Investment Market Update

Issue 34 - April 2009

Welcome...
In this 34th edition of CIPL's Investment Market Update we discuss some of the recent economic stimulus measures announced by the Federal Government.

Economic conditions continue to be tough, as reflected in the share market. There are however a few indicators which provide some glimmers of hope. We discuss these in further detail in the newsletter.

A recent development for CIPL has been the unveiling of our re-designed website. We hope that you take the time to stop by the site and view some of our articles and newsletters.

We hope you enjoy the newsletter. If you have any comments or suggestions we would be happy to hear them.

Regards

David French
Managing Director
Senior Investment Advisor

RUDDBANK

The government brings out the chequebook as growth slows

Only one item is fit to lead this edition of our quarterly newsletter – the single largest fiscal policy stimulus in Australian history.

There is a common generalisation in Australian politics that the Liberal party are economic conservatives, believers in small government and averse to debt, while the Labor party prefers to adopt more of a big-spender approach to economic policy.

The Rudd Government has done its bit to live up to this stereotype, unveiling Australia's largest ever spending package as it seeks to cushion the economy from the worst of the global financial crisis.

The 'Nation Building and Jobs Plan' amounts to a projected spend of $42 billion. Key measures include free ceiling insulation for 2.7 million homes; to build or upgrade a building in every Australian school; $900 one-off cash payments to most Australians and $650 million to be spent on local community infrastructure and maintenance on Australian highways.

While some may quibble with the exact proposals under the stimulus package, the package succeeds in its most important goal – getting the money flowing into the community and stimulating economic activity, be it retail, building and construction or other related industries.

Many other governments around the world have taken similar steps. Accepted economic policy is for the government to step in when the private sector is unable or unwilling to maintain the desired level of economic activity.

The government's balance sheet acts like a shock absorber: expanding during the bad times as it takes on debt and increases spending; and contracting during the good times, when increased tax revenues allow for reductions in both debt and spending.

While no government action will be able to completely immunise the economy from the full impact of slowing global growth, targeted spending initiatives will assist in shortening the length of any downturn or recession.

ECONOMIC OUTLOOK

Stimulating discussion

Across the globe interest rates are falling and Governments are spending like there is no tomorrow. That is almost certain to sow the seeds of the economic recovery. In the same way that the share market foretold of the impending economic downturn, it is very likely to begin recovering before jobs and GDP recover. That us why we are busy restructuring client portfolios (see below).

The thing that is lacking is confidence, both in the economy and in markets. But there are some encouraging signs even there. On Monday 8 March, a new market opened in the US, for trading Credit Default Swaps. These instruments are insurance policies, taken out by lenders, against the risk that the borrower will go broke.

To date most of these instruments have been private contracts, and as such their terms, conditions and size have not been readily quantifiable. Public trading of these assets, is a huge step forward in financial transparency, and consequently in restoring confidence in the banking system.

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Within a few weeks, we expect an announcement regarding the establishment of a 'bad-bank' – a public/private trust that will purchase rubbish assets from financial institutions. This has happened before, successfully, in the USA, Switzerland and Sweden. Again, clarity will win the day.

Reinvoking the up-tick rule in financial markets will prevent short sellers from driving prices down, and some tighter regulation will also assist in cleaning out rogue elements in the market.

Many of these initiatives have been discussed over the past 6 months, but it is only now that they are being implemented.

SUPERANNUATION CHANGES

Changes to the way minimum pensions are calculated

On the 18th of February the government announced the suspension of the minimum account-based pension draw down requirements.

Under the existing system, income streams drawn from account-based pensions were required to be at or above a minimum amount, calculated as a percentage of the assets funding the pension stream. For example, if you were 65 years old and had $100,000 in your superannuation account paying you an annual pension, you would be required to withdraw at least 5% of the balance (i.e. $5,000) as an annual pension.

The percentage draw down is calculated on an age-based sliding scale, structured to ensure that retirees draw down their superannuation capital during retirement, rather than rely on the age Pension and other government benefits.

The government has recognised that this requirement placed a significant burden on some self-funded retirees as fund balances have fallen.

In some instances retirees were compelled to sell assets to meet their annual minimum draw down which was calculated on asset balances as at 30 June 2008.

If you are interested in reducing your monthly draw down for the remainder of the financial year, please contact our office to make the necessary arrangements.

THE BUSINESS

New website makes a splash

Regular users of the online portfolio reporting system, which is accessed through the Client Portal, will have noticed some significant changes to CIPL's website.

