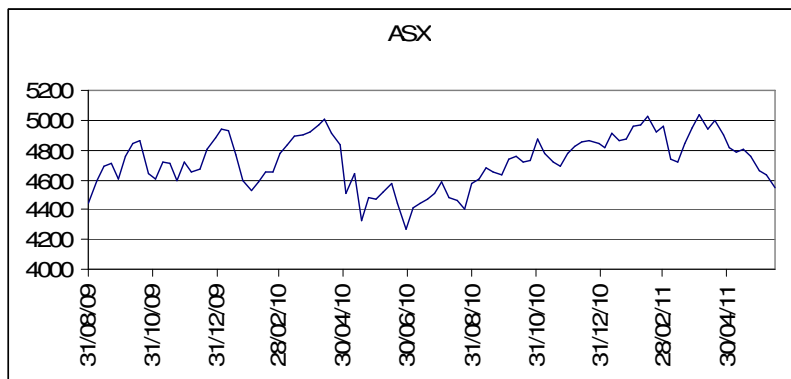


Growing flowers in the desert

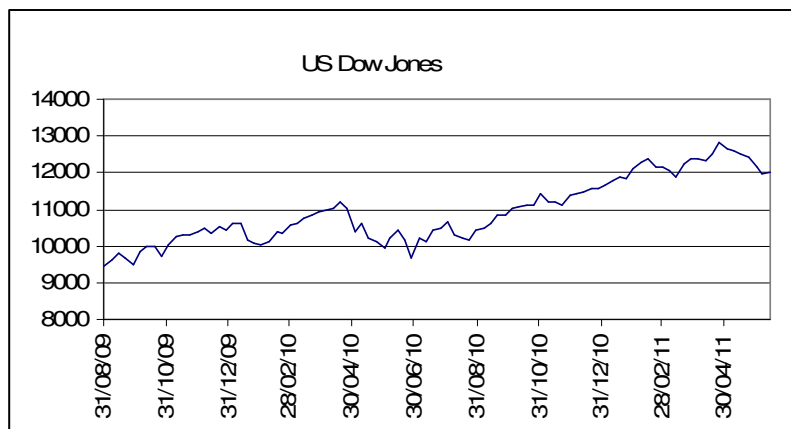
At BL&A we are always interested in client feedback. By listening to this feedback we can see if there are any significant issues arising in the minds of our clients. Over the past few weeks, there has clearly been one issue on the mind of BL&A clients – “Why aren’t my investments going anywhere?”

To answer this question, the first step is to break down the investments into their major components. Within most investments classified as “balanced” or above, shares constitute the largest part of the investment. Consequently, the performance of the share market is obviously critical in this regard.



The Australian share market has been moving sideways for the last 22 months. This is shown on the above graph, which represents weekly movements in the All Ordinaries Accumulation Index since the end of August 2009. The Graph clearly shows that the current position of the market is roughly where it was in September 2009. During this period the market has experienced a number of “runs”, where on three occasions it has moved beyond the 5000 mark. However, on each occasion this momentum was short lived, with bad economic news reversing the growth trend.

The situation is a little different with international share markets.



Over this same period, the US Dow Jones Industrial Average rose by 27%, from 9441 to 12 004. However, Australian investors holding overseas shares will hold them in overseas currencies, thus making them vulnerable to an appreciation of the \$A. Over this same period the \$A rose some 28.19%, from US\$0.8268 to US\$106.24. Put simply, the rise in the \$A over this period completely cancelled out the rise in the value of the overseas shares.

We know that Australian and international shares are the “engine room” of most investment portfolios. However, since August of 2009 the flat nature of the Australian share market and the rising \$A has meant that these sectors have produced nothing to drive the portfolios forward. This has given rise to the title of this email, in that it is difficult to grow flowers in the desert.

This stagnation of portfolios is not unique to the fund managers that we invest with. Returns for all growth based superannuation, pension and investment managers have been flat over this period. Quite simply, without the world share markets going forward, investment performance remains flat.

Question – Surely not all shares are flat, some individual shares have bucked the trend and gone well over this period? Why don’t the fund managers simply get rid of all the flat shares and purchase the ones which are doing well?

