

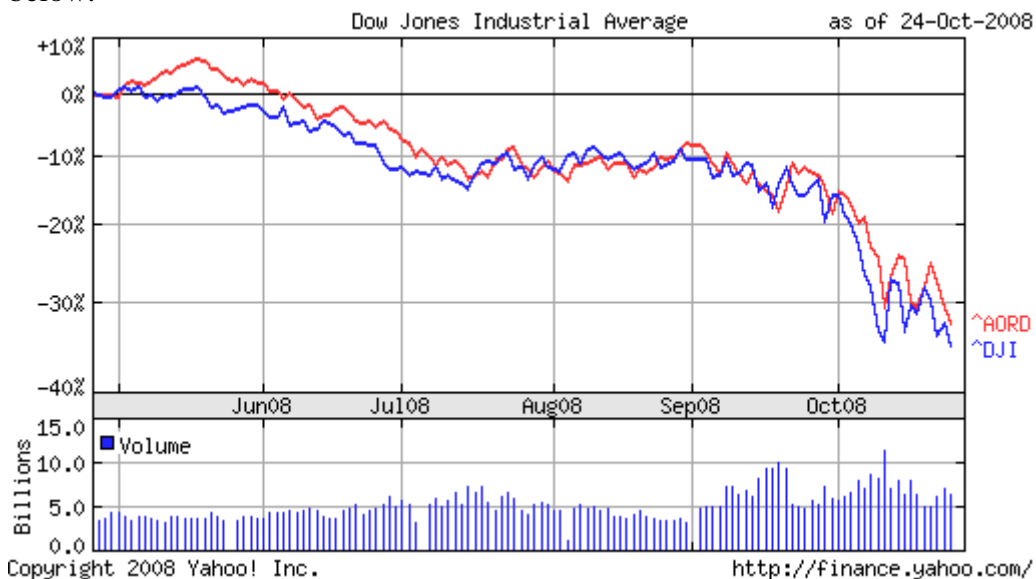
Making rational decisions concerning geared share funds, in an irrational share market.

There is now no doubt that we have entered into a phase of irrationalism in world share markets. There is no justification, other than self fulfilling pessimism, that can see share markets fall with the degree of volatility we are seeing take place. As I am sure you are aware, we are seeing daily swings on share markets of 3-10%, as the market reacts to any bit of economic news, good or bad. October has historically been a “trouble month”, and there is little doubt that October 2008 will live up to that reputation.

At BL&A we are trying to maintain a rational approach to investing, but understand that this is not where the markets are right now. As difficult as it is to put rationalism to one side, we feel we must make some recommendations as to how to deal with this current situation.

Some background.

It was only some six months ago that the US Government bailed out Bear Stearns. Following the initial falls in the share market in January, the market started to rise. In a two month period the ASX rose from 5133 to a little over 6000 in mid May. For all intents and purposes, it appeared that things were “back on track”. The next six months on the Australian (in red) and US share markets (in blue) can be seen on the graph below.



This is really a graph of “three parts”. In the period of May to July, we saw an “orderly fall” in share prices. At this stage the world was reacting to rising oil prices, which peaked at \$147 a barrel in July. There was also an underlying concern, though not critical at this stage, of the extent of banking write offs associated with the sub prime crisis.

In an “orderly fall” of this nature, one will always be reluctant to take any definitive action. The history of the share market is full of “orderly falls”, and will normally see a “V” type correction at the other end.

The period July – mid September seemed to confirm this. Over this period both the Australian and US markets bounced around, up one day, down the next. Importantly, for this period the market was consolidating its newfound level, absorbing information, looking for direction.

The last month however, has been somewhat of a Tsunami. This is clear in the above graph, where falls have been drastic. These falls continue today, with European and American markets falling overnight, and the ASX falling further today. Unfortunately these falls are not in line with any new information available to the markets; the markets appear to be reacting to fear itself. Last night the US market was at an “even” point for the day with twenty minutes of trading left. In the last 20 minutes the market fell 200 points. There was no new information made available to spark this sell off, it was typical of a market not willing to wait for tomorrow’s trading to see what might be announced before then.

