Investment Market Update

Issue 49 – Summer 2013

Message from the Manager

February marks 7 years since CIPL was part of The Rock Building Society. Perhaps it's worth reviewing what has been achieved over that time.

Initially, rising markets meant that we could focus on putting in all the structures a growing business needs. An early decision to remain "fee-for-service" meant CIPL was, even then, shielded from distractions caused by regulatory change. Investment in the Portfolio Administration System allowed continuous improvement in internal reporting and measurement, and our interaction with clients.

It wasn't enough. Despite our best efforts, the onset of the GFC affected all of us. Nevertheless, CIPL continued to invest, and its systems and processes enabled the grief to be managed.

We learned from the GFC. We have tried to become less "boffinish", and more obviously client focussed. We set in place regular face to face meetings and rolling portfolio reviews. Staff were guided into specialist roles, and we formalised our compliance activities. We built a managed fund to gain access to alternative asset classes. We invested heavily in our investment committee, and we changed staff to suit the new demanding environment.

Now CIPL starts 2013 with most if not all portfolios showing attractive returns, with a strong balance sheet and business capabilities that include personal finance work, funds management and corporate finance and economics. Its activities span Australia and internationally. CIPL is an organisation that grasps change. The buzz in the office is palpable. I think the hard work and ongoing support of our clients is beginning to pay off.

David French
Managing Director
Senior Investment Advisor

Financial tension

Economic Outlook

Investment markets have been much more buoyant of late. Generally, portfolios managed by CIPL have substantially outperformed benchmarks and I thought clients might find it interesting to investigate why.

There are a number of factors that set the tone for the market but only three are really important. Those three are the level of interest rates prevailing in the economy, profit expectation for the corporate sector, and as noted by John Maynard Keynes "animal spirits".

Interest rates have a big part to play, because interest is the return that is earned on a bond. When you enter into a bond with someone, there is typically an obligation to pay interest and give you your money back at some stage. This "promise" (my word is my bond), means that, for a given issuer bonds are less risky than other investment choices - equity (shares) for example. With equity, there are no such promises - you "pay your money and take your chances".

The "promise" behind a bond is the reason why people have flocked to this asset class since the GFC, pushing prices up. Government bonds have been most sought after and in many western countries are now so expensive that the real interest rate (headline rate less inflation), is negative. In effect, bonds and especially Government bonds are seen as a safe port in a storm.

The expected level of profits in the corporate sector is important too. This is because, unlike bonds, the owners of a company (equity holders), depend on the level of company profits for their returns. Increased profits mean increased investment for the future and increased dividends, whereas decreasing profits suggest leaner times for equity.

Finally "animal spirits" is a grab bag for a whole lot of things that we just don't really understand, but which are nonetheless incredibly important. While bonds and equity are in effect mathematical constructs, "animal spirits" is the reason why observed outcomes can vary so widely from the result derived from the math. I like to think of animal spirits as related to Carl Jung's postulation of the "collective unconscious" - probably the best example of which was Germany's behaviour in and leading up to the Second World War - a whole population did irreparable damage to others and themselves, based on a "view" regarding Jews. To my mind Germans as a race are detailed, industrious, artistic and handsome. In the hands of animal spirits, it seems they were so fearful and angry, the population accepted or at least acquiesced to a view that monetary problems were caused by a relative small group of people generally acknowledged as having a gift for being commercially astute.

I am going to say that such fear and anger, is no different to that which

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drives bear markets – it's facts versus perception, and in the short run, perceptions can be powerful and difficult to change.

Over a longer period however, people seem programmed to develop/achieve/grow. So given time, this other aspect of "animal spirits" prevails. That must be true; otherwise we would be still living in caves.

Let's bring this all together in the context of share market analysis. First we have the tension between the bond market and the stock market. A negative outlook for company profits and therefore equities will, on balance, result in a greater demand for bonds, forcing bond prices up and interest rates down. That is often described as a "flight to safe assets".

But declining interest rates reduce the cost of funding capital projects and therefore promote investment. It does not matter whether that is corporate investment or housing, what matters is that a declining interest rate environment sows the seeds of the next economic recovery. This is why the market rallies when interest rates are falling as they are now - investors are observing reduced interest returns, and are looking forward to increased corporate earnings. Money flows from the bond market (term deposits can also be thought of as a bond) and into the stock market, driving share prices up.

