

# intelligentinvesting

QUARTERLY INVESTMENT NEWSLETTER

## CEO's ADDRESS What A Year That Was!

It is fitting that we reflect on the year that was. Not just because we find ourselves eagerly anticipating the coming events of this year, but more because it was one of the most extraordinary and astonishing years on record.

In this Summer Edition of the Intelligent Investor, Officium Capital's Acting Chief Investment Officer, John Nunan, looks at what the future may hold for economies and investment markets in the year ahead and provides some focus as to the issues that we believe will be prevalent in the coming months. We have also included an article on the money spent thus far on keeping economies afloat following the worldwide credit crisis, and specifically how much money the US has already committed to fixing the problems.

No one predicted the severity of this economic downturn and market turmoil. By the time markets had reached their lowest levels for 2008, America's Dow Jones and Australia's All Ordinaries stock market indices had both declined by nearly half their value since the beginning of the year. At one stage, after having almost reached parity with the US dollar, the Australian dollar abruptly fell by more than one-third in two months.

October got the prize for best typifying 2008's turmoil. During the week ending 10 October, the US government announced a \$700 billion banking system bailout, the Dow Jones lost 18% in five trading days and the Australian market fell 10%. The Australian dollar fell US\$0.12 and nickel dropped to its lowest price since 2005. Not to be outdone, the British government put £200 billion into its banks (four times that of their US cousins in terms of the relative size of their economies). Strange days indeed.

No doubt markets will recover eventually, but this time round they may recover more slowly, and from deeper depths than previous post-1930s downturns.

Out of all the various headline grabbing "stranger than fiction moments" that served themselves up in 2008, the following two are etched foremost in my mind as demonstrating the dramatic consequences of the economic and financial market downturn:

- In February, ABC Learning had forecast a 15% rise in net profits for the 2008 financial year. Less than six months later, it told the market that the profit rise had become a \$437 million

loss. By November, ABC Learning was in receivership and the newspapers went to town on the resulting child care centre closures.

- Babcock & Brown was once a market darling. It started the year with a market capitalisation of \$7.5 billion. By the end of 2008, its once exalted CEO had fallen on his sword and the company was fighting for its life with a market capitalisation of \$50 million.

Let's hope 2009 heralds less dramatic headlines and less volatile markets. Whatever 2009 brings, rest assured, a clearly defined investment strategy, based on sound advice, will inevitably lead to recovery.

Finally, I hope the Christmas and New Year break eased some of the unavoidable tension and anxiety that arose during the 2008 market turmoil, and the entire team at Western Pacific look forward to working with you in 2009.

**TONY McDONALD**  
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(incorporating Western Pacific Financial Group)

**"Learn from yesterday,  
live for today, hope for  
tomorrow. The important  
thing is not to stop  
questioning."**

*Albert Einstein*



Summer 2009

# MARKET OVERVIEW

## 2008 – An Unprecedented Year

Welcome to 2009. We have never looked forward to a new year as much as this one. In 2007, when the first signs emerged of the unravelling that was to follow, few could have predicted just how bad things would become.

The events of 2008 (and late 2007) have been analysed and re-analysed repeatedly over the last few months so rather than go into great detail about what has already happened, we would prefer to sum it up briefly and then take this opportunity to look forward to 2009 and beyond.

The best and briefest summary of 2008 that we can give is that the markets of the world reached over-inflated levels due to “investors” paying too much for assets with money that, in many cases, they didn’t have (the word “investors” is in inverted commas because in many cases the purchasers of these assets who pushed the price up would be better classified as “speculators” rather than investors). This led to the speculators, and those trying to earn returns in a more long-term traditional manner, beginning to take ever increasing levels of risk for ever diminishing levels of return. Unfortunately, the fall from the market highs has impacted both the speculators and the true investors alike. To paraphrase Warren Buffett, “the bigger the party, the bigger the hangover”.

So where does that leave us now?

We’re not about to rush into making predictions. We didn’t see crude oil reach USD 200 per barrel by Christmas 2008, and we are yet to see if it reaches USD 20 per barrel, yet both extremes have been given an airing in the last 12 months. The fact that such wildly different prices can be suggested in such a short timeframe, using supposedly sound underlying rationale, demonstrates the folly of trying to predict a specific price for a commodity/index/currency.

