.

The unemployment rate of 5.1% is widely viewed as being very close to full employment in the Australian economy (unemployment can never reach 0% due to permanent unemployment due to structural and frictional reasons).

Aus Unemployment Rate

A way to go still, but as good as 2005



Low unemployment directly translates into higher household income and a higher level of consumption, which helps underpin domestic economic growth. This feeds through into improved company earnings and ultimately should be reflected in equity valuations.

The downside of continued labour demand is of course inflation, as workers are able to bid up wages as competition among employers for both skilled and unskilled workers increases. The Reserve Bank is very sensitive to the potential for wage demands to accelerate inflation, which will be swiftly countered by further interest rate increases.

Offsetting this however, are the continued problems overseas, where credit remains tight, unemployment rates remain high and consumer sentiment is weak. These concerns are likely to keep the Australian market in check to a certain degree, although a return of investor confidence in the major overseas markets would have a beneficial impact in Australia too.

The next few weeks will be important in the context of setting the tone for the remainder of the year, as the US reporting season is about to begin. As the major US companies report their results, we will be able to more accurately judge the likelihood of a double-dip recession in the US (which we still consider to be only a slim possibility).

A solid showing from the bellwethers of the US market (GE, Microsoft, Intel, Google, Citigroup and others), will go a long way in reassuring investors that the economic recovery is not in danger of petering out.

DO YOU TRADE OR DO YOU INVEST?

Research fails to back up the claims of 'traders'

A common discussion in the investment industry and indeed across any sector or individual with a stake or an interest in the stock market, is of the relative merits of "buy and hold" investing versus short term trading.

At CIPL we're occasionally asked by potential clients (and even a few existing clients) why we don't 'trade' client portfolios. Why don't we buy BHP at $38 and then sell it at $42? Shouldn't we sell CBA at $50 and buy it back at $45? Why didn't we buy that Alice Springs-based uranium exploration company that listed at 5c last week, and was worth 8c at the end of the first day's trade?

The simplest and shortest answer to all those questions is this: it doesn't work in the long run.

That's not to say that for a short while, someone who buys and sells their shares on a daily basis won't make money – there is every possibility that they will indeed perform better than if they had just held their investments over the same period.

The problem however, is that over the long term, as the number of opportunities and probabilities of making a wrong decision increase, the excess returns achieved by traders vanishes, along with most of their profits.

As you would expect, this topic is a fertile field for researchers, who have spent a lot of time testing the claims of both traders and advocates of the buy and hold philosophy.

One of the most well-known studies appeared in the April 2000 issue of the Journal of Finance. Written by Brad Barber and Terrance Odean, their paper '*Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors'*[2], exposed the myth of excessive trading and its promised high returns.

[2]http://faculty.haas.berkeley.edu/odean/papers/returns/Individual_Investor_Performance_Final.pdf

Brad and Terrance examined the investment accounts of 66,465 households in the US during 1991 and 1996. They found that those accounts which were traded the most earned an annual return of 11.4% over the period, while the market as a whole returned 17.9%. Therefore all of those frequent traders would have earned a higher return simply by buying the index and not trading at all.

According to the study's authors, traders "strongly prefer to sell their winning investments and hold on to their losing investments, even though the winning investments they sell subsequently outperform the losers they continue to hold." So what happens is that the traders systematically weed out all the good investments in their portfolio and are left holding the poor ones.

That's not to say that simply buying the index and doing nothing is the optimal solution either – as with most things in life, the best outcome sits somewhere between these two extremes, exactly where we believe our investment philosophy falls.

We don't 'trade' client portfolios on a daily or weekly basis – we believe that the only person who benefits from that is your stockbroker as he watches his commissions climb as the value of your portfolio is eroded by transaction costs. But neither do we buy a bunch of shares and throw them in the bottom drawer for 5 years. We believe that careful construction of your investment portfolio in the first place is one of the keys to successful long term investing – we then monitor the portfolio for any changes in the investments and the economy, and take action as required.

We'll recommend an investment is sold or a new one is bought when the reasons are appropriate, not because the share price went up by 5c since yesterday and you could make a $100 profit by selling now, at the same time incurring brokerage of $55.

There's no optimal number of trades per year that should be made or that should be avoided, it all depends on each specific investment. It also depends on the availability of alternative investments, and for many people, capital gains tax considerations. We're always looking at client portfolios, so be assured that we will contact you if we think excellent opportunities have arisen or changes need to be made.

BUSINESS UPDATE

A tale of many things

CIPL's life insurance offering has been well received and portfolio clients can gain premium discounts when they switch their life insurance affairs to CIPL. The discounts apply to extended family and not just the portfolio owners or trustees.