What has happened over this last month is a “two fold” impact. Firstly, there was the concern about the stability of the US banking system, and the flow through impacts on the world economy. This “emergency” saw unprecedented action take place across the world, including:

- Some \$2.3 trillion dollars in bailout packages;
- The unprecedented actions of the US Government buying into bank stocks (almost a form of reverse nationalism);
- Aggressive cutting of cash rates in Australia and overseas; and
- Government across the world, including the Australian Government, guaranteeing bank deposits.

The good news is that these measures seem to have worked. There has been no new bad news on the viability of the banking system, as it would appear that these coordinated, world wide efforts should result in a new found optimism. This optimism should be greatest in countries like Australia, where the banking system was never really under any doubt anyway.

However, before the markets had the chance to bask in a stabilized banking system, recessionary fears started. In their own right, a recession does not mean stock market chaos, as the US has had 11 recessions since WWII. However, on the back of the oil crisis, and the banking crisis, this recessionary fear has accentuated. This has caused the sudden spiral in world share markets.

Why are we sending this recommendation now – and not a month or six months ago?

As can be seen from the graph, events have moved very quickly over the last month. In the previous months (the period July – mid September), we had a situation where markets were volatile, but for every bad day there was a corresponding good day. There was always light at the end of the “rational tunnel”. Even over the past month we continue to get mixed signals from the market. Only last week, on Monday and Tuesday the ASX rose a combined 8% in just two days, signaling the possibility of the “bottom of

the market’. However, four days of negative leads from the US saw this to be a false hope.

We are clearly not in the business of trying to spook our clients. The one thing that is **more** dangerous than getting out of the share market, is picking the time to “get back in” again. Clearly, it is inappropriate to go back to cash in the long term. This will only be the second year in the last 20 where cash has exceeded all other forms of investment. An easy decision amongst this daily volatility is to go back to cash to “weather the storm”, the more difficult decision is “when to get back in”.

This is a critical issue. With cash rates falling (in line with Reserve Bank interest rate reductions), investors will not recoup their recent losses sitting in cash for the rest of their lives. There is no doubt that share ownership has traditionally been the means of achieving “above inflation” returns, and in the long, rational term, this will undoubtedly be the case. As we saw in the March – May increase this year (where the market rose some 18% over an eight week period before starting to fall), it is very difficult to predict when is the right time to move back in.

Our concern, at the moment, extends to those clients in geared share funds. In a geared share fund the market movement is accentuated. When the market rises (as it did on Monday and Tuesday last week), the rise in the gear fund is accentuated, dependent on the level of gearing. Where the market falls, the gearing accentuates the falls.

Therefore, to state the obvious, the falls in geared funds over the current financial year have been greater than those in non geared funds. Our “rational” approach to this problem is that this gearing works both ways, and when the market corrects, the gains will be accentuated to recover these losses.

The difference however between a geared share fund, and a non geared fund, is that a geared fund has the potential to see all funds disappear, if the market falls far enough. In a non geared fund, where the fund has a diverse range of shares (across all sectors), the fund will always be worth something, as long as there is a share market.

The level of volatility and falls in the market, occurring at the moment, is not normal. It is not normal that the Australian Government has to guarantee bank deposits, nor is it normal that traditionally “safe” investments like mortgage trusts are now faced with freezing withdrawals, as they suffer from not being “Government guaranteed”.

Only last night a client emailed me and asked the question: “What is your wisdom on the current market situation, would it go any worse?”

At times like this, where the “not normal” has become the norm, it is impossible to give any collective wisdom to this answer. At the moment, the market will continue to be driven by sentiment, and right now, that sentiment is negative. How far this negative sentiment will take the market is unknown. How long it will be before positive sentiment drives it forward, is again unknown.

What we do know however is what we expressed in our last general email of 17 October. That is, with the significant fall in the \$A recently, coupled with Australia’s superior scope for monetary policy (interest rate cuts) and fiscal expenditure (surplus budgets),

we believe that if you are in shares, Australian shares are likely to weather a world recession better than international shares. Our view on this has not changed.

The question at this point in time however, is whether you should maintain your exposure to geared shares or not.

If hindsight ends up showing that we are in fact at the bottom of the share market fall, then moving out of geared shares will have been a mistake of biblical proportion for your finances. Having ridden the share market down, the most important thing is to “be there” when the market recovers. As stated earlier, with cash rates falling, the losses in your portfolio will not be recovered by moving, and staying back in cash. The issue however, is whether you will have money in your geared share fund when the recovery finally happens.