Overlaying that with the "animal spirits" observation explains why the inverse correlation between the bond and stock markets is not perfect. All markets are essentially an auction, with prices dependent on the perceptions of individuals. This includes how willing people are to accept facts or the probability that something is likely to happen or not. Economic shocks like the GFC generally put people in a negative state of mind, while the euphoria of a boom is just as difficult to counter. That means the perceptions of a mass of people serves to lengthen or shorten the time the math/economic relationships become evident, and this exacerbates the outcomes. Understanding this difference, and that, as in Nazi Germany, human beings can act irrationally and to their own detriment, is a key component of successful investment.

Right now many clients have said they appreciate the good returns we have been able to generate since the GFC. Let me tell you, we appreciate the feedback – it's been a while! But the reality is that the strong performances now are due less to the fact that we picked the interest rate cycle well, and more to do with our actions in tending portfolios since the GFC. In particular staying the course and recommending ditching of non performing stocks, and investment in additional assets at severely depressed prices. You might say we have been a bit contrarian in our approach - buying when the crowd was still smarting from the grief.

Looking forward, it seems that global economic recovery is getting closer. The recent monetary co-operation between European states, and gradually improving economic conditions in the USA, make recovery much more likely. This will create new challenges for portfolios, and it is one reason why we are paying more attention to the way we manage small-caps and hybrids - as you have probably read in recent correspondence and will hear at our upcoming seminar.

David French
Managing Director CIPL

Business Update

You may have got the feeling that more changes are taking place at CIPL. It's true. These changes take two forms:

First, a really strong focus on investment performance means we have beefed up our investment committee with the addition of Owen Evans and Michael Peet - both noted as leaders in investment management. In client service we have employed a new assistant for Sue (Lei Nelson), substantially increasing our ability to deal with client requests. Bronwyn's transition to maternity leave has been seamless with the addition of Jane Eklund, and Samm Morris has replaced Jaimi Summerton who went off to university to study sociology and psychology.

CIPL has been winning a range of economic/business type projects, including several business valuations, feasibility studies and business plans, business restructuring projects and has just completed a white paper on the impact of the National Disability Insurance Scheme (NDIS) for a local provider of disability services (a project we are particularly proud of).

The really big news is our December acquisition of Eaton Capital Partners, a business associated with CIPL's chairman. This initiative has doubled the size of the business, and allows us to move into areas that are much less exposed to market influences than traditional financial planning services. The acquisition now means we have deep expertise in advising legal and professional services firms, particularly engineering and international aid. Our operations include clients in London, Bangkok, Singapore and throughout Australia, and mean that costs of running the overall business are spread across a variety of operations. It is a very exciting time, and to be truthful, a dream come true for a person who starting with just myself and a desk always dreamed of transforming our company into a boutique private and investment bank.

In short, we have never before had the range of services and skills that CIPL now offers, and already that is showing, whether through portfolio performance, quality and consistency of work, or the ability to be involved as a niche player in international business.

Superannuation

Concessional Contributions Cap

The concessional contributions cap (i.e. the amount that may be contributed by your employer plus any salary sacrificed contributions, or the total amount that an eligible member may contribute) has been reduced to $25,000 per annum as from 1 July 2012. If you currently salary sacrifice to superannuation, it is important that you check on the level of contributions made to date to ensure that you don't exceed this $25,000 cap. The tax consequences of exceeding the cap are high.

As from the 2012/13 financial year, self-managed superannuation fund trustees are required to regularly review the fund's investment strategy. The review is designed to ensure that the investment strategy continues to reflect the purpose and circumstances of the fund and its members. It is also now necessary to consider insurance for members of a self-managed superannuation fund as part of its investment strategy.

If CIPL manages the preparation of your self-managed superannuation fund's tax return and annual statements, the investment strategy review will be undertaken as a matter of course. This may mean that life insurance held by the self-managed superannuation may have to be established for a member. CIPL is able to assist with life insurance needs. Please contact Lei Nelson in this regard on free call 1800 679 000.

If your self-managed superannuation fund's income tax return is undertaken by an external accountant, you will need to ensure that this investment strategy review is carried out.

Trustees of self-managed superannuation funds need to value the fund's assets at market value from the 2012/13 financial year. This means that you will need to determine the market value of assets such as properties and other unlisted investments held in your fund as at 30 June 2013, and every year thereafter. Previously these assets have been valued every 3 years.

Since 01 July 2008, the government has allowed relief from the requirement to draw the statutory minimum pension draw downs. Initially the reduction was 50% and has since been reduced to 25% of the statutory minimum pension draw downs. Unless the government changes its intention, draw downs will return to the normal statutory minimum from 01 July 2013.