Aside from Life Insurance, CIPL has been busy on many fronts including finalising the integration of the Tamworth business, improving the Portfolio Administration System and improving internal operations for the ultimate benefit of clients.

Two notable improvements are:

- Integrating PAS with BGL software. BGL is the industry standard in Self Managed Super Fund (SMSF) accounting software, and this initiative is expected to assist in preventing SMSF accounting fee increases.

- Switching Rockhampton CMA clients to a new high interest CMA at The Rock and the active management of term deposits. Clients who switched have benefitted from significantly improved interest rates and Tamworth clients will be offered the opportunity to switch to The Rock, in a month or two. CIPL has no obligations to The Rock, but our long standing business friendship means CIPL can often get better terms from The Rock, than from other institutions. At the same time Rockhampton clients will be offered the opportunity to use the Macquarie CMA. Of course, any switches will be entirely at client's discretion.

For more than 2 years CIPL has been working on a managed fund offering. We are nearing the end of this project with a Product Disclosure Statement due out in August. This fund will be of particular use for smaller size investors and for reducing overall fees on some larger portfolios. The focus of the Capricorn Diversified Investment Fund is to invest in a diversified portfolio of assets, including some regionally based opportunities. We think it is a very exciting initiative.

Just a reminder that toward the end of July clients will receive a copy of the new Financial Service Guide, which we hope will improve awareness of the services we offer to clients. Clients will be contacted to arrange face to face meetings in advance, and to set an agenda for those meetings. This way of working has been successfully in place in the Tamworth office for some time, while the Rockhampton office has relied on more of an open door policy. While we won't be closing the door, it's clear that formal face to face meetings help form strong professional relationships and enable us to be better prepared ahead of time. We are expecting that this will further improve client outcomes, which is after all, what we are here for.

Sallyanne Cook will be joining us from Sydney in August. She'll be groomed into our firm under the direction of Sue Dunne and David French. She'll also be visiting Tamworth to become familiar with the needs of that office. Sallyanne has financial planning qualifications, and a Masters in Applied Finance. Sallyanne is keen to migrate to the private client side of the industry. She has extensive big end of town experience in managing and monitoring portfolios, through roles at ING, Burns Philp and Co., Morningstar and InvestorWeb. Attracting someone the calibre of Sallyanne is a real feather in CIPL's cap, and can only benefit clients.

CIPL's staff are always here to attend to your requirements. If you have any questions or requests please feel free to contact us.

Calculating returns

More than meets the eye

Calculating returns is a difficult matter for any fund manager, and it may surprise clients as to how much work is actually put into it. Many people think it's just a matter of looking at the current balance of their portfolio and comparing it to what they contributed in the first place.

In fact the portfolios that CIPL manages are run like a series of individual managed funds – one for each client. On an ongoing basis, people are contributing money, drawing it out, buying assets and selling assets. At the same time dividend and interest income is being deposited, and superannuation pension payments are being made. These movements are happening day by day, and in simple mathematical terms, they each change the numerator and/or the denominator (numerator/denominator) used to calculate a percentage.

With that information, you can see how tricky accurately calculating returns actually is. To overcome these problems, the industry standard is to use a measure known as internal rate of return (IRR). It is basically saying, "given today's portfolio valuation, and taking into account all deposits and withdrawals and the date they were made, what is the return on my portfolio?" The IRR captures in one figure, the overall performance of the portfolio.

We know that some clients would like a measure of their income return and another measure of their overall return. We can provide a snapshot of that currently on an individual basis, but we are working on including that information in all clients' reports. Please be patient – as gardening clients would know, the idea is great but...

SUPER TAX CHANGES FOR 2010

Spotlight on DIY super

Superannuation is in the news again with the release of the Cooper Review. Many of CIPL's clients run self managed superannuation funds, and the Cooper review has accepted the place of these funds in the retirement environment, with very few changes. Interestingly accountants will not be able to give advice on DIY super unless they have a financial services licence. That's very interesting because combined with financial planners having to become accredited to give tax advice; it seems that regulation will force the amalgamation of both sides of personal financial services.

Running a self managed super fund does come with some additional responsibility. Trustees are ultimately responsible for making sure that the fund is run according to the law, and there are harsh penalties for not doing that. It's not difficult, but it's worth the money to have a competent advisor working with you. The data shows that, even paying for an advisor, it is still often cheaper than a retail fund, and all things considered, often not much more expensive that an industry fund, or the proposed my-super funds.

The big benefits of self managed super lie in the fact that you can actually manage it. You can see what assets you have, and what income they are generating. You can make big or small adjustments to match your needs. You can increase exposure to income earning stocks if the fund is paying a pension, or to capital growth investments if you're younger and saving up. You can move assets in and out of the fund, you can have property and other investments in the fund and small business can have the premises they run from in the fund. There is so much flexibility available with responsibility and good advice.