In a worst case scenario (where the funds were invested just before the market started to fall last November), the value of geared share funds has fallen around 60%. Clearly, this will not be the position for everyone, with long term investors making substantial gains in these geared share funds over the period 2002-2007, when markets were positive, and those gains accentuated by the gearing. As devastating as a reduction of this nature is, it should not be forgotten that when markets rebound, gains will be made very quickly. History has shown time and again that the greatest share market gains are made after significant falls. The problems that we have in this irrational market, is whether the market will continue to fall, wiping out balances in the geared funds, before the investors have the opportunity to recover.

Last week I was buoyed by the comments of the world’s most famous investor, Warren Buffett, who, in announcing that he was buying back into shares said that “one should be fearful when everyone is greedy and greedy when everyone is fearful”. This comment is true, and hindsight will probably show that Mr Buffet bought some quality stocks at “bargain basement” prices. However, I appreciate that none of us have the sort of fallback cash that Mr Buffett has, so although I am buoyed at his belief that the market is near its bottom, I must be mindful that he can afford to be wrong. If he is 20-50% off his mark, he will not go broke, but geared share funds do not have this room for error.

At this stage we are only providing this advice to those in the Colonial and Advance geared share funds, as they have a higher level of gearing, and are therefore more at danger of further market falls. In short, we believe that investors in these funds have two options.

Option 1. Stay invested and “ride it out”.

Under this option the investor stays put, notwithstanding our current recommendation to be in geared Australian shares rather than geared international shares (our email of 17 October refers). The advantage of this option is that if the rebound occurs sooner rather than later, they will be there to benefit from it. The downside is that if markets continue to fall in the irrational nature of the past month, they could have no capital in their geared funds to recover.

Option 2 – Move to a non geared version of the fund.

Under this option, any future losses in the share market would not be accentuated, meaning that no matter how far the share market falls, your investment will still be worth something. The risk of this option occurs when the market rebounds. Having ridden “geared shares” down, the gain on a non geared portfolio would not be as significant.

The danger of this option however is that the investor must pick the right time to get back into the geared share funds, for fears of losing the gains from any rebound. As we saw over the March – May “false start”, this can be a very difficult process.

With markets behaving as irrationally as they are right now, we have no way of knowing which of these options will end up being the correct choice. It was not our expectation that markets would fall this far, and with sentiment taking over the market, there is no way of knowing whether the next month will see a bounce of 20% or another 20% in falls. Unfortunately, we are now dealing with a market temporarily bereft of rational behaviour. As such, we cannot advise our clients as to which of these two options will ultimately be best for them. It really boils down to their own risk tolerance.

In putting forward option two, we do place a caveat on it. The purpose of moving out of geared share funds to a non geared share fund is only to “ride out” the current volatility, which is accentuated in the geared funds. As stated above, if you were out of the geared share fund for any rebound, this would be detrimental to your financial health. As such, a move of this nature is just temporary, until things “settled down”.

Unfortunately, at a future date we will have no way of knowing, for sure, whether the market has settled down or not. Virtually all financial analysts were fooled by the March – May rise this year, where after eight weeks of positive share market activity, it really looked like things had “settled down”. In hindsight, this just proved to be the eye of the storm. If we go back to the market downturn of 1972-73, there were eight “false starts” before the market finally moved forward.

Therefore, where an individual switches from geared shares back to (non geared) shares, two things are obvious:

1. This should be a short term switch, until things have “settled down”. When markets do recover, the only way that you will regain your losses is to be back in geared share funds. Although a non geared share fund will ride the market back up, it will not accentuate the gains the way that a geared share fund will.
2. There is no way of knowing when that time to “switch back” has arrived.

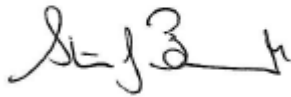
Taking the last issue into consideration, our approach is to “dollar cost average” back into the geared share funds. This approach sees you buying back into the geared share funds, bit by bit, on set dates. This minimises the risk of going back in on the “wrong day”. These graduated switches would be made on set days, every couple of months, regardless of any perception of how the market is travelling.

We would see that action is required from every geared share fund investor at this point in time. Those who wish to retain their position in geared shares, should still consider moving to