

The "Great Crash of 2008"

2008 has been the worst year on record for the Australian sharemarket.

In the years leading up to the stockmarket peak in Nov 2007, it was easy for investors to get caught up in the emotion of **euphoria and greed**. Borrowing money to put into the rapidly rising sharemarket was all the rage. The leveraged speculators of last year have gone, many of them wiped out in a barrage of margin calls at lower and lower prices. Some of them lost their life savings by borrowing through share-lenders such as Opus Prime and Lift Capital. Others did it the old-fashioned way - through margin loans.

Recently it has been very easy for investors to get caught up in a climate of **fear and panic** when the media is full of doom and gloom. It is unpleasant to see the sale price of your investment portfolio fall substantially. We expect that it will take some years to recover the paper losses experienced this year - the market has fallen from a quite a high peak.

The Australian sharemarket value lost over \$800 billion since its peak in 2007. Australian banks alone have lost over \$150 billion in market value, yet they only had exposure to \$3 billion of US subprime loans! There may be more write-offs to come, but in my view, this "correction" has been overdone. It has been largely due to forced selling by leveraged investors and panic-selling by unleveraged investors who are alarmed by the scary and possibly irresponsible headlines in the media.

The recent strength of the US dollar

Over the last 7 years the US dollar lost significant value against the most other currencies. Over the past four months the US dollar has actually **gained** significant value over those same currencies.

Given the mess the US economy appears to be in, the US dollar should be continuing to fall in value! The strong recent rise in the US dollar against most other countries is a result of a massive shortage of liquid US dollar cash by the global financial sector. I need to explain how this works: The global financial sector has a lot of debt, and most of it is priced in US dollars. In order to raise the US dollar cash necessary to repay that debt, other currencies (and liquid assets in those other currencies) have been sold, and swapped back into US dollars. **This created a massive, short-term demand for US dollars.**



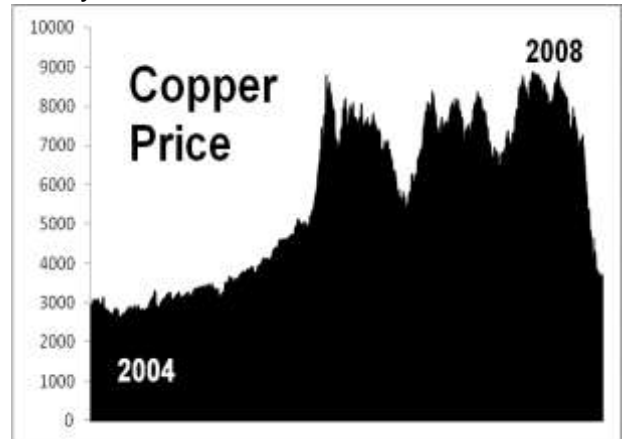
Once this liquidity crisis period has passed (hopefully within the next 12 months), I expect the US dollar to resume its long-term deterioration reflecting in part the huge amount of US dollars which have recently been pumped into the financial system to improve liquidity and rescue large, debt-laden financial institutions. Over US\$4 Trillion has already been generated to fight the "credit crunch", with hundreds of billions of dollars of further bailout monies announced almost daily. This truly is "Monopoly money" - it doesn't come from anywhere, but is created by the US Government.

The US government is taking on massive levels of credit risk. US treasuries were once considered essentially "riskless" as the US Government can always print more money to repay its debt. The cost of buying "credit insurance" on US debt is now 25 times more expensive than it was 18 months ago. US debt is now considered to be more risky than the debt of France, Finland and the Netherlands! Like all modern currencies, the US dollar is a "fiat" (faith based) currency. There is nothing specifically backing the US dollar except the "faith and credit of the US Government". Every time the US Government creates another billion dollars, they devalue the worth of every US dollar in existence. I can not see how the US dollar can retain its current strength.