The one thing we can say with certainty is that equity markets, by definition, are much closer to their lows than they were 12 months ago, and that there are many more attractive opportunities for astute managers than in recent history. For 2009, finding these opportunities and avoiding the inevitable “landmines” will be key.

We referred earlier to the influence of speculators on the markets recently. As a general theme, we are seeing a lot of the highly leveraged, risk taking participants forced out of markets both at the investor level (think of the numerous high profile executives

caught up with well publicised “margin calls”), and the corporate level (take your pick of any of the US companies that have been “bailed-out” by their government). This forced selling of shares (individuals) and assets (companies) has, however, presented abundant opportunities for the more “boring” or traditional investor who is prepared to be patient and make investments with a long-term outlook. Going forward, having the assets in the hands of long-term, conservative investors bodes well for a more steady market, once the current volatility settles down.

The other general theme that we think will be important in 2009 and beyond is remembering the importance of risk and reward. This is something that seemed to be forgotten in the heady days of 2007 when many investors seemed willing to buy anything, on the basis that prices will “just keep going up”. Clearly prices don’t have to keep going up, China and the US haven’t yet “decoupled” and we didn’t enter a commodities super cycle. In a well diversified portfolio of investments there is a place for both more risky and less risky investments, provided the investor is being appropriately rewarded for making these investments.

Whilst individual circumstances vary, in general, with markets pricing in more appropriate returns for the risk taken, a strategy of very low risk for very low returns is no more suitable than a strategy of very high risk for (hopefully) very high returns. Instead, a wide range of investments with differing risk and return profiles makes sense, with the key being not to place all of one’s eggs in any one basket. There may be no better example of this than recent movements in the price of US Government Bonds. In a world that is shunning risk, there has been a rush to purchase these “safe haven” investments. This has led to dramatic price increases recently, and as we have seen, dramatic price increases can be followed by dramatic price declines. (The current return on 10 year treasuries is only just above 2% per annum. If investors demand a higher return, then the price of these instruments will fall.)

Chasing last week’s winner can be a losing strategy, and the best plan is generally to take a long term view and invest accordingly. Switching out of any asset class that has performed poorly and into one that has done well often ends badly as the underperforming class recovers and the outperformer comes back to earth. The best analogy we have for this is changing lanes in a traffic jam – how often have you become frustrated with being stuck in the “slow lane” whilst cars next to you whiz past, only to switch lanes as yours starts to move again and

# MARKET OVERVIEW

then find that the “fast lane” is now the new “slow lane”? The same thing can and does happen in investment markets, and having an adviser who can guide you through difficult times, and help you make smart decisions rather than reactionary ones is vital. Cash as an asset class could well be a classic example of this; it has been a standout performer for the last 12 months and a great example of being rewarded for taking minimal risk. However, with much lower cash returns currently on offer and opportunities elsewhere that are more attractive than they have been recently, cash could well be one of the worst performing asset classes in the next 12 months.

What are some of the other themes that remain at the forefront of our minds going into 2009?

## ECONOMY

We can expect to see some tough times on the economic front this year, both domestically and globally. However, tough times have been priced into investment markets already and only time will tell whether markets are being too pessimistic or too optimistic. On a positive front, the governments of the world have shown that they are prepared to take unprecedented steps to minimise the damage of any slowdown, and we think they will continue to act until they get a resolution.

## INFLATION

Whilst the general view seems to be that inflation risk has passed, we don't share this outlook. As outlined above, the level of stimulus by governments is unprecedented, and with the high level of debt being taken on by the US government in particular, a moderate level of inflation would be a preferred outcome for it. If you are able to borrow substantial sums of money when the perceived risk of inflation is low, you can borrow at low rates of interest (as we are seeing) and “lock-in” the value of this debt.

If, subsequently, inflation is higher than expected, whilst the value of the debt outstanding remains unchanged, the value of the assets you own tends to increase. If the US government is able to engineer this outcome it will go a long way to repairing the damage done to both the national balance sheet, as well as the balance sheet of its citizens. This is unlikely to occur in the short term, but we think that in the medium to longer term, inflation is still something that needs to be considered.

## RESOURCES

Whilst the resources sector did manage to hold up quite well until mid 2008, since then it has been hit particularly hard. Although we expect to see a slowdown in demand for the commodities produced as a result of economic slowdown, we are also likely to see a decrease in output over the next few years as unprofitable mines are shut down or mothballed, and new projects are put on hold due to a perceived lack of demand, or in many cases, a lack of finance. This should bring us back into a classic commodities cycle of boom and bust (as opposed to the so called “supercycle”), with those operators with strong balance sheets and well run mines able to benefit from their competitors' difficulties.