We are asked this question often. It does however fall down on two fronts.

Firstly, it is only with the benefit of hindsight that we know which shares have done well. The reasons as to why one share performs well and another underperforms varies enormously and often arises from a factor (such as a takeover event) that occurs without notice.

Secondly, the logistics of consistently turning over a portfolio to “follow your nose” are also a consideration. If shares are turned over quickly they do not qualify for the “discounted capital gains tax rules”, meaning the fund pays a higher rate of tax (compared to shares held for at least twelve months). Additionally, it may well take a large fund several months to dispose of a particular share and purchase another. The larger the fund, the larger the individual shareholdings are likely to be. If a major fund took the decision to sell share X and buy share Y instead, it may mean selling tens of millions of dollars of share X and finding tens of millions of dollars of share Y. If everyone is thinking the same way (getting rid of share X in favour of share Y), then there will simply be no one buying share X and selling share Y. It could take months to complete this transaction.

Question – Surely the fund managers ‘saw this coming’? Why don’t they get out of shares during these bad times and come back into the market when things are better?

We continue to be a bit surprised as to how often this question is asked. There are several points to be made here.

Fund managers effectively invest as they are told to. For example, an “Australian share fund” must be true to its name and invest only in Australian shares (other than holding a small cash balance for liquidity purposes). It does not matter whether the trustees think the Australian share market is a good place to be (or not), they have no choice but to invest only in Australian shares – as that is what the name of the fund says it will do.

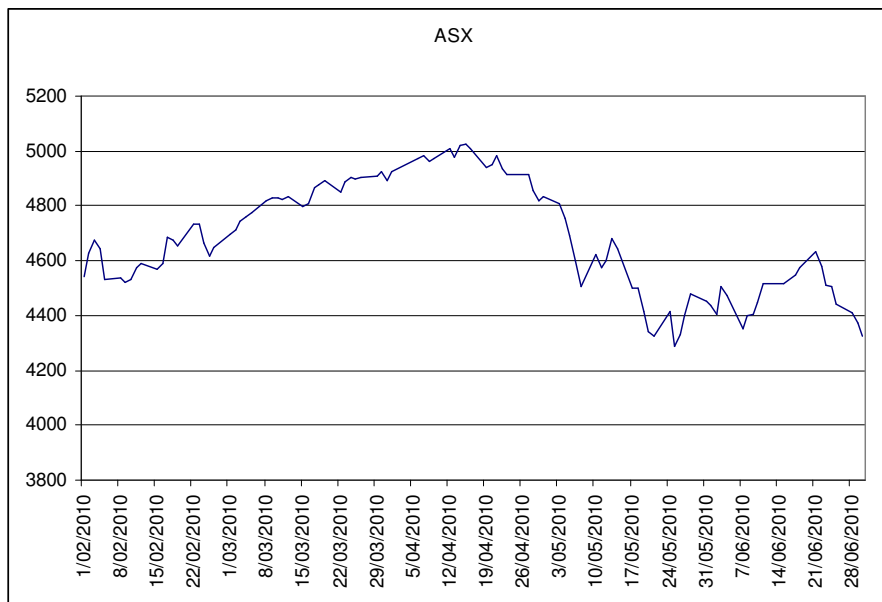
This aspect is critical to investing. It is up to the investor and the adviser to decide what “appropriate” investments are and place them accordingly. If a fund is given a percentage of the portfolio to invest in Australian shares, there will be a reason for this (generally that these

are needed for the balance of the portfolio). If the manager then chose to ignore this and invest elsewhere, the balance within the portfolio becomes out of kilter.

This is not to say that fund managers do not change the type of shares that they have within the portfolio. If a manager is feeling defensive, they may well reduce their exposure to 'growth' type stocks (such as Macquarie Bank) and choose to be overweight in 'defensive' stocks (like Woolworths). However, the manager must remain totally invested in the asset allocation (eg shares) that they advertise.

The second aspect of this question is the ability to "see it coming". This was an issue that arose many times after the GFC, in that surely people should have "seen this coming".