If we have reduced your pension drawdown from super to the 'minimum required', we will need to increase your payment from the beginning of the new financial year. We will be checking drawdown levels and will advise you of any changes that are necessary.

After 30 June this year, in specie transfers of shares by a member into a self-managed superannuation fund are expected to be banned. If you have been planning to transfer some of your personal shares into super as a contribution, this will need to be completed before that date, so please contact us soon to organise any transfers for you.

Sue Dunne
Financial Advisor

Age of beneficiary (at 1 July)	Minimum % drawdown 01/07/2008 to 30/06/2010	Minimum % drawdown 01/07/2011 to 30/06/2013	Minimum % drawdown 2013/14 and later years
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 more	7%	10.5%	14%

Insurance Matters

Your new Insurance contact at CIPL

Hello. For those clients that I have not yet had the opportunity of meeting, my name is Lei Nelson and I will be your contact person for all your insurance matters. Having moved from Brisbane to Rockhampton has been quite a change for me. Fortunately the team here at Capricorn Investment Partners have warmly welcomed me into the area and I am yet to experience the 'hot' weather that is often thought to occur.

As we are all aware, the wet weather which Queensland has been experiencing in the past month or so feels like it will go on forever. It is at times like this watching the creeks build and flood waters either locally or on television that we contemplate if the general insurance we have for our homes or car is up to date. This consideration also needs to extend to ourselves and our family. If a crisis was to occur, you need to feel confident that you have adequate risk protection in place.

If you are contemplating updating your life, trauma, TPD or income protection insurance or would like to check that you have adequate protection, feel free to contact me and we can arrange a time to discuss your situation.

Lei Nelson
Assistant Financial Advisor

Investment Briefs

Corporate actions for the October quarter

FLT: Some companies seem to defy gravity. Flight Centre (FLT) is engaged in the travel agency business. The Company provides a complete travel service for leisure and business travellers in Australia, New Zealand, the United States, Canada, the United Kingdom, Africa, Middle East, Asia, New Zealand, and Europe. The FLT business is based predominately on the traditional shop front model whereby traffic is defined by feet and not clicks on a keyboard. Therein lies the paradox. Despite seemingly swimming against the movement to internet structural tide, FLT has instead defied all odds and has not only managed to survive, but thrive.

FLT recently reiterated FY13 guidance of Profit before Tax of between $305m - $315m led by growth in its corporate business. This is especially encouraging as it underlines that the business is not just being buoyed by a strong Australian Dollar (which in turn is assisting its international travel market). FLT is adapting like all the best business' do. It is placing emphasis on developing its online business to compete against incumbents such as Wotif (WTF) and Webjet (WEB) and the initial evidence suggests the company is making inroads.

The FLT business is based upon a cash rich model and management have achieved steadily increasing EBITDA margins since the GFC. As a result, FLT is able to comfortably pay a 4% fully franked dividend. The stock can be bought for a discount against international peers (14.3x FY12 earnings) with 23% return on equity. However, we would prefer a retracement in the share price before getting set.

WPL: It appears WPL shareholders are finally being rewarded for their patience. Depending on the Final Investment Decision (FID) of the Browse project, WPL has for the foreseeable future completed its intensive investment capital expenditure programme. The Pluto project 190km off the coast of Karratha in WA was first approved in 2007 and completed in 2012. The project is underpinned by 15 year supply agreements with Japanese companies Kansai Electric & Tokyo Gas.

Now that Pluto is on stream, the company is able to reap the benefits of these long dated contracts. In fact the benefit is compounded from a cash flow perspective as the injection of cash flows from Pluto combines with the marked reduction in capex. The benefit was clearly seen in the company's 2012 full year result. Not only was there an 18% jump in full year NPAT but operating cash flows spiked by 51% from $2,208m to $3,346m. The market has been hesitant to mark up the share price of WPL probably on the back of uncertainty over the FID at Browse. However, we have been increasing our weighting to the company as we see it as fundamentally undervalued with Pluto capex now behind it and the possibility of an increase in the dividend payout ratio now that management have more flexibility.

Companies such as WPL require patience and are probably best bought mid way through major projects due to the sometimes marked down share price. The market tends to be focused on the short term nature of operations and as a result this presents opportunities for longer term investors willing to look through short term cash flows for longer dated profits.

Lachlan McKenzie-McHarg
Equities Advisor & Dealer

Rio Tinto: On 17 January the Chairman of RIO announced that it would take an impairment charge of approximately US$14b on an after tax basis. This would consist of $10-11bUS relating to the aluminium business (essentially Alcan) and $3bUS relating to the coal assets in Mozambique (Riversdale). The group also announced that it was severing ties with CEO Tom Albanese following a mutual agreement. Reading the compensation details for Mr Albanese the mutuality is difficult to ascertain.

