Investment Update – August 2009

Pretty Average Returns

The 2008/2009 financial year was a horrible year for investors. The financial media has been in frenzy mode since September 2008. The global financial crisis hit its peak when major financial institutions either failed, were acquired under duress, or were subject to government takeover. Fear and uncertainty took hold of the globe, massive falls in share and property markets ensured and global economic growth has been put in reverse. The purpose of this investment update is not to relive the pains of the past 12 months (we have all done enough of that already). This report seeks to place these events into historical perspective and look at the positives that have or are soon to emerge.

Sharemarket crashes and global economic slowdown are nothing new and the current crisis will certainly not be the last. Sharemarkets and economies have always moved in cycles and will continue to do so in the future. In fact, the lessons for successful investment present themselves with far more clarity during these downturns. Downturns are almost always the result of a reality check, following a period where markets and investors get ahead of themselves. These boom years, where bubbles emerge and eventually burst, are usually the market abnormalities and the resulting crash often reflects a return to normality.

The good news is that the current downturn appears to be past its worst for now. Asset prices have rallied globally with the ASX All Ordinaries Accumulation Index recording 4 positive months in a row, up 21.7% from March to July. The same has occurred for property and global markets. The ASX Listed Property Trust Accumulation Index and the MSCI ex-Aust Accumulation Net US$ Index have returned 16.6% and 29.2% respectively, over the same period. The current environment represents a perfect opportunity for all investors to readjust return expectations, reassess tolerance to market risk, reset investment objectives and prepare their portfolios for the next market cycle.

Credit Crisis or US Housing Bubble?

The terms "credit crisis" and "global financial crisis" are the commonly used phrases to describe the cause of our current financial market and economic woes. The root cause however, was the bursting of a housing bubble in the US in late 2005, early 2006. These crisis terms describe a by-product the bursting of this housing bubble and are a good example of investor behaviour during boom periods. Between 1997 and 2006, the price of the typical American house increased by 124%. This housing bubble resulted in quite a few homeowners refinancing their homes at lower interest rates. Others used this to finance consumer spending by taking out second mortgages, secured by the price appreciation. During the good times of abnormally high returns, the desire to invest (or spend) increases and the obviously solution for many is the use of debt.

Fortunately for US investors and consumers, interest rates were extremely low. From 2000 to 2003, the US Federal Reserve lowered the federal funds rate target from 6.5% to 1.0%. This was done to partly to soften the effects of the previous dot-com bubble and of the September 2001 terrorist attacks. This allowed US consumers to assume an unprecedented debt load. The Fed then raised the Fed funds rate significantly between July 2004 and July 2006. Suddenly, the interest payments for variable loans were becoming increasingly expensive. This also contributed to the deflation of the housing bubble, as asset prices generally move inversely to interest rates and it became riskier to speculate in housing.

Due to the huge amounts of money being made from this housing boom, investment banks around the world were seeking new and inventive ways to keep the good times rolling. Obvious problems were emerging in terms of the ability of investors to repay their loans, so the banks had to get creative. Aggressive and predatory lending practices ensued. Investors were offered loans with ultra low introductory rates that reset to higher interest rates later and the criteria for obtaining a loan was greatly reduced. The emergence of the NINJA (No Income, No Job or Assets) loan best reflects how reckless banks had become in trying to keep the boom alive.

To spread (or bury) the risk, the amount of financial agreements called mortgage-backed securities (MBS) and Collateralized Debt Obligations (CDOs), deriving their value from mortgage payments and housing prices, greatly increased. These derivative instruments became increasingly complicated and in late 2003, Warren Buffett famously (and aptly) referred to these as "financial weapons of mass destruction". Such financial innovations enabled institutions and investors around the world to invest heavily in the booming U.S. housing market, also with borrowed money. They allowed the bad loans to be packaged up with the good loans and sold on at a tidy profit.

