



# Investment Market Update

Issue 32 September 2008



## Welcome...

In this 32<sup>nd</sup> edition of CIPL's Investment Market Update we outline some of the new developments within the business.

One of the most exciting of these is the rollout of our new Portfolio Administration System. In the newsletter we discuss some of the benefits and enhancements we expect it to bring.

We have also devoted a significant proportion of the newsletter to discussing and analysing economic and market conditions. While we share your disappointment with the market's performance, we believe there is some silver lining in the clouds.

## David French

Managing Director  
Senior Investment Advisor

## OUR NEW LOOK!

### Welcome to our new-look newsletter

We have spent some time improving the look and design of our quarterly newsletter. We hope that you enjoy the more contemporary and modern style. If you have any feedback we would be happy to hear it.

## THE BUSINESS

### Our new Portfolio Administration System goes live

The past few months have been very significant for CIPL, with the unveiling of our new Portfolio Administration System (PAS).

While our original administration system has served the business very well, it was not able to be easily customised. To that end Ben Scott, our IT Manager, has spent the past 18 months developing a new system from the ground up.

Clients will notice improved clarity in presentation of their investment reports, and the new system has greatly increased the efficiency of the administration function within the business.

Many repetitive manual tasks which used to occupy the valuable time of our administration staff have been automated or made simpler to complete. I expect clients will notice that staff have more time for direct contact with clients.

Being able to easily customise the system also means that we can respond to client requests for data in a more timely fashion.

CIPL's intention is to continue to improve reporting abilities (including charts and graphics), and add a more streamlined process which automates and speeds up various tasks, such as portfolio analysis, ATP generation and order transacting.

### CIPL embraces the Internet Age

By now you would have received a letter from us confirming your contact details and outlining our intention to make quarterly and annual portfolio reports available online.

Using less paper in our day-to-day activities is consistent with our commitment to sustainability and reduces the amount of paperwork you will need to deal with.

By making reports available online we hope to make the record retention process easier for you, as well as increasing the speed at which we are able to make your reports available to you.

Of course we understand that some clients either do not have internet access or are uncomfortable with using the internet as their primary form of communication. Rest assured that we will continue to communicate with you as usual if this is the case.

If you would like to attend a free training course on how to use the internet, and CIPL's Website, please call Robyn on 49204653.

### Trust or account?

Clients are probably aware that the Federal Government has guaranteed deposits at banks, building societies and credit unions. The Rock CMA accounts, through which client portfolios are managed, fall within this guarantee.

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## Property Fund update

We are nearing the final stages of what has been some pretty intensive work on the Property Trust. The main aspects of this have been the generation of a Product Disclosure Statement (PDS) and preparation for our submission to The Australian Investment Securities Commission (ASIC) for a licence to operate the fund.

This process has been made particularly interesting given the increased focus by the regulator as a result of the global financial issues.

We expect the ASIC submission to be sent off in the next few weeks and the PDS is at a point where all the key content is in place and we are refining the marketing and investment strategies.

The Grand Hotel continues to operate and the redevelopment plans are to be submitted to council in coming weeks. The current designs are looking very promising.

## MARKET UPDATE

2008 is unlikely to be remembered as the year of the Beijing Olympics and is more likely to be recalled as a period of unprecedented financial instability.

Clients are probably tired of hearing the phrases "sub-prime crisis" and "credit crunch". We certainly are.

## On a global scale...

While there is lots of technical jargon surrounding the issue (Collateralised Debt Obligations, Credit Default Swaps), the underlying problem is that as a consequence of very low interest rates, and supportive government policies overseas banks took on many bad loans. Strong global economic growth caused interest rates to increase, and many of these loans began defaulting.

Banks began to assess the extent of these non-performing loans and discovered that much of the global banking system had exposure to them. They became suspicious of each other's balance sheets, and stopped inter-bank lending.

Banks have to lend to each other so that they can match their assets and liabilities from day to day – it is a core part of their business. The freeze on lending began to threaten many normal business transactions, and impacted on market values for financial instruments including those in our clients' portfolios.

Coincidentally new accounting rules had been put in place such that banks' assets had to be valued at current prices. As the fear spread, asset prices were pushed down, making banks' balance sheets weaker still, and causing some to go out of business. That threatened a run on banks, which is something no western Government can tolerate.

International leaders in stout, Ireland, threw down the gauntlet and guaranteed all bank deposits. Overnight Irish bank deposits became more valuable than other countries' deposits, and consequently all of the western world was forced to follow suit.

Subsequent measures included Governments purchasing stock in a wide range of banks and having a say in how they are run, co-ordinated interest rate cuts, and guarantees on interbank lending.

**The evidence is that these measures are now starting to take effect.**

It is helpful to note that the underlying problem is with the housing market, and the banks.

