Paul Melling Retirement Planning

The Retirement Income Specialists

Investment Update – Christmas 2009

Looking back

Just one year ago, the ASX 200 Australian Share Index had fallen to around 3500, interest rates were falling and the Australian dollar was fetching US$0.63. Australia was forecast to enter recession and economists talked about having Australian unemployment of over 10%.

At the Christmas 2008 Get-Together we talked about dividend yields of over 10% including franking, which appeared very attractive even after allowing for possible short-term dividend cuts of up to 30%. Double-digit yields were available on a wide range of very high quality corporate bonds and hybrids. Despite the gloom and doom that was in the air, we felt that this was a rarely to be repeated, "once in a lifetime" opportunity to increase sharemarket exposure and buy shares at big discounts.

The sharemarket bottomed in March, and we have enjoyed a strong recovery over the past 9 months. The ASX200 Australian Share index is around 4750, interest rates are now rising, the Australian dollar now buys over US$0.90 and Australia avoided having a recession. Australian unemployment appears to have "peaked" at 5.8% from 4.0% before the "credit crisis".

Australian Sharemarket Update

The Australian sharemarket has risen around 50% from the bottom in March, but it is still 30% below the very high peak reached in November 2007.

The 12-month forecast gross dividend yield on the Australian sharemarket index has now fallen to around 5.3%pa, which is slightly below the long-term average. The 12-month forecast "Price-Earnings ratio" is around 16 times, which is slightly above the long-term average. So the sharemarket, on these simple measures, is no longer cheap – but it is not yet expensive either.

Where the sharemarket goes from here will depend on earnings growth over the next few years. There is consensus amongst many equity analysts that company earnings growth is expected to be strong (over 20%) in the 2011 financial year (and beyond). This is largely based on cost reductions made during the financial crisis and an expectation of a continued strong Australian economy. If these earnings growth expectations are met, then further share price appreciation would be justified – growing earnings and growing dividends justify higher share prices. However, the end of the 2011 financial year is still 18 months away, so even if earnings do grow as expected, the increase in share prices should take some time to reflect this earnings growth. We certainly cannot expect a repeat of the past 9 months sharemarket performance!

As a result, I am still positive on the outlook for the Australian sharemarket, but I expect it will be a slower progression upwards as healthy earnings growth is realized over the next 18 months and beyond. Further, I expect that the high level of volatility which we have seen in the sharemarket will remain for the foreseeable future.

The primary objective of the sensible sharemarket investor (as opposed to the speculator) is to purchase shares, at a reasonable price, which will generate healthy and growing dividends along with the associated franking credits.

International Sharemarkets

Whilst sharemarkets globally have enjoyed a good recovery, this has been largely driven by Government stimulus and increased liquidity (low interest rates and government quantitative easing programs). The economic fundamentals in the US, UK, Europe and Japan are still very poor.

The US economy remains on Government life support. Much of the "growth" in the economy is coming from Government stimulus. Over 15 million people in the US are now unemployed, which represents 10% of people who are actively looking for work. Ten million people are no longer eligible for unemployment benefits as they have been unemployed for more than 6 months (an extension was recently granted) and 7.3 million jobs have been lost since Dec 2007.

It is possible that money can be made by hedging currency risk and investing in international sharemarkets as money is printed overseas, pushing up overseas share prices. However, this falls under my definition of speculation, not investment, and so we will maintain the majority of our clients sharemarket exposure to Australian companies rather than risk money investing overseas. Where we have a part of client portfolios invested overseas we are focused on global resources and Asian shares.

It is worth noting that Australia is increasingly seen internationally as a "safe haven" for investment – a strong economy and currency, a strong banking system, a strong political system and exposure to the continued demand for resources driven by the growth of Asia. This bodes well for the Australian investment markets.

Managed Portfolio Service Update and Performance

The **Managed Portfolio Service** has performed very well since it was introduced last year. We took advantage of low share prices last year and early this year to increase exposure to the sharemarket at its lows, and we have reaped the benefits of this increased exposure over the past 9 months.