As with every bubble preceding it, the US housing bubble burst. In early 2006, then President Bush (who is not renowned for his economic prowess) explained this simply and actually quite well: "If houses get too expensive, people will stop buying them... Economies should cycle." Buyers for new homes began to dry up, housing prices began to fall, many home loans became larger than value of the home and foreclosure rates began to sky rocket. The unprecedented borrowing by both consumers and large financial institutions to participate in the boom became unsustainable. Due to the complex MBS and CDO derivates that had been spread throughout the global financial system, nobody really knew where the true risks lay. Banks refused to lend to one another, financial institutions reported the losses on their highly geared balanced sheets, some big names collapsed and we have a “credit crisis”, “global financial crisis” and global economic downturn.

The Australian Resource Bubble

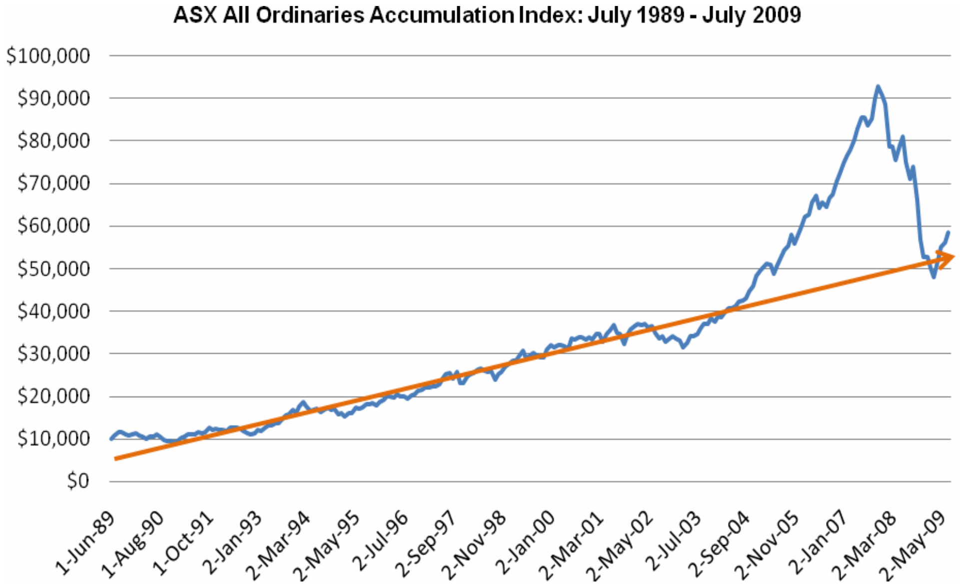
With the increased interdependence of global economies, the boom in US housing prices led to other booms all over the world. As the world’s largest economy and with consumption accounting for two thirds of its GDP, when cashed up US consumers are spending like crazy, it sets the whole global economy in motion. Demand for Chinese and South East Asian exports increase and these fast growing economies grow even faster. To deal with this growth they require more raw materials for infrastructure and development, and resource-oriented economies like Australia join in on the action. While Australian GDP is dominated by the service sector (68% of GDP), most of the funds flowing into the economy come from the agricultural and mining sectors (10% of GDP combined), which account for 57% our nation's exports.

For example, between early 2003 and mid 2008, oil prices climbed by 320% and internationally traded food prices by 138%. The resource driven Australian sharemarket was a huge beneficiary of these rises. In the 5 year period preceding the current downturn, from September 2003 to August 2008, the S&P/ASX 300 Resources Accumulation Index rose as massive 292.4% or 31.4% per annum, pulling the rest of the sharemarket higher. This rally came to an abrupt end and over the past financial year, the S&P/ASX 300 Resources Accumulation Index fell 30.4% and the S&P/ASX All Ordinaries Accumulation Index fell by 22.2%.

Major Crash or Return to Average?

