

# intelligentinvesting

QUARTERLY INVESTMENT NEWSLETTER

## CEO's ADDRESS A Brave New World

Later in this Review, we touch on some of the lessons learned from 2008, and the importance of adjusting to the new environment that we now find ourselves in. Mention is made of the impressive rally from the depths of despair in early 2009. For most investors, the end of year financial statements that arrive in the mail boxes will still show a loss, however. But there are signs in the current environment of emerging opportunities to make smart, long term investments at attractive entry prices, that should lead to positive returns in the future for the patient investor.

The world has changed though – materially and irrevocably – and will continue to change. While it is important to stay with tried and tested investment principles that have stood the test of time, it is also important to change with the times – hastening slowly in that regard.

In the subsequent article, we outline some of those tried and tested principles – the importance of liquidity in investments, not investing in things that we don't understand, and staying diversified.

But there are changed conditions that affect the way in which "Intelligent Investors" will apply their craft in a brave new world. The way in which we approach alternative investments in the future will be different to the way we have approached them in the past. We also know that the way different types of investments move together or apart may change – in times of stress, assets that would not normally move together can quickly become correlated. As a value investor, we also know that in a recovery phase, pockets of value may open and close quickly.

The "Intelligent Investor" needs to understand this and adapt quickly. We intend to find ways to do that on your behalf. Working with our "Intelligent Investing" philosophy, we intend to learn from the past, making changes to suit the times, while also continuing to apply the tried, tested and proven.

This approach also applies to our industry – the wealth management industry. It too needs to change, while not jettisoning the practices that have worked well in the past.

Much has been said and written recently in relation to the wealth management industry, some of it in very unflattering terms, and in many cases with good cause.

This is a point not lost on the current government. The Labor Government has served notice on the wealth management industry that it would like to see improvements to suit the times so as to better serve Australians, particularly in relation to superannuation. We agree with the general thrust of the government's reform agenda. We welcome continuous improvement, both in relation to the way we do things and to the way in which the industry works more generally. We too would like to see some of the less savoury aspects managed out of the industry so that you, the client, are better informed, receiving value for money, and are better placed to build, protect and enjoy your wealth.

That's the business we are in. We are committed to working with Australians to help them build, protect and enjoy their wealth. We pride ourselves on being advisers first and foremost.

Hopefully, in a brave new world, with constructive dialogue between the government, industry bodies, the respective parts of the industry and the consumer, that's indeed what will happen – and you the client should end up being better served for it.

**TONY McDONALD**  
**CEO**

Snowball Group Limited  
(incorporating Western Pacific Financial Group)

**"If past history was all there was to the game, the richest people would be librarians."**

*Warren Buffett*



# MARKET OVERVIEW

## The Class of 2008

Two quarters ago we wrote that we have never looked forward to a new year as much as we had looked forward to 2009. Now that we are half way through 2009, and, at least for the time being, some of the dust seems to have settled, we thought it would be appropriate to look back on not only the last six months and what has transpired, but also the last couple of years and the lessons we have learned from the turmoil we have been through.

Let's start with the last six months. After a brief flurry in the first week of January, the Australian share market returned to the downward trend of 2008, with the All Ordinaries hitting an intra day low of 3,090.8 on 10 March. This left us wondering if 2009 was really going to be something to look forward to. Since then however, the market has staged an impressive rally, with a closing level on 30 June of 3,947.8, which is 7.9% above the level at the end of 2008, but still a long way below where it was at the start of the financial year, 12 months earlier. Does this mean we are breaking out the champagne? Not yet. Whilst we feel the risk of catastrophic financial system failure has substantially abated, we still believe there are substantial hurdles to be overcome in the broader economy, and some aspects of the recent rally may well be due to investors getting a little ahead of themselves. We feel that the easiest trap for the optimists' camp to fall into is to assume that once the "recovery" starts we will be back at the levels of 2007 before we know it. We don't subscribe to this point of view as we feel the corporate profits being earned at the top of the market were unsustainable, and even when things return to a more even keel, it will be at a less leveraged, less profitable level than that which we remember. Having said that, we think that there are ample opportunities for astute managers in the current environment, and so long as investors have realistic expectations and patience, we hope 2009 turns out to have provided an opportunity to make smart, long term investments at attractive levels.

So that's the easy part out of the way; now let's go back to 2008. As tempting as it is to brush it under the carpet and pretend it never happened, the reality is it did, and it wasn't fun for any of us. However, to simply forget about it would be a wasted opportunity as all experiences, good and bad, provide valuable lessons to be used in the future. The following list looks at some of these lessons, and how we have been putting them to use and intend to continue to do so.