The 12 month performance numbers for each of the **Managed Portfolio Service** options are listed below. Please note that these performance figures are to 1st December 2009 for Allocated pension investors and are after all fees.

Managed Portfolio	1 year return	Managed Portfolio	1 year return
100% Minimum Secure	5.4%	40% Minimum Secure	21.3%
90% Minimum Secure	6.4%	30% Minimum Secure	25.0%
80% Minimum Secure	8.8%	20% Minimum Secure	28.3%
70% Minimum Secure	11.6%	10% Minimum Secure	32.7%
60% Minimum Secure	14.7%	0% Minimum Secure	37.2%
50% Minimum Secure	18.1%		

Managed Portfolio Service Rebalance

As described earlier, we have enjoyed a significant rally in the Australian sharemarket, and the sharemarket generally can no longer be considered cheap. We have recently implemented a rebalance of client's Managed Portfolios, the effects of which are explained below.

Increase in Secure Portfolio Allocation

The **Managed Portfolio Service** operates on the basis of ensuring that your **minimum** level of security is maintained each time we conduct a rebalance. It is our intention to allow a buffer between the minimum level of security and the actual level of security, each time we do a rebalance.

Our latest rebalance has brought the level of secure investments to 10% above the minimum, in recognition that the very obvious opportunities which existed over the past 18 months have now been taken advantage of. It is time to lock-in some of the significant profits which have been generated over this period. Sharemarket risk increases as valuations increase – a sensible approach is to reduce exposure as risk rises.

You will note that the amount of money in your secure allocation has been increased as a result of this rebalance. For example, if you had $500,000 in the 30% Minimum **Secure Managed Portfolio** at the start of April 2009, you would have had $175,000 of your money in secure investments. As a result of the strong investment performance and the increased buffer, you should now have around $245,000 in secure investments (40% of your total balance of around $615,000).

Increased exposure to Real-Index Australian Shares

We are pleased with the performance of the Real-Index Australian Shares fund, which has replaced the Index Australian share fund in the **Managed Portfolio Service**. As explained previously, the Real-Index Australian shares fund weighs company holdings by business fundamentals rather than by market capitalization. Since introducing the Real-Index Australian Shares fund to the **Managed Portfolio Service** in March 2009, it has generated a return of over 40% compared to the Index fund return of 34%. Our recent rebalance has further increased our exposure to this fund.

Increased Focus on dividends via increased exposure to share income funds

The vast majority of the performance over the past 9 months has been generated by share prices recovering from extremely low levels reached during the investor panic. This is to be expected in the early stages of a sharemarket recovery, but as share prices reach more reasonable levels, we expect that sharemarket returns will increasingly be driven by dividend yields.

We have increased our clients exposure to share income funds in the **Managed Portfolio Service**. These funds focus on buying dividend paying companies and using options to reduce the share price risk and to generate additional income. These funds will not perform as well as traditional share funds where the sharemarket is extremely strong, but should perform very well, with a reduced level of risk, when the sharemarket slowly trends upwards. The targeted dividend income yield on these funds is around 7-8%pa.

Reduction in CFS Geared Australian Share Fund exposure

With interest rates rising and dividend yields falling, the attraction of investing into geared shares is not as strong as it was when we introduced the fund to the **Managed Portfolio Service** in March 2009. The cost of gearing is now around 5%pa, which is around the same level as the dividends on the companies held in the fund. The cost of borrowing will rise as interest rates rise. As a result, we have reduced our exposure to the CFS Geared Australian Share fund in the **Managed Portfolio Service**. This fund has generated a return of 80% since it was introduced in March 2009, and this is the second time we have taken profits from this excellent performer.

Increased Exposure to Corporate Bonds and Hybrids in the Secure Allocation

Whilst the **very** high yields which were available from good quality corporate bonds and hybrids earlier in the year are no longer available, the yields available from this sector are still very attractive. Importantly, we only use investment options which have a floating interest rate, so that as interest rates rise, yields will rise. The Schroder Hybrid fund and the Macquarie Income Opportunities fund have performed very well since we introduced them to the **Managed Portfolio Service** in July this year, with returns of over 9% (Schroder) and over 4% (Macquarie) over the 5 month period they have been held. Within the Secure section of our clients Managed Portfolios, we have increased exposure to these two funds in our most recent rebalance.