The problem is reflected in the share market, but readers will note that share markets continued to work. For example, Commonwealth Bank and General Property Trust raised a combined \$3.6bn at the height of the crisis.

The measures that are now in place are expected to help lend stability to both markets.

## On a local level...

Regardless of the current semantics, the Australian Federal Government and the Reserve Bank have shown an understanding of the problems facing the economy and have demonstrated a willingness to act:

- Interest rate cuts are the correct response to an expected slowdown in economic activity. The RBA cut official rates by 1 per cent in October, following an earlier cut of 0.25 per cent.

This is now beginning to flow through to the real economy, and we expect more cuts, beginning as soon as November.

- Short term fiscal measures to pump \$10.4 billion into the economy. This spending is targeted at groups that traditionally pay little tax, and consequently its effect on spending is greater than would be the case if the money was delivered in the form of tax benefits.

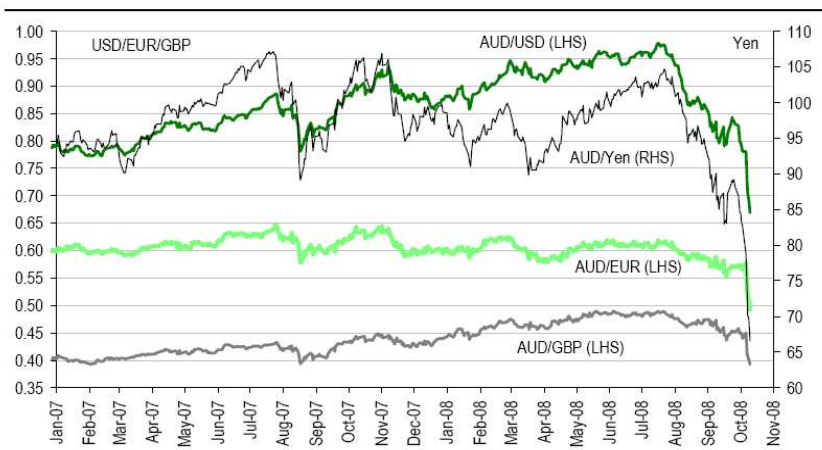
Our estimates suggest that the final annualised impact on GDP will be in the order of 1.6 to 2 per cent – enough to offset a loss of around half current GDP growth.

- The rapid fall in the value of the \$A against other currencies is linked to interest rates cuts and falling commodity prices. A weaker \$A benefits exports, and over time reduces demand for imports.

The chart on the next page shows the performance of the Australian dollar against our major trading partners.

Note the rapid decline against the US dollar over the past 2 months.





Source: Datastream, UBS

- Falling oil and commodity prices will cause a decrease in inflation, and assist in bringing interest rates down.
- The bringing forward of \$72 billion of infrastructure spending. This will take some time to crank up, but is certain to absorb employment released as a result of the downturn in commodity prices.
- The new Federal government is anxious to avoid being a one-term government. We expect further spending initiatives and policy proposals aimed at maintaining a reasonable level of economic growth.

The result is likely to be that Australia does not experience a widespread economic downturn. Instead certain sectors are likely to weaken, while others benefit – that is, we believe there will be a switching in economic activity.

With the stabilisation of the banking system in hand, our view is that many investment opportunities now exist, especially in the banking and infrastructure sectors.

**“The stock market is a wonderfully efficient mechanism for transferring wealth from the impatient to the patient” – Warren Buffett**

Consistent with the global financial instability, stock markets have experienced both sharp falls and extreme volatility. Along with global markets, the ASX has fallen significantly, with a decline of 24.7 per cent since the start of the financial year.

Although falls of this sort are both worrying and upsetting, it is important to remember that income earned by your investments is generally unaffected by changes in the market value of the company share price.

Investors receive dividends based on the number of units of each share they hold, not the value of the holding. Even through periods of weak economic growth, directors are reticent to cut dividends.

For example, if you own 100 shares of XYZ Corporation and it declares a 5 cent dividend, it is immaterial if your shares are worth \$100 or \$200 – you would receive the same income (\$5) in either case. This is a particularly important point to remember in those cases where the investments are required to meet drawdowns for pensions, loans or other payments.

## Your portfolio...

At CIPL our investment strategy specifically takes into account the income needs of clients and we aim to construct portfolios which will not ordinarily

require unintended sales of capital to fund drawdowns.

As clients would be aware, we have been advising maintaining faith in the share market and to resist the temptation to join in the general panic and swap their investments for the relative safety of cash.

**The simple logic behind our attitude is that, over the long run, the share market outperforms every other asset class.**

Although cash does have a role to play in the portfolio construction, the opportunity costs associated with holding large cash assets must be kept in mind.