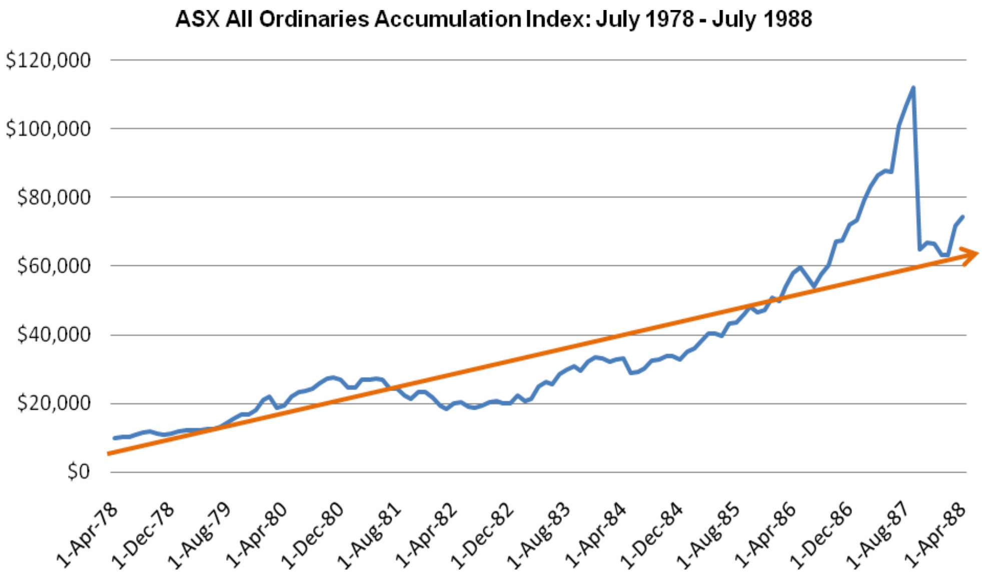
It is human nature to want to invest heavily when markets are returning greater than 30% and then to be bitterly disappointed during the subsequent crash. But, the successful investor, with an understanding of historical returns, is more likely to question their returns during these boom periods. The following series of graphs illustrates this point.

To put the current downturn into perspective, let’s take a look at $10,000 invested in the ASX All Ordinaries Accumulation Index over the last 20 years. Despite the expected short term ups and down, we can see the market exhibits a clear and consistent positive trend up until around March 2003. This is when the US housing (and Australian resource) boom starts to kick and the sharemarket really takes off. More and more investors are drawn to the market (many with borrowed money), pushing prices even higher, and further away from the long term average. In September 2008, the problems created earlier come to a head and result in a swift market crash. But looking at the long term trend, this actually looks much more like a return to the historical average.