### **IN TIMES OF STRESS, UNCORRELATED INVESTMENTS CAN BECOME CORRELATED**

One of the key benefits of a diversified portfolio is having uncorrelated investments. What this means is that you hold investments that should move in the opposite direction to some of the other investments in the portfolio to protect your overall portfolio value. What we found in 2008 was that, in times of severe stress, assets that would not normally be correlated can quickly become so. Consequently, when everyone is selling indiscriminately all prices come under pressure. Whilst short term dislocations can cause high levels of correlation,

appropriately structured portfolios should be able to withstand such short term aberrations with the benefits of non-correlation becoming apparent when markets stabilise. What is key is avoiding investments that must be sold during the period of dislocation (see "Liquidity is Important" below) as well as considering the most appropriate way to access a specific asset class.

### **LIQUIDITY IS IMPORTANT**

Liquidity is a very broad term and pretty much all of its meanings were important last year. Companies needed to be liquid (i.e. able to access or generate cash quickly) as credit dried up and refinancing maturing debt became nearly impossible for all but the highest quality borrowers. Similarly, managed funds with too many illiquid (i.e. unable to be sold) underlying investments ran into difficulties as they were unable to sell assets to meet redemptions and were forced to freeze their funds. Finally, managed funds with liquid underlying assets which became forced sellers in order to meet redemptions helped to drive down prices of the investments they were selling, causing their unit prices to fall and resulting in further redemptions which perpetuated the cycle (this forced selling was one of the problems which caused uncorrelated assets to behave in a correlated manner as mentioned above). The lesson to be learned is that leverage at a company level, (including off balance sheet or non-recourse leverage, such as debt that is secured over specific assets and is only repayable from those assets) becomes increasingly important as times become tougher. Also, for managed funds, monitoring the liquidity of underlying investments, and considering how this liquidity might be impacted in a difficult environment is vital.

### **IF YOU DON'T UNDERSTAND IT, DON'T INVEST IN IT**

As the boom of 2006 and 2007 wore on it became more and more difficult to earn returns without taking excessive levels of risk. This led to a proliferation of investments which became increasingly complicated with increasingly unfavourable terms. Post the purging of last year a lot of these investments no longer exist, but more importantly, opportunities to earn reasonable returns without resorting to complicated investment products now appear to be available. This lesson also applies to individual stocks. If management can't simply and clearly explain their business, generally speaking, they are best avoided as investments. The other important lesson is that in a period of irrational exuberance, it pays to be prepared to stand aside from the crowd and not chase the last piece of marginal return. Just because everyone else is doing something doesn't mean it is the right course of action.

### **DIVERSIFY, BUT NOT JUST FOR DIVERSITY'S SAKE**

With so many factors at play, and the ability for the rules to change overnight (i.e. unexpected government intervention) it is more important than ever to maintain a well diversified portfolio. This includes accessing a particular investment theme (for example,

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commodities or emerging markets) in more than just one way. This topic is so important we have included an extensive report below (see Diversification). Foremost, ensure you are diversified with a purpose, i.e. do not just invest in everything, rather invest in many assets and asset classes with consideration of how they could all react in both "normal" and "abnormal" times.

## BONDS MAY BE BORING, BUT THEY HAVE A ROLE TO PLAY

If we had to put our hand up and identify the biggest mistake we made in 2008, it was assuming alternative assets were a substitute for bonds. They weren't, due primarily to the points covered above under correlation and liquidity. This was a painful lesson, but one well learned, and we are now firmly of the view that "alternatives" are an alternative asset class, and not a substitute for any other asset class.

They do have a place in a diversified portfolio; however, they need to be accessed in a manner that takes into account all of the points covered above.

## LOOKING FORWARD

Finally, whilst 2008 was a horror year, it wasn't a normal year, and one of the biggest mistakes that could be made going forward would be to assume that the few investments that did work well in 2008 are going to be the best investments going forward. Likewise, building a portfolio that is totally immune to the 1 in a 100 year event simply means it is likely to underperform in 99 years out of 100. We are in a new year, and the playing field to a large extent has been reset. We are taking on board the lessons we have learned, we are adjusting our thinking and we are building portfolios that we believe are appropriate for the environment we now find ourselves in.