The reality is that investment managers make decisions based on the information available at the time. That information may reflect a positive or negative sentiment, but can turn very quickly. If we look at the first graph (the ASX), you will see that the ASX first crossed the 5000 mark in April of 2010. If we pinpoint this one period, we see an interesting pattern.



For the 10 week period from 1 February 2010, the market was gradually building. This was not "red hot" growth, just good weekly growth based on good economic data at the time. The sentiment was positive, the reports on the evening news suggested that the economy was continuing its post GFC recovery. The market reached 5000 in mid April and stayed there for four days. Within six weeks the market reversed this situation, falling some 14.6%.

The reason for the reversal was the announcement of the debt problems of the Greek Government. To capture the more significant dates and points of this:

- On 23 April 2010, the Greek government requested that the EU/IMF bailout package (made of relatively high-interest loans) be activated. The IMF had said it was "prepared to move expeditiously on this request". The initial size of the loan package was €45 billion (\$61 billion) and its first installment covered €8.5 billion of Greek bonds that became due for repayment.
- On 27 April the Greek debt rating was decreased to BB+ (a junk status) by Standard & Poor's amid fears of default by the Greek government. The yield of the Greek two-

year bond reached 15.3% in the secondary market. Standard & Poor's estimates that in the event of default investors would lose 30–50% of their money. Stock markets worldwide and the Euro currency declined in response to this announcement.

- On 1 May a series of austerity measures was proposed. The proposal helped persuade Germany, the last remaining holdout, to sign on to a larger, €110 billion EU/IMF loan package over three years for Greece (retaining a relatively high interest of 5% for the main part of the loans, provided by the EU). On 5 May, a national strike was held in opposition to the planned spending cuts and tax increases. Protest on that date was widespread and turned violent in Athens, killing three people.

Each of these events created a lack of confidence in the Greek economy, the Euro zone and the world economy collectively. Not surprisingly, the dramatic fall in markets over this period of time relates directly to the Greek situation rather than anything happening within our own economy.

This series of events gives a clear demonstration of two very important factors.

Firstly, instability in the Australian share market can come from literally anywhere. In terms of our economy, it is very true to say that the fortunes of Greece have very little to do with the fortunes of the Australian economy. In 2009/10, it was estimated that Australia's total exports to Greece amounted to some A\$37 million. This is in comparison to the A\$8 BILLION we exported just to New Zealand. Yet, the uncertainty created in the Greek economy caused a 14% fall in the Australian share market.

Secondly, the “they should have seen it coming” argument clearly has no weight. On each of the above three events, the market fell sharply on each announcement. The only way that one “could have seen it coming” would be if they (for example) knew that the Greek Government was in trouble and were going to ask for the bailout, before it actually happened. Alternatively, one would have to have known that Standard and Poor's were going to downgrade Greek government debt to junk status, before this announcement was made.

Quite clearly the share market reacts to the news of the day, as it is announced. Short of a good set of tea leaves or a crystal ball, no one can ‘see it coming’.

Where does this leave investors?

The purpose of this email was to pre-empt the enquiries that we imagine will come when investors receive their end of financial year statements. Just as it is difficult to grow flowers in the desert, it is difficult to show investors double digit returns when the markets themselves have not moved in almost two years. It is hoped that this email provides an insight into why this is happening, rather than just assuming that fund managers are incompetent.

Importantly, none of this changes our investment philosophy. Critical in our thinking is that share markets will sustain periods of stagnant and negative movement. This has been the case for the past 100 years and will be the case in the future. It was this acceptance of the volatility of markets that means our first bucket is always held in cash, away from the volatility of the market.

We do however appreciate that most of our clients would like to hear, first hand, where ‘things are’ right now. As explained above, no one can ‘see it coming’, but it is possible to get an objective view on the state of the Australian and world economic situation based on the information that is ‘out there’ at the moment.

We are currently looking to put on a seminar within the next few weeks, where we will seek a prominent Australian economist to give our clients their view of the current state of play. As we fine tune details of the seminar, we will advertise via email. For those clients who are interstate or unable to attend, we will look at some means of providing a copy of the seminar to them (taking advantage of internet technology).

As always, if you have any questions, please do not hesitate to contact us.

Regards,
BL&A Team