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QUARTERLY REVIEW

This quarter's update marks the most volatile period in world equity markets for almost a century. The ASX 200 is down 11% for the quarter to 30 September and is down almost 45% since its peak in November 2007. Credit markets have locked up and the US economy is headed into recession.

Given the unprecedented falls in global equity markets and the issues that have emerged around the world during the past few months, we thought we'd dispense with our usual "asset class" based review and related outlook of markets and provide views on what we think are the key issues to focus on going forward.

The Crux of the Problem – "too much, for too little"

People are talking about the sub-prime problem being at the heart of all the problems that we're experiencing; but in actual fact its a broader and more basic problem. The sub-prime issue was symptomatic of a two-fold problem. Firstly, we'd borrowed too much and secondly banks and other lenders hadn't charged enough for it. We're now seeing the deleveraging affect in full swing - witness the dramatic share price falls and the huge jump in credit spreads.

The modus operandi of hedge funds provide an interesting insight into the dramatic impacts of deleveraging. Some hedge funds are geared-up ten times, so every time an investor wants to redeem a dollar out of such a fund it has to sell $10 worth of stock as well, placing downward pressure on stock prices. When you add margin loan "call" pressure into the mix the problem is further exacerbated - lower share prices lead to margin calls, which lead to shares being sold which lead to lower share prices which lead to margin calls, which lead to shares being sold, etc. Overlay thinner trading volumes (with buyers being reluctant to enter the market) and the equity market is only going to head in one direction.

The Heavy Price we pay for Listed Investments

The double edged nature of listed investments is evident for all to see at present. Liquidity is a valuable characteristic in most investments and listed securities are now showing the "premium" (or cost) of liquidity. The price of a listed investment is simply determined by balancing-up the demands of buyers and sellers at any point in time. There is always a price (you mightn't like how low it is, but there will always be a price) and you can always buy into or sell out of a listed security.

One of the more interesting asset classes where the vagaries of unlisted market forces are clearly evident is property. Listed property has fallen well over 50% in the last twelve months, yet up until recently, many direct (or unlisted) property investments had only suffered relatively small falls in value. Any portfolio holding direct property would have performed much better over the past twelve months, however, many direct investments have now been frozen (ie no liquidity) and distributions and unit values are being revised downwards. A similar situation is also occurring in fixed interest and mortgage markets. Essentially, the listed markets take their medicine quickly and pre-emptively – unlisted vehicles can suffer the pain for an extended period of time.

WHERE TO FROM HERE

Every day we hear a plethora of the bad news and it seems there is every reason for markets to continue to free-fall. There are however a number of positives:

China

Demand from emerging nations, including China is a long-term theme that is not expected to change materially. Yes, growth in China is slowing from 12% plus to around 9% in the September quarter (which is still healthy) but a lot of industry was closed down prior to/during the Olympics and stock piles and inventory are currently being run-down rather than new orders being placed. There is some softness in the local housing market (ostensibly the upper end) and some marginal companies are being allowed to fail. However, the Government is contemplating a significant fiscal stimulus (which will be good news for Australian resource stocks) – something the Government has resisted to date because of concerns about inflation.

Credit Markets

A significant proportion of the recent falls in equity markets has reflected concerns about credit markets. Banks were not lending to one another and it appeared that the global banking system was going into melt-down. However, decisive intervention (including government guarantees of both deposits and inter-bank loans) has had an immediate stabilizing effect. This is evidenced by reductions to inter-bank lending rates and at the time of writing, the 3 month LIBOR rate (which is the benchmark inter-bank lending) had fallen for the 12th straight day to just under 3.5% (it has been as high as 6.88% in early October).

With concerns about credit markets abating, the focus will shift back to the state of the US economy and forecast company earnings.

Easing of Monetary Policy

In addition to direct Government intervention, we have also seen synchronized reductions in monetary policy around the globe. In the case of Australia, the Reserve Bank has now eased cash rates by 2%, unwinding in a little over 2 months what it took over 4 years to put in place. The official cash rate still sits at 5.25% leaving the RBA with plenty of scope to feed further rate reductions into the system.

Fiscal Policy

Governments around the world are now looking to stimulate their respective economies through fiscal policy. In Australia, we have recently seen the Federal Government announce "spending" of the order of around $5bn. A further round of initiatives (including tax cuts) could also be on the cards in the new year. It is anticipated that around the globe, the governments of most of the developed nations (including China) will also soon announce stimulus packages.

RISKS

With any outlook, there are always risks to the downside:

- **Credit rationing** – banks will slow their rate of lending to businesses and if the rationing is significant it will prolong any downturn in economic activity.
- **Re-regulation** – with any period of market dislocation comes the inevitable calls for re-regulation and Government intervention. What will follow in global financial markets will be over-due and over-done.
- **Company failures** – there will be another round of company failures. We've seen the initial fall-out from those companies that were over-geared (big "single name" risk). The next round of failures will involve those companies unable to manage the margin compression that comes with falling revenues.
- **Unemployment** – As companies look to protect their margins, "staff expenses" will be the first line item to get a haircut. With unemployment rates at historic lows, we can digest a reasonable level of redundancies. The risk is that if the downturn is prolonged and unemployment spikes, it will put pressure on Government welfare, further reduce tax receipts and (most importantly) put pressure on peoples ability to meet mortgage repayments. The single biggest factor driving mortgage stress (which in turn puts pressure on Australian house prices) is high levels of unemployment.
- **Falling dividend yields** – most companies are currently indicating that they are looking to maintain dividend payouts. There will be some reductions, but if dividend yields fall too much, this will reduce the relative attractiveness of equities (see "equity risk premium" below)

THE BOTTOM – ARE WE THERE YET?