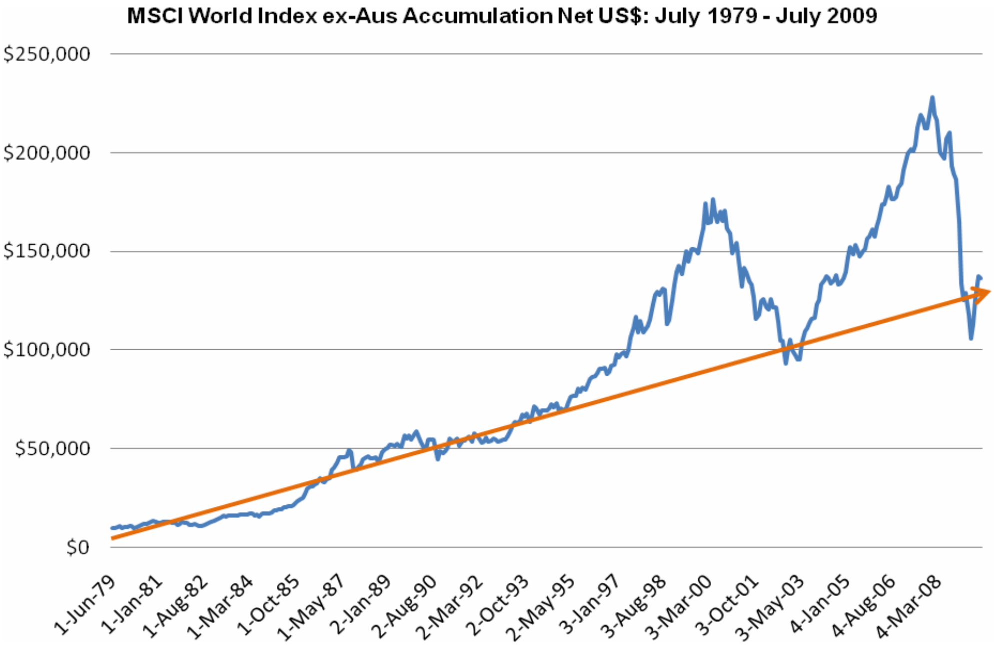
We've seen this before…

Looking at the 10 years preceding the previous Australian market crash on 1987, we see exactly the same thing occurring. Although it appears more volatile due to the shorter time period chosen, the market move around a fairly consistent average return until it starts to creep away from it. The exact cause of the 1987 crash continues to be argued today, but what is agreed upon is that sharemarkets were highly overvalued. This crash came on extremely sudden, beginning on 19 October 1987, and by then end of October the Australian market had fallen 41.8%. Again, we see this massive fall land very close to the long term trend, where it continues to rise again.



and globally…

If we take a look a $10,000 invested on the MSCI World Index ex-Aust Accumulation, over the last 30 years, the same occurs globally. The market rotates around the long term average for 15 years before starting to accelerate. Note that the crash of October 1987, which hit global markets just as hard as in Australia, looks like a mere blip on the radar over this time period. The dotcom bubble emerges resulting in another massive boom period from 1998 to 2000. Huge returns were being made off companies that weren't even making a profit (or in many cases had no income). More and more investors are drawn to the market until sure enough, this bubble burst. Shortly after this global markets took another massive blow with the September 11 attacks in 2001. The result is a series of major market downturns that once again land firmly on the long term trend. Our US housing bubble begins, 5 years of amazing returns are followed by a major global financial crisis and economic slowdown. The market crashes, back down to the long term average.



Average Returns

Fortunately, these historical average returns from share and property markets are high. In fact, it is because these historical returns are so high that investors take on the additional risk to invest in them in the first place. The following tables shows the historical returns of all the major asset classes for the 31 January 1971 to 30 June 2009 as well as then number years of negative returns that have been experienced. These figures are supplied by van Eyk Research.

Asset Class	Australian Equities	International Equities	Property and Infrastructure*	Fixed Interest	Cash
Average Historical Return	14.68%	11.76%	13.35%	10.40%	8.76%
Likelihood of Negative Return (1 yr in…)	4.2	3.7	8.6	37.5	Never

*Data series commences 31 December 1979

These average return figures incorporate every major market downturn, including the current crisis, since January 1971 (December 1979 for Property and Infrastructure). We can never assume that past performance figures are exactly what we should expect in the future, but they provide a very good guideline in preparation for it. The table highlights one of the golden rules of investing. That is: higher long term returns come with the compromise of having to endure more negative returns in the short term.

Conclusion

The historical events of the last 12 months will be a major catalyst for change in decades to come. Investors, large and small, have been hurt by the often reckless actions of many market participants and companies during a boom period. The result is massive depreciations in wealth around the globe. The global economy has been seriously weakened and it will still take time for confidence in markets to be fully restored. The positives to be taken from this are that governments around the world are taking unprecedented steps to restore both economic activity and confidence in investment markets. We will see a significant increase in the regulation of financial markets and participants, over the coming years, to avoid these same problems occurring again. The problems in the US housing market will sort themselves out and the growth of developing nations, like the giants of China and India, will continue to fuel global economic growth for a long time to come. New, unforseen problems will arise again in the future and markets will respond accordingly.

It is important to put into perspective the returns you receive from your investment portfolio. Overextending yourself during the good times can be just as dangerous a strategy as selling off all your investments when the going gets tough. A sound financial strategy should seek to satisfy specific performance and financial objectives in balance with the level of risk you are prepared to take. Whilst markets can overshoot on the upswing and undershoot on the downswing, it is important to remember that the trend for all of the major asset classes is up, and that setting reasonable return targets and choosing the appropriate investment timeframe is key over the long-term.

There are a huge range of tools and strategies available to ensure your portfolio is set on a path for success. Markets appear to have come off their lows, which means that now is an opportune time to meet with your Count Adviser and set your plan for the future.

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