As we see it there are a number of issues in regard to this announcement that can be constructive in making investment decisions and are part of the thought process we use at CIPL. Before delving into the instructional value of this announcement it is worth working through what actually occurred in chronological order.

Tom Albanese was appointed CEO on 1 May 2007 following a long career at Rio. At the time of Mr Albanese becoming CEO, RIO was involved in two potential major corporate transactions. It was rumoured in the press, and eventually came to pass, that BHP was seriously considering a hostile bid for RIO.

Simultaneously Alcoa had made a hostile bid for Alcan and RIO was a potential counter bidder.

On 4/5/07 Alcoa bid $28.6bUS (mostly in stock) for Alcan. This represented a near 25% premium to the pre bid price.

On 9/5/07 RIO received a query from the ASX which noted that the RIO share price had increased by 20% in a week

(to $97/share) following rumours of a BHP bid. RIO, sensibly in our view, said that it had no knowledge of a potential bid from BHP.

On 12/7/07, 11 weeks after Mr Albanese became CEO, RIO made an agreed $38bUS bid (plus $6bUS in assumed debt) for Alcan. This represented a 33% premium to the Alcoa bid valuation and a 65% premium to the pre-bid price. It represented a multiple of 16x Alcans' 2006 pre-tax profits or roughly a P/E of 25x.

In a presentation regarding the acquisition RIO stated that it expected $600mUS in after tax synergies from the merger (this was later increased to $1.1bUS in pre-tax benefits) and noted that 'the offer is value accretive to RIO shareholders based on RIO's rigorous project evaluation criteria.'

The presentation also included a detailed analysis of why aluminium was an attractive business and how RIO could grow the combined group to become the largest player globally.

RIO also stated that it would use its balance sheet to entirely debt fund the purchase, effectively increasing debt by $44bUS just as the GFC was beginning to bite.

In 2008 and 2009 it became apparent what a horrible acquisition Alcan was turning into. As the table below shows, EBIT has been below the value of the proclaimed synergies for five years (the 2012 figures in the table are the first half actuals times two).

In addition there has been $17.5bUS of after tax write-offs prior to the recently announced $10-11bUS write-off. On a pre-tax basis RIO has written off more than its initial $38b investment in Alcans' equity. In addition to being an earnings disaster the extremely aggressive funding structure resulted in the (eventually aborted) convertible note issue to Chinalco and the BHP iron ore jv. In June 2009 RIO bit the bullet and raised $15.2bUS in new equity at a wealth shattering price of $28.29AUS per share.

In October 2011 RIO announced that six of the aluminium smelters owned by the group would be divested, an ongoing process that shows no signs of concluding imminently. In January 2011 RIO bid $16.00AUS (later raised to $16.50AUS) per share for **Riversdale**, **which owned a number of potential coal mines in Mozambique**. In total RIO spent **$3.7bUS** acquiring RIV. The expectation was that RIV would eventually produce more than 20mtpa, which would be barged down the Zambezi River and exported.

In 2012 Riversdale produced 0.45mt of coal, of which roughly half was railed to port and exported. The company has not been able to procure dredging permits, which means that in the medium term there is no viable means of exporting more than about 2mtpa of product.

In addition the quantum and quality of the reserves base have both been reduced, resulting in a $3bUS write-off. In less than two years **RIO has written off 80% of the purchase cost of Riversdale**.

The lessons we take out of this are as follows:

- In contested takeovers the acquirer can be expected to pay top price. If one pays 25x NPAT for a business an adequate return cannot be made unless earnings double or treble rather quickly. **Price discipline matters**;
- In cyclical businesses having too much debt creates considerable risks. **The balance sheet matters**;
- One person's rigorous project evaluation criteria are another person's best guess. **It is difficult to predict the future** of currencies, commodity prices and volumes. A healthy amount of scepticism and humility are useful and the most diligent are likely to be wrong with some regularity; and,
- The most important lesson we take from this is one must have trust in the judgement of management. **Management matters**.

Over the past five years RIO has experienced a fourfold increase in earnings from iron ore, its biggest business (over a decade iron ore earnings have risen by nearly a factor of 40x). In the first half of 2012 iron ore in Australia generated $7.3bUS of EBIT. It is making nearly 100% returns on assets employed. The share price, however, is virtually unchanged over that period, due primarily to the wealth destruction caused by the Alcan acquisition.