Moving on from DIY super, there were some changes made to super in general in the last budget:

- Increase of the Superannuation Guarantee rate to 12% by 2019/20;
- Raising the Superannuation Guarantee age limit from 70 to 75. Workers aged 70 to 74 would be eligible to have

Superannuation Guarantee contributions for the first time effective 1 July 2013.

- From 2013/14, a government superannuation contribution of $500 annually, for people earning less than $37,000 per annum.

- From 1 July 2012, the $50,000 concessional (tax deductible) cap to be extended permanently for individuals aged 50 or over. The benefit has been limited to those with total superannuation balances of less than $500,000.

- The Government's co-contribution matching rate will remain permanently at 100%.

From 1 July the tax rates have changed again. The threshold for 15% tax has been increased by $2,000 to $37,000 and the second top marginal tax rate has been reduced from 38% to 37% for income between $80,000 and $180,000. These changes mean that a taxpayer whose income is $37,000 or less will save $300 in tax and a taxpayer on $180,000 (the maximum in that bracket) will save $1,300.

INSURANCE MATTERS

Tack on the little tackers:

The subject of child illness or death can be difficult to broach. But a child suffering a serious medical condition can have a significant, emotional and financial impact on any family – especially if your child needs to be offered full time care.

Every parent knows bumps and bruises are a normal part of growing up. But what if your child needs more than just your sympathy? Research has shown that 37% of families with a sick child needed to borrow money to cover for financial effects of their child's illness.

When purchasing specific life insurance products, we can offer child protection insurance for as little as $1 per month. Having trauma insurance for children can:

- Give parents the flexibility to take unpaid leave from work
- Allow double income families to drop to one income for a period of time
- Fund travel for treatment overseas, or from remote areas
- Pay any out of pocket medical expenses

A recent case in Rockhampton really highlighted the need to look at children's trauma when doing any form of risk insurance. In this case the son was diagnosed with cancer, and with ongoing care that is required for him, his mother had to leave her job. The child's mother was insured - she had an income protection insurance policy. Had she have been given the option of children's trauma insurance, she could have had a lump sum of $50,000 on the diagnoses of the cancer for as little as $5 per month.

As it stands at the moment, the family is looking to have to leave their home as they cannot sustain the rental payments due to mum not working, and maybe even leave the city completely due to higher rents currently being sought around Rockhampton.

Most people that have an insurance policy in place have the option to take out children's trauma insurance. If you don't have it, please give Jason a call. He can alter your policy so that it does. Should your child suffer more than bumps and bruises we can reduce the financial impact it may have on your family, giving you more time to be there for your family emotionally.

INVESTMENT BRIEFS

Here are some ideas for our trading clients:

GPT Group (GPT)

GPT is a property trust which invests in quality retail office and industrial/business assets. Its focus is on active ownership and fund management.

Brokers value the units at between $3.07 and $3.08 with a price target of $3.10. It is trading at a discount to its net asset value, and is undervalued compared to peers.

As a result of a strict program for de-gearing and returning emphasis to core businesses, the trust has a solid balance sheet and a sound liquidity position. Gearing is at around 24.5 per cent and the trust has ability to drawdown $700M+ before reaching the target gearing range. GPT's conservative gearing places it well to participate in opportunities which may arise in a recovering commercial property market.

With a valuation of $3.07-$3.08 and a price target of $3.10 the trust expects a full year 2010 yield of 5.7 per cent.

Metcash Limited (MTS)

MTS is a marketing and distribution company operating in the food and fast moving consumer goods industries through IGA Distribution, Campbell's Cash & Carry and Australian Liquor Marketers.

MTS recently announced that it will acquire 85 Franklin stores for $215M and expectations are that:

- Full year revenue will rise by $500M
- Profit will lift by 4.5 per cent
- National market share will increase to 22.0%

All of the 85 stores are to be on-sold to existing IGA store owners and the acquisition will be funded from internal MTS sources. Completion is expected by Sept 2010.

It is expected that the Franklin strategy and the current Mitre 10 strategy will contribute to a strong profit performance going forward and to maintaining a sound market position.

Brokers suggest a price target of $5.10 and an expected yield of 6.0% for full year 2010.

STW Communications Group Limited (SGN)
SGN operates a mix of advertising and media consulting businesses through direct and indirect ownership in Australia and New Zealand. It is involved with 60 companies with equity interests ranging between 25 per cent and 100 per cent. The parent company is involved in administration, firm management, procurement, IT and knowledge sharing, planning & training.