Small Companies

We continue to hold exposure to the Australian Small Companies sector through the Real-Index Australian Small Companies fund. The gross dividend yield on this fund is around 8% which is higher than the yield on the larger companies index. In a positive economic environment, this fund should continue to perform well. Since we introduced the Real-Index Australian Small Companies fund to the **Managed Portfolio Service** in March, this fund has returned 60%. Whilst we have slightly increased our percentage exposure to the Real-Index Australian Small Companies fund, by the nature of the very high performance of this fund we have again been forced to take some profits in our rebalance. This discipline is an important part of the **Managed Portfolio Service**.

Macroeconomic Outlook

Dubai World – "Storm in a tea cup", or sign of things to come?

The nervousness of global investors was demonstrated recently with a near panic after Dubai World mentioned in an investor presentation that it would be asking bondholders for an extension on repaying $3.5billon of debt which was due to be repaid in December. The sharemarkets reacted quite badly to this "news". European markets fell by over 3% in one day, and Australia followed with a similar fall.

This turned out to be an overreaction - Dubai's level of debt and property market issues were already well known. Dubai itself has total debt of $80billion, half of which is held by western (mostly European) banks, but it has been generally expected that Dubai's wealthy sponsor, Abu Dhabi, would support Dubai if it needed help. Abu Dhabi's sovereign wealth fund is the largest in the world, with over US$600billion in assets.

The sharemarket fall was a reaction to what was considered a potential ***Sovereign Default***.

Sovereign Default Risk

In 2008 the financial system was saved by Government intervention. Government support and nationalization of banks saved the financial system from a complete loss of confidence. Stimulus packages have been put in place to try to get global economies back on their feet. The result has been a large-scale transfer of debt and risk from the banking system to the balance sheets of Governments. Developed world Governments used to have the highest credit ratings, but this is changing. There is now a significant chance that a number of countries will default on their debt. Ireland, Greece and Italy are already at risk of defaulting. The UK Government is likely to have its credit rating downgraded in the near future. As the US dollar is still the reserve currency, it will probably not be downgraded. US Government default will likely come in the form of currency depreciation. The most likely result of this increased indebtedness and increased risk is that global Government bonds yields will rise – and thus global Government bond prices will fall.

I continue to hold the view that the Government bond bubble (high prices resulting from demand for perceived safe investments) has yet to burst, and that one of the least attractive investments you could hold would be Government bonds issued by highly indebted developed world Governments.

By comparison, Australian Government debt has minimal credit risk as the Australian Government is in the fortunate position of having relatively little debt, and there is no need for further stimulus in Australia. However, given the risk of rising interest rates, we will avoid Australian Government debt for now – rising interest rates cause prices of Government bonds to fall.

Gold and the US dollar

Recent months have seen a strong rise in the price of gold, which is now at around US$1200/ounce. This has been driven by the expectation by speculators and Governments that the US dollar is no longer suitable as a reserve currency, and that in future currencies may be required to be backed by hard assets such as gold. This would in effect be a return to the "gold standard".

Before 1971, US dollars were backed by gold reserves, which limited the amount of currency which the US Government could issue. It is clearly of much concern to the foreign holders of US dollars that the US Government is spending, borrowing and printing money with reckless abandon, which is already starting to impact the real value of their US dollar holdings. In such an environment, purchasing gold rather than holding depreciating US paper dollars looks attractive. At some point in the future, it is possible that there will be a crisis of confidence in the US dollar, and a new gold standard may emerge.

By being invested in Australia and having little exposure to the US dollar, our clients have a natural hedge against the concerns which are driving up the price of gold. I would not recommend buying gold and burying it in the back yard!

Steve Melling, CFA   4th December 2009