Without wanting to sound too glib, the most confident advice we can provide on this question is that we're closer to the bottom now then we were at the time of our last quarterly update. Anyone who claims that they know when markets will bottom is having you and themselves on. Moreover, markets rarely bottom uniformly. The low (to this point) for most Australian financial stocks appears to have been in July'08 whilst the last month has seen resource stocks plunge to their lowest levels for 3-4 years which in turn has dragged the broader ASX index down with it. The Australian market is now trading at a price earnings (PE) ratio (which benchmarks company earnings to currently traded share prices) of 9.5 times – its lowest level in 25 Years.

Markets typically "over-buy" at the top and "over-sell" at the bottom. We've clearly seen a lot of over-selling of late with some very good quality stocks being sold at bargain basement prices – witness the fall of BHP over recent weeks to the point where it was trading at a PE of around 6.0 times.

Fundamental analysis won't tell us when we'll reach the bottom, but it certainly helps us understand what represents compelling longer term value. You can now buy most of the big Australian resource companies and major banks at prices cheaper than 4 or 5 years ago. If they were good investments then, logic says that they should be even better investments now because they are much bigger and profitable. Yes, times are different today and we are facing some tough economic times, but again we're talking about investments with (say) a 3-5 year time horizon.

SOME FOOD FOR THOUGHT

- Historic Bear Markets - People argue that this time its different – and it is, every time is different. The big overlay on this occasion has been the problems that emerged from the credit markets which have been unprecedented. However, there has been significant, timely and continued action from world governments and central banks across the globe. This commitment to timely intervention is most encouraging and has had an immediate positive impact on credit markets.

  UBS has examined bear markets over the past 80 years (S&P 500) and produced the following statistics:

  ✓ The average peak to trough fall has been 37%
  ✓ Average duration has been 16 months
  ✓ The average subsequent 12 month performance **from the trough point was 44.2%**

  Its this latter point, exemplifying the magnitude and speed of market recoveries, that leads us to conclude that incrementally up-weighting equity exposures in the current market is a sound longer term strategy.

- Distinction between Equity markets and the Real Economy – Equity markets are **anticipatory mechanisms.** They don't look at what has happened or even simply what is happening; they try and anticipate what will happen and how this might affect company profits. In this regard, the market has already factored in a 40% drop in company earnings. Recent estimates are that, excluding US investment banks, company profits have actually fallen around 12% (ie we still have a further significant fall in earnings baked-in). The economic news to come out of the US over the next 3-6 months will not be pretty but the impact of a lot of it (if not all of it) is already reflected in current share prices. We can expect that equity markets will turn around long before the US or global economies begin to register tangible signs of a recover.

- Warren Buffet is now buying equities – Buffet's investment company (Berkshire Hathaway) has recently taken large stakes in Goldman Sachs, GE, Constellation Energy and Dow Chemicals to name but a few. He has also been buying up US stocks in his own personal account which, up until now, has consisted of nothing but US bonds and treasuries. His rule of investing is simple …. "be fearful when others are greedy, and be greedy when others are fearful".

- Equity risk premium – The relative return that can be achieve from cash or fixed interest as opposed to equity yields (dividends) significantly influences the behaviour of investors. Presently, share prices have fallen sharply and equity yields are high (take for example Australian Bank stocks which are currently delivering yields of between 8-12% before franking credit benefits are overlaid). Contrast this with a cash rate which is currently just over 5% and likely to fall significantly over the next 6 months as monetary policy is further relaxed by the RBA. As the differential in favour of dividend yields increases, funds will preferentially flow back into equities.

- Liquidity – reports from fund managers and professional investment houses are that there are significant sums of cash sitting on the side lines at present, waiting for some improvement in equity markets. As we have stated before, whilst liquidity is not a compelling argument for investment in its own right, it does offer the potential for a further kicker in equity markets.

AN INVESTMENT STRATEGY

We (like most investors) have an inherently optimistic view of equities over the longer term – however, our faith has certainly been tested over recent times. The nature and scale of any immediate recovery may be patchy and we can expect to continue to take two steps forward and one step back. This see-sawing in markets is likely to continue over the short term but we feel that the trend will be up. We are expecting to see a sustainable (and sizeable) rally develop at some point during the first half of 2009.

Markets will recover and when they do, the recovery is likely to be swift.

Hence, our current strategy is to incrementally build equity risk exposure in client portfolios where appropriate, with a clear bias to blue-chip Australian stocks and, in due course, benchmark unaware international equities. As markets begin to consolidate and economic news improves, additional allocations to "small cap" shares and emerging markets may be appropriate.

Regards

Andrew & Stephen