SGN has confirmed that the business continues to track well and that there is potential for earnings upgrades later in the year. Consensus forecasts are for 13 per cent net profit growth for the full year 2010 while revenues for the 4 months to April'10 have increased by 12 per cent.

New work acquired in the first half of the year sits well with an increasing demand from existing customers.

The balance sheet is sound with a net debt position of $52.0M forecast for 31 Dec'10. A dividend of 4cps is forecast for the full year 2010. The stock trades at $0.88 and brokers value it at around $1.05.

AGL Energy Limited (AGK)
AGL controls Australia's largest natural gas, electrical and dual fuel consumer base of 3.2M accounts. It has substantial long term gas supply contracts, a growing portfolio of upstream core seam gas resources and is involved in hydro and wind power.

The company has again flexed its strong balance sheet by making a $123.8M takeover offer for Mosaic Oil to access its gas storage capability in Queensland. It also revealed that it has struck a gas storage deal with BG Group. AGL is expected to fund the development of a storage facility at Mosaic's depleted Silver Springs gas fields in the Surat Basin. BT will make a one-off capital contribution to the development of the storage facility but no specific amount has been mentioned to date.

The cash offer for the Mosaic share is $0.15 which the share-based alternative is 1.01 AGL shares for every 100 Mosaic shares. AGL shares are trading at $14.90 with a broker target price of $16.35.

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.

THE ROCK CASH MANAGEMENT A/C

Fee-free for clients

Clients who have a cash management account at The Rock Building Society may have recently received a letter from The Rock regarding the fees on the account. Please ignore that letter!

We have a special arrangement with The Rock whereby all client portfolio cash management accounts are fee-free.

The account we use at The Rock is a special account for clients of CIPL only – not only is it free of fees, but we have also negotiated a bonus rate of interest which is 0.75% above the Reserve Bank cash rate.

If you have any further questions regarding your account, please feel free to contact us.

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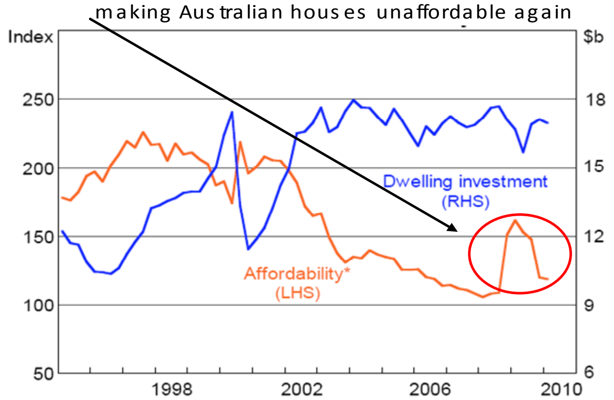
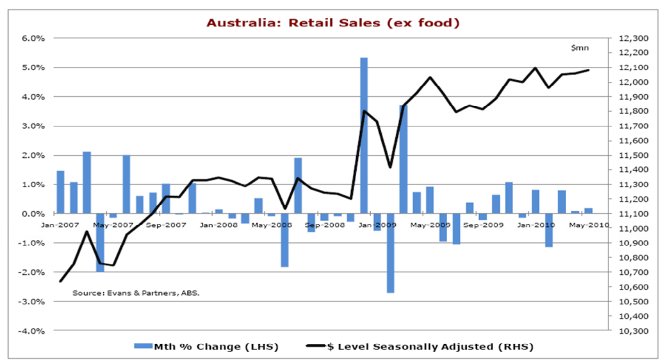
CHART PACK

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

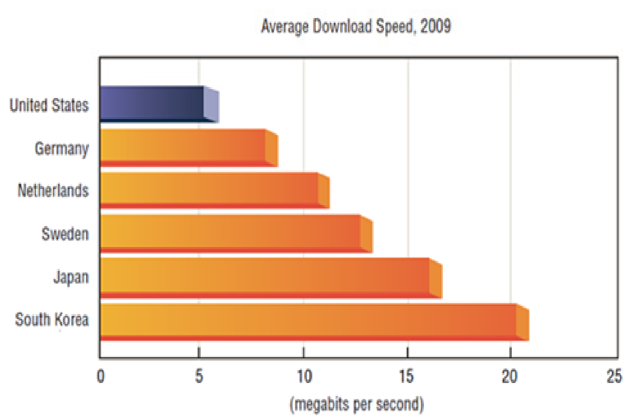
Home Loan Affordability - property price increases are making Australian houses unaffordable again



Australian Retail Sales - sales growth is low, while the impact of the stimulus payments in 2009 is easily spotted



Global Internet Download Speeds - Australia ranks poorly in global internet speeds (3 Mb/s) says the OECD



BP's share price - BP shareholders (and the environment) take a beating as oil spills into the Gulf