# DIVERSIFICATION

At Western Pacific we believe diversification is the best way to generate attractive returns while lowering your risk of experiencing losses. Diversification is a risk management technique implemented at every level of our investment approach including asset class, investment manager, financial instrument and geographical region. Diversification has always been an essential element of our investment process. However, as we emerge from the unprecedented turmoil in the global financial system and we witness some of the "unintended consequences" arising from government intervention, we now consider diversification as one of the most essential elements in the construction of client portfolios.

Diversification is often explained by the phrase "don't put all your eggs in the one basket", but what does it really mean in the context of investment portfolios and how do we implement diversification for you?

The theory behind diversification is that different assets and securities produce varying returns at different times and under different

circumstances. By having a mix of assets you will reduce the volatility or risk in your portfolio.

## 1. DIVERSIFICATION ACROSS ASSET CLASSES

Diversification across all asset classes is essential. We believe an appropriate mix of cash, fixed interest investments, domestic and international shares, alternative investments, and property securities makes sense. To illustrate the benefits of diversification using two of these asset classes consider the benefit of "mixing" shares and fixed interest. The following example looks at the S&P/ASX 300 Accumulation Index (which represents shares) and the UBS Composite Bond Index (which represents fixed interest) for the 5 year period, ending 30 April 2009.

Using an even mix of shares and fixed interest with annual rebalancing, you are able to achieve a higher return than if you were 100% invested in either shares or fixed interest for almost half the risk of being 100% invested in shares.

| Time Period                    | Portfolio 1:<br>100% "Shares" |       | Portfolio 2:<br>100% "Fixed Interest" |       | Portfolio 3:<br>50% "Shares"/<br>50% "Fixed Interest" Risk |       |
|--------------------------------|-------------------------------|-------|---------------------------------------|-------|--|-------|
|                                | Return                        | Risk* | Return                                | Risk* | Return   | Risk* |
| April 2004 – April 2005        | 22%                           | 7%    | 7%                                    | 2%    | 15%  | 5%    |
| April 2005 – April 2006        | 38%                           | 9%    | 5%                                    | 2%    | 21%  | 5%    |
| April 2006 – April 2007        | 23%                           | 9%    | 5%                                    | 2%    | 14%  | 5%    |
| April 2007 – April 2008        | -6%                           | 16%   | 4%                                    | 2%    | -1%  | 9%    |
| April 2008 – April 2009        | -29%                          | 22%   | 13%                                   | 4%    | -8%  | 13%   |
| 5 Year Average Compound Return | 7%                            | 12%   | 7%                                    | 2%    | 8%   | 7%    |

\* Risk is measured by Standard Deviation

# DIVERSIFICATION

## 2. DIVERSIFICATION ACROSS INVESTMENT MANAGERS

Exposure to several investment managers is paramount to a well diversified portfolio for several reasons including the obvious risk that the investment manager may go out of business or all the key investment staff leave. However, it is also important because investment managers often have inherent biases towards certain sectors, regions or even specific stocks.

At Western Pacific we ensure that our clients have exposure to many investment managers, either directly or indirectly.

## 3. DIVERSIFICATION ACROSS FINANCIAL INSTRUMENTS

Although we would all like to think we could pick the “Winning Stock”, it is a very high risk strategy placing all your retirement savings in one stock. Further, in an environment where governments intervene periodically it is difficult to know what impact a change in policy could have on that “Winning Stock”. For example, on 3 February 2009 the Federal Government announced their policy on Energy Efficient Homes and rebates for the installation of ceiling insulation. Cool or Cosy (an ASX listed stock) jumped 66% in two days on the back of this announcement. Good news if this was your “Winning Stock”. Conversely, if your “Winning Bet” was 30 year US Treasury Bonds you would be down over 20% for the year to date (until mid June 2009). Not such good news – particularly in an environment where the Australian All Ordinaries Accumulation Index rose 18%.

## 4. DIVERSIFICATION ACROSS GEOGRAPHICAL REGIONS

Diversification across continents, countries and even states is relevant within a portfolio as over time different regions will produce different returns. For example, in the last six months we held the view that Asian share markets should outperform the US share markets and we ensured that our portfolios did have some exposure to this region. From the end of November to the end of March 2009, the Shanghai Composite Index was up 40% and the Dow Jones Industrial Average was down 4%.

At Western Pacific we think it is essential to have exposure to various global regions and countries within our clients’ portfolios.

We think diversification is an essential element of our Intelligent Investing Philosophy and is an integral part of our commitment to help you build, maintain and preserve your wealth.

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