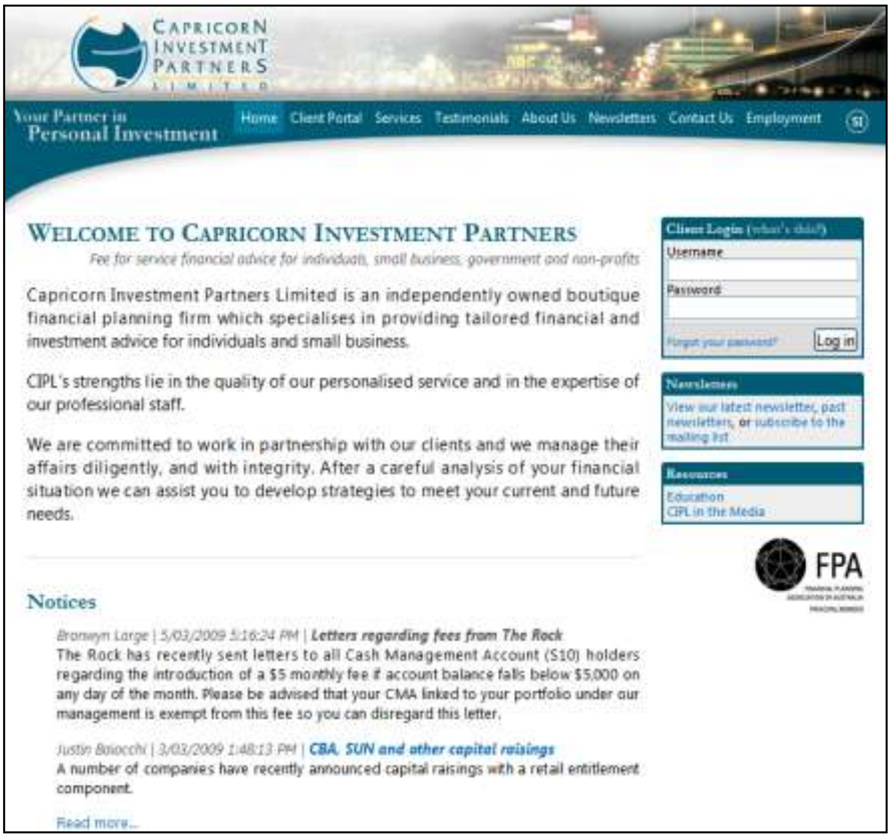
Although the portfolio reporting system is the same, the home page, structure and most of the content on our website is new or has been redesigned.

A new feature on the website is a section dedicated to news, portfolio and market developments and other information which may be relevant to clients (the 'Notices' section).

It is our intention to use this area of the website as means of continuously providing information to you. We encourage you to use this resource on a regular basis as an important source of information regarding your portfolio or general events.

Many interesting and informative articles can now be accessed through the website and we encourage you to spend some time browsing through our new content. So have a look and let us know what you think of it! Your feedback and any ideas regarding the website are always welcome.

Ben Scott, our IT Manager, has put a lot of time in the redesign and we congratulate him on a job well done.



Client web training

If you are not using our new website, you are not getting the best out of CIPL. You get up to date portfolio reports, information on issues that affect clients (rights issues, and other items of general interest), newsletters, articles and more.

Clients are also able to authorise purchases and sales of investments through the website.

CIPL will provide free training not only to use our website, but to use the internet in general. If you do not have a computer, and would like one, we will negotiate a deal with a reputable supplier for you.

We strongly encourage you to contact Robyn to discuss getting online.

If you would like to attend a website training session on Thursday 23rd of April, please also contact Robyn 07 4920 4653.

MARKET UPDATE

Continued slowing growth and economic uncertainty, both in Australia and abroad, weighs heavily on Australian share prices

Gloomy economic news from Australia's major trading partners has continued to force Australian share prices back toward their November lows.

This is despite the recent reporting season being viewed as more or less in line with expectations, which were fairly low to begin with.

Earnings per share across the market as a whole fell by just under 14%, which was the worst performance since 1991-92 (source: AFR 02/03/09). In line with falling earnings, a number of companies announced reductions in their dividend payouts, chief among these ANZ, AMP, BlueScope Steel, Wesfarmers and Tabcorp.

While the dividend cuts are disappointing from an income point of view, the market has rewarded those companies that have indicated a willingness to conserve capital. Shares such as ANZ and Wesfarmers have outperformed the broader market following their dividend announcements.

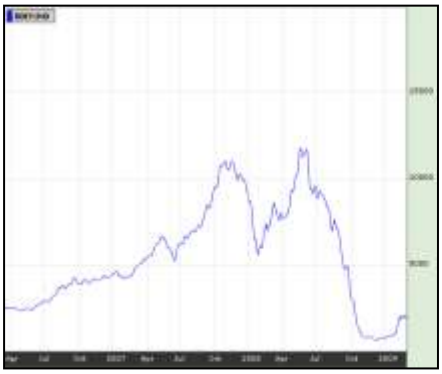
A number of companies were in a position however to increase their dividend, among those a number of companies which we view favourably, such Woolworths, CSL, and DUET Group.

Despite the continued poor performance of the share market, there are some positive signs as an antidote to the gloomy news.

A little-known indicator of economic activity, though of importance in an Australian context, is the Baltic Dry Index.

The index is simply a measure of the cost of moving major raw materials by sea (coal, iron ore, grain and others).

The index is calculated by canvassing shipping brokers around the world on the cost of shipping a range of cargoes on various routes (for example, how much would it cost to ship 1,000,000 tons of grain from Los Angeles to Tokyo?).