At CIPL we have tried to invest in businesses where we think management have demonstrated good judgement in acquisitions and funding decisions. We have not had RIO on our recommended list for a number of years due to scepticism regarding the Alcan acquisition and our view of management.

In future we will continue to be cautious about companies that make aggressive acquisitions. While we will not always be correct in our judgement of management we continue to believe that management matters and sensible, if somewhat dull, management is no bad thing.

Owen Evans
CIPL - Investment Committee

RIO Aluminium Earnings 2007-2012 ($B US, calendar years)

	2007	2008	2009	2010	2011	2012e	Totals
EBITDA	1.7	4.1	0.6	2.4	1.7	1.1	**11.6**
D&A	0.6	1.9	1.6	1.6	1.1	1.1	**7.9**
EBIT	1.1	2.3	-1.0	0.8	0.6	0.0	**3.7**
Net Assets	43.9	34.8	36.0	38.2	26.2	26.9	**206.0**
RONA	2.5	6.6	neg	2.1	2.3	0.0	**1.8**
Impairment	-	7.9	1.0	-	8.6	10-11	**27.5-28.5**
Share price (A$ at 31/3)	**62.16**	**96.62**	**44.86**	**78.32**	**85.84**	**65.40**	

Source: company reports, IRESS

Your team at Capricorn Investment Partners Limited

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Jane Eklund
Compliance Manager

Samm Morris
Reception/ Administration Support Officer

No image available

Sandra French
Bookkeeper

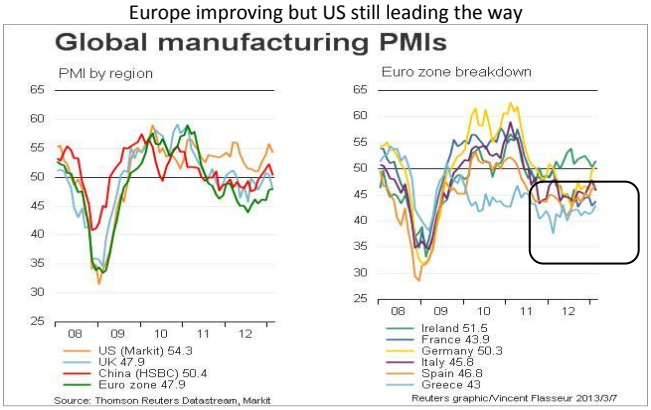
Christine King
Bookkeeper

CHART PACK

Information at a glance ***(Reuters, NAB)***

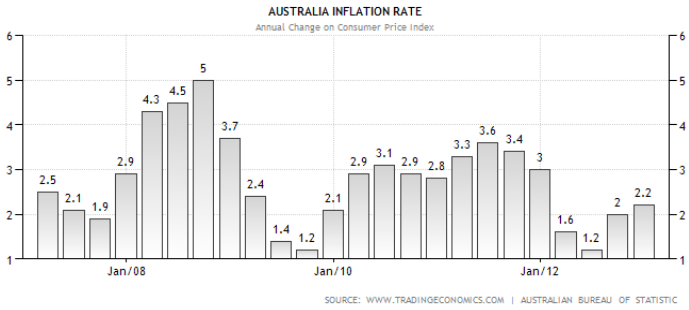
Global Manufacturing Growth Indices

Europe improving but US still leading the way



Australian Inflation Rate

Are we the 'goldilocks economy'? Inflation stays in line with the RBA's target.

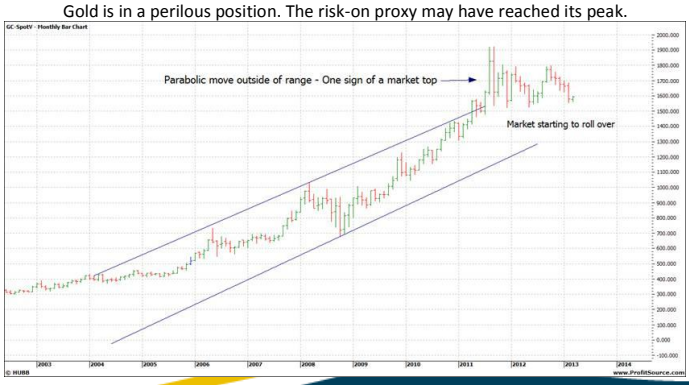


Japanese stockmarket

The Nikkei is up by 37% since mid Nov last year. Will 'Abenomics' save the day?

Has the gold bug finished?

Gold is in a perilous position. The risk-on proxy may have reached its peak.



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