We believe that moving to cash now is a particularly bad plan, given that interest rates are falling and remedial measures are well advanced in other markets.

Attempting to ‘time’ the market and pick the ‘bottom’ are also strategies that we discourage. Numerous studies have found that missing out on even just a few days in the market can cause your overall return to fall dramatically over the long run.

For example, during the past 10 years, the ASX All Ordinaries Index would have provided total returns, including dividends, of 258.5%. But if you had missed just the best 10 days of market gains in that period, the return would fall to 172.4% - which equates to a return equivalent to only two-thirds of that which could have been gained by remaining invested in the market.

Although further market falls may occur, we believe that market valuations have reached a point where the fundamentals of many reliable and market leading companies are being ignored.

Just as the share market increases in value beyond fundamental fair value in times of a market boom, it can also be expected to fall below fair value during bear markets.

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In the meantime, as we have repeatedly said, clients of CIPL generally do not rely on asset sales to support their income needs. This means they are exposed to the inevitable market recovery.

CIPL portfolios have four features that make them different:

- They are income focussed. Dividends are much less volatile than asset prices, and we generally do not have to sell assets at depressed prices.
- Diversification means that the portfolio as a whole will not fail.
- All portfolios have some assets with known maturity dates. This means that cash becomes available at regular periods, which can be reinvested according to market conditions.
- The vast majority of assets are liquid and so can be sold – that is there is a price that you can sell them at, if desired.

Remember that you are entitled to call in for a chat or come in for a meeting anytime. You are paying us to assist you with your affairs, and we have a knowledge base that will see clients through these times.

We are never too busy to see you, but making an appointment helps us organise our day better.

## Investment Briefs

Here are some trading ideas for non-portfolio clients:

### **Commonwealth Bank of Australia (CBA)**

Commonwealth Bank dominates Australian retail banking and its share price has outperformed its rivals since 2006. CBA has weathered the sub-prime

crisis relatively well compared to its peers, particularly overseas banks.

The bank recently took advantage of the financial turmoil to announce the acquisition of BankWest and St Andrews for \$2.1 billion. The transaction has been favourably received by analysts, with acknowledgement that CBA was able to negotiate a very attractive purchase price 20% below book value.

The successful completion of the transaction will allow CBA to maintain its position as Australia's largest retail bank, as well as providing CBA with exposure to fast-growing WA economy. UBS has a 12 month target price of \$46.00, compared to current prices around \$42.75.

### **Bank of Queensland Perpetual Equity Preference Shares (BOQPC)**

Bank of Queensland is a third-tier bank which has traditionally focused its operations in Queensland, although it has more recently expanded nationally.

The BOQ PEPS are preference shares which entitle holders to semi-annual preferred dividends. The dividends are calculated based on a margin above the 180 day Bank Swap rate. The current calculated rate is 7.52%. The security is traded on the Australian Stock Exchange, with current prices of around \$86.60 and it is rated investment-grade.

Current prices equate to an implied yield to maturity, including conversion discount, of approximately 14.00%. We believe that hybrid securities in general will benefit from falling interest rates and the eventual easing of the credit crisis.

Current prices of BOQPC allow investors the opportunity to purchase a highly-rated security at an approximate discount of 13% to its face value.

### **Macquarie Airports (MAP)**

September '08 figures for total passenger traffic were down 0.1 per cent on September 2007, with international -4.3 per cent and domestic +2.3 per cent. With economic conditions softening, some weakening in traffic growth can be

expected. Despite this, it is believed that earnings growth will hold up due to cost control and redevelopment initiatives.

Market conditions have caused MAP to be oversold, but we believe the company's earnings will be resilient in the medium term. A \$1 billion buy-back, due to commence soon, is expected to underpin the price.

The share price valuation and target is \$4.00, and at current market price, the yield is 10.4 per cent.

### **Arrow Energy Limited (AOE)**

The company currently produces and sells coal seam gas and electricity into Eastern Australian markets. It is capitalised at \$1.3 billion, and carries less than 10 per cent debt.

The company recently sold mining interests to Shell and an initial payment of \$650 million, on this account, is due in 3 to 4 weeks.

With a strong expenditure program underway, focussed on reserves identification and definition, it is forecast that AOE will have about \$470 million in cash at 31 December 2008, or 66 cents per share, with the operating coal seam methane gas projects separately representing \$1.90 per share. A buy recommendation reflects the current 45 per cent discount to the target price of \$4.15. Looking at it another way, leases and exploration activities are not being valued at all.

Production and sales both seem robust and defensive, in the current economic climate, and there is significant growth potential for the future.

*You are advised to seek advice regarding your particular situation before acting on anything contained herein.*