The chart (above) clearly shows the index reached an unsustainable high in 2008, with very rapid falls in the second half of the year. The encouraging aspect however is that it does appear to have bottomed in recent months, which is a positive sign for export and thus economic growth (source: Bloomberg).

The index is closely followed as an economic indicator because it is a very close proxy for global economic activity.

The demand for global shipping has a high correlation with the consumption of raw materials, which is closely tied to future levels of economic growth.

A recent spate of corporate activity is also a welcome development, as it is generally a sign that companies themselves are beginning to view one another as undervalued. We expect to see a number of companies take advantage of their strong balance sheets to acquire competitors or to diversify their operations in new markets or geographic regions.

Housing market clearance rates have also improved over the past 4 months, helped largely by the government's First Home Buyer bonus and the rapid reduction in interest rates by the RBA.

STORM FINANCIAL

Very different

While we generally prefer not to comment on other businesses or advisors within the financial planning industry, given the publicity surrounding the Storm Financial disaster, we do feel compelled to point out the significant differences between Storm and ourselves.

As far as we can tell, Storm's business model essentially revolved around gearing up its clients to the eyeballs, levying a large 7% upfront fee on the available assets and borrowed funds, and then trusting that the stock market only ever went up.

While borrowing to invest can have a role to play, it appears that the majority of Storm's clients were carrying levels of debt which they had no chance of ever repaying.

Anecdotal evidence speaks of retired couples on little or no incomes borrowing against their homes to invest in the stock market, assets which where then again borrowed against to effectively double-up, in some cases resulting in million dollar debts or more.

The funds were then invested in Storm-branded managed funds, resulting in more fees accruing to Storm.

This is not how Capricorn Investment Partners operates.

Our aim is to protect investor's capital while earning an income and capital return in line with their risk profile.

Although we can't control the share market and we do occasionally get it wrong when assessing investments, at all times our primary concern is for the well-being and interests of our clients.

NEW RECOMMENDATIONS

Opportunities

We have been methodically working through client portfolios, making recommendations for new investments, and pruning some investments that we do not feel will live up to expectation.

We are about half way through the portfolio list, and we have been recommending relatively modest investments, which given depressed prices can have a significant impact.

The aim of the recommendations is to increase portfolio income and better position the portfolios for recovery. Buying assets at depressed prices will mean a greater boost to asset values as markets recover.

We realise some clients are sceptical. That's only natural, given the dreadful shellacking that the market has had over the past 16 months. We'd ask you to reflect though, that while we have made some poor judgements, much of what we have predicted over the past 18 months has been right.

We said in our December 2007 newsletter that we expected a market downturn, we said in mid-year client presentations that interest rates would be cut in the face of slowing economic growth, and we have consistently said that China would not support Australia in preventing an economic downturn.

Now we are saying that things in financial markets are slowly getting better. If we are right, then the grief of the past 16 months has a silver lining and purchasing assets at depressed levels will serve you well.

INVESTMENT BRIEFS

Here are some trading ideas for non-portfolio clients:

ConnectEast Management Limited (CEU)

ConnectEast is a toll road linking the exiting Eastern Freeway through Melbourne's eastern suburbs and on to Fransktson. The traffic corridor is one of the busiest in Australia. Initial tolled traffic volumes were less than expected, and the market has struggled to see value in the stock since. Notwithstanding that, traffic volumes have gained by 12 per cent since the road opened in August 2008.

The company reports continuing improvements in road use, cost reductions and initiatives designed to attract more use of the road. With the company nearing cash flow break even and traffic volumes increasing, we expect the stock is due for a substantial rerating. The stock is trading at $0.39.

Multiplex Sites Limited (MXUPA)

Multiplex Sites are a hybrid security secured by subordinated guarantee against the assets in Multiplex' property trust. According to the December accounts debt comprised only half of the asset value and the trust had more than 3 billion of equity.

There is no evidence that Multiplex or its Canadian parent, Brookfield Asset Management, have experienced refinancing issues, and the refinancing profile is in any case, not onerous. The security is trading at $29, compared with a face value of $100.

Fairfax Media Limited (FXJ)

FXJ recently announced a restructuring of its operations in Australia, New Zealand and the United States. The new structure is designed to improve business opportunities by grouping operations around core functions such as metropolitan, regional and community masthead, printing, business media and on-line. It added that the new structure will aim to improve the way its print and internet businesses work together.

A recent 3 for 5 rights issue to institutional shareholders was successful and provided $500 million for the reduction of debt, due in 2011. The share is trading at $1.05, and with a target price is $1.60.

AXA Asia Pacific Limited (AXA)

In a sector where capital and debt management are closely monitored, AXA has announced a capital raising for a minimum of $890 million. The company is obviously comfortable with the resulting excess capital which could rise from $780 million to $1 billion.

Some dilution for shares will follow, but is expected to be offset by a falling $A. Earnings per share for 2010 should benefit by an additional 3 per cent on forecast. The raising should definitively ease any concerns the market has about the company's capital base. The price target is $4.10, compared with a market price of $3.54.

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