Commodity and resource markets

The Australian dollar has suffered even more than many other currencies because we are considered a commodity currency - as you will be aware commodity prices have fallen heavily over the past few months.

The commodity price bubble was caused by two interrelated factors. Strong growth in demand volume started to push up the prices of many commodities. This was accelerated by the huge level of speculative monies which then poured into commodity index funds and hedge funds by large institutional investors, as I discussed in May 2006. This speculative money pushed commodity prices to unsustainably high levels.



This bubble is now being deflated at a rapid pace as commodity funds and hedge funds face massive redemptions and are forced to cash out to meet these redemptions. This has formed an "anti-bubble" or vacuum, as money is sucked of commodity and equity markets into cash.

However, the underlying, real demand for commodities, largely by China, is still there. Even if China only grows by 5% pa (as compared to the previously forecast 9%pa), China's need for commodities is largely driven by an enormous infrastructure build up. Not only are the original infrastructure plans still going ahead, China has also announced a further 4 Trillion Yuan (A\$800 Billion) "stimulus package" which is largely to be spent on infrastructure projects and social services. A dollar also goes a lot further in China than in the West! China has US\$2 Trillion in currency reserves - it can easily afford to continue to develop its economy under its own steam.

The ferocious drop in commodity prices has meant low-cost producers have had to suspend some production. The combination of lower prices and lower volume this year will certainly decrease their profit this year. However, these low commodity prices are devastating for their high-cost competitors - many Indian miners are now looking at negative cash-flow cost of production. I expect the low-cost producers to be in a strong competitive position when commodity prices revert to their longer-term upward trend.

Inflation or deflation?

In uncertain times people cut back their spending. This lowers demand which results in a period of asset-price deflation. Prices of non-essential goods and services fall - a scenario which - without intervention - could last for a number of years. However, Governments around the world have come to recognise that the threat of deflation is an even bigger concern than the threat of inflation. Deflation is particularly dangerous when you have a high level of debt as the cost of repaying the debt actually increases in real terms. As a result Governments around the world, but led by the US, have unleashed the biggest reflationary campaign in history. **I expect that it will not be long before inflation is again a serious issue.**

Looking forward - Australian Shares

Investor emotions have been extreme. The pessimism (if not raw panic!) which has dominated investor sentiment this year, the forced selling which has taken place through "deleveraging and liquidation" (selling by hedge funds and retail investors) is offering long-term investors an attractive entry point into a market which had become increasingly expensive.

In my view **the current period will provide what will probably turn out to be one of the greatest buying opportunities in my lifetime.** The Price Earnings ratio on the sharemarket is around 8 times next years forecast earnings. The forecast dividend yield on the banking sector is now over 9%pa fully franked, at a time when the banks are in the strongest competitive position they have enjoyed for many years. This is a rare opportunity to hop into a "time machine" and buy large, profitable Australian companies at prices which are unlikely to be repeated for a long time, if ever. The clock has been wound back to 2003, and for anyone who has not been leveraged in 2008, this is our chance to take part in a "once in a lifetime, 50% off sale".

It is said, during periods of crisis, that shares return to their rightful owners, from weak hands (leveraged, distressed, forced sellers) to strong hands (unlevered, patient buyers). We expect further volatility, probably even further short-term falls, but the buying is good today. We will reap the benefits of this sharemarket fall in the years to come.

The banking sector

It is possible that the banks will write down the value of more assets - they hold a lot of debt against the property sector. They will continue to be exposed by loans to failed companies such as ABC Learning, Allco and Centro. However, these are "asset-writedowns", and only really have the effect of reducing the accounting value of the banks assets. This may mean they need to raise capital to ensure they have a prudent level of reserves (National Bank recently raised \$3billion) by selling shares at a discount. This is not good for the share price (ie if you want to sell the shares), but it is good if you are the investor buying the shares at a discount! Most importantly, these writedowns do not affect the cash-flow profitability of the bank. Certainly, with the benefit of hindsight, it would have been better to have sold the overpriced bank shares last year when their book-values were inflated, and bought them back now at a discount. The point is that Australian banks remain profitable and now appear to be attractively priced.