In summary then, whilst there are still tough times ahead on the economic front, the investing landscape is now healthier and more “normal” than it has been in recent years, with the risk-reward equation being a lot more balanced. For investors with the ability to stay the course and benefit from the opportunities being presented, without reacting adversely to the events of the past year, we expect to see very good opportunities in a variety of sectors that should show the benefits of holding a well diversified portfolio of investments.

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## WORLDWIDE GOVERNMENT INTERVENTION

No economy was untouched by the recent credit crisis and, over recent times, there have been a plethora of stimulus packages released and bailouts initiated, by both small and large economies to combat falling consumer spending and rising unemployment. The US, which has been one of the economies worst hit by the credit crisis, introduced an economic stimulus package as early as January 2008, worth around \$107 billion. At the time this looked like a lot of money; however, since then this figure has been dwarfed by subsequent events. In the last 12 months, the US government (including the Federal Reserve and the Federal Deposit Insurance Corporation) has committed to a total of between \$7.8 trillion\* and \$8.5 trillion^ through a variety of measures, including bailouts of companies (such as AIG and Citigroup), loans, capital injections, and guarantees on mortgages and bank deposits.

When you say it quickly, \$7.8 trillion doesn't sound that bad. However, to put this massive figure into perspective, at \$7.8 trillion the US has now spent or committed more on bailouts, guarantees, stimulus packages etc. in 2008, than it has over the last 230 years on wars, which according to the Congressional Research Service is around \$7.2 trillion in inflation adjusted dollars. This figure is also equal to over half of the US gross domestic product (GDP) and represents an investment of around \$25,000 per person in the US. Put another way, \$7.8 trillion is more than \$1,000 (around AUD \$1,400) for every man, woman and child in the world today, or around half a million Australian dollars for every man, woman and child in Australia.

During the last quarter, most other major economies have also started to implement economic stimulus packages, as growth has trended down and consumer spending has slowed. In mid-October 2008, the Australian government announced a AUD \$10.4 billion (USD \$7.4 billion) package focused on low to middle income families and pensioners. It also included an increase in the first home owners grant and a doubling of available training places. The total package is worth around 1% of Australia's GDP and equates to an investment of approximately AUD \$480 per person in Australia. New Zealand's stimulus package, while lesser in value (\$4.1 billion), represents around 3.2% of its GDP and just under \$1,000 per person.

Germany, France, Spain and the United Kingdom all announced stimulus packages worth around 1% of their country's GDP (not including money injected by central banks and rescue packages for companies affected by the credit crisis), with most packages focusing on the motor vehicle industry and infrastructure investment. The European Union also pledged \$278 billion to its 27 member nations.

The Japanese government originally pledged ¥5 trillion (\$109 billion) to help households and small businesses cope with the slow down, however, in early December the Japanese government doubled its plan to ¥10 trillion. This represents an investment of \$850 per person and around 2.5% of Japan's GDP. The package consists of tax breaks on mortgages, a bank rescue scheme, relief for small firms and ¥2 trillion for individuals.

In November, the Chinese government announced plans to spend about 4 trillion yuan (\$586 billion) over the next two years on low-cost housing, infrastructure (new railways, roads and airports), health, education, environmental protection and technology. The government also said it would rebuild disaster areas, including the Sichuan province, where 70,000 people were killed by an earthquake in May 2008.

South Korea also revealed a 14 trillion won (\$10.5 billion) package of extra spending and corporate tax breaks; and India announced a 200 billion rupee (\$4 billion) stimulus package to revive spending.

Whilst the total value of the various packages certainly is astronomical, their effectiveness will only be known with the passage of time. What can be stated with certainty though is that the governments of the world are desperate to avoid a repeat of the 1930s, and the commitments they have made, which have been outlined in this article, are testament to their level of determination.

Note: All figures quoted are in US Dollars, unless indicated otherwise.

Source: WorldBank and Bloomberg, unless indicated otherwise.

\*Source: UN – Report on World Economic Situation and Prospects 2009 and the New York Times.

^Source: The Casey Report, CNS News, Bianco Research.

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