As I mentioned previously, many of the bank's competitors are leaving the market. Overseas banks are retreating, direct mortgage competitors are being left out the cold during the credit freeze, and some smaller banks have been gobbled up! The Government's recent deposit and wholesale funding guarantees have made it easy for the banks to attract funding. Despite the negative headlines, Australian banks look to be very profitable for the foreseeable future.

Lets have a look at the current valuation of the big four banks:

Company	Estimated P/E	P/E if earnings fall 20%	Estimated dividend yield inc franking credits
National Bank	7.8	9.1	14.0%
Comm Bank	10.1	11.2	13.2%
ANZ	8.4	10.2	13.8%
Westpac	8.9	10.1	12.7%
Index	9.0	12.0	8.3%

These figures are based on analyst estimates for the next 12 months. Even if dividends are reduced during that period these are still very attractive yields, and I expect the bank share prices to recover over the next few years. The value-managers and Share Income funds used in the Managed Portfolio Service have a strong emphasis on high-yielding shares.

Australian v International Shares

The US (and most of the developed world) is now going through a recessionary period. Australia may or may not meet the technical definition of recession, but is certainly in a stronger position than most of the developed world.

I don't know how long or deep the US recession will be, but I do know that the Australian sharemarket is cheaper than the US sharemarket. The forecast dividend yield on the US sharemarket has now risen to 3.8%. The forecast dividend yield on the Australian sharemarket is now around 7%pa plus franking credits. Even if both sharemarkets perform identically for the foreseeable future, the dividend yield alone would make the Australian sharemarket a better place to be. Australia is a country with a strong economy and at present has a very cheap stock market.

With cash rates low and falling and dividends yield high, even if the Australian sharemarket is flat for the next 5 years, the dividend yield on the Australian sharemarket would generate a higher return than cash. **The time to have a high weighting to cash has passed.**

Share Income Funds

In the Managed Portfolio Service we have introduced two "Share Income" funds. As discussed previously, these share income funds focus on buying shares of companies which have high franked dividend yields, but use options to reduce the share-price volatility of the portfolio. The result is a fund with a higher level of dividends and distributions than the sharemarket, but a lower level of volatility than the sharemarket. With dividend yields so high at present, we feel that these Share Income funds will provide good returns over the years to come.

Managed Portfolio Service Rebalance

In investing, there are only 3 things that really matter. The price at which you buy, the price at which you sell, and the dividends received in between. If you are borrowing to invest, interest rates are also important - only borrow to invest when interest rates are low and dividend yields are high.

Last year I talked about investing being like buying cans of Tuna - high prices are bad news if you are investing - they are only good news if you are selling.

As Warren Buffet says, "*Investing is simple, but it is not easy*". What he means is that the principles are quite simple, but investing requires **patience** and the ability not to get caught up in the emotion of the crowd. For most people, this is not easy.

The Managed Portfolio Service aims to lock-in profits from the share market when it appears that shares are over-valued and to increase your exposure to the share market when it appears that shares are under-valued.

We expect that we will rebalance client Managed Portfolio's over the next few months. For most clients, this will result in an increase in Australian sharemarket exposure. The decision to increase your share exposure at a time when the market is weak requires the application of logic and experience, without being affected by emotion.

Our business is investment and we feel capable of making decisions which investors may find hard to make themselves. At our Get-Together last year when we were encouraging clients to rebalance their portfolios (i.e. to reduce their exposure to share and property markets) the forward Price Earnings Ratio of the Australian Share Index was over 17 - today it is below 10. We expect further volatility, maybe even further short-term falls, but the buying is good today, and we will reap the benefits of this sharemarket fall in the years to come. Our decision to increase our investment in the Australian sharemarket is based on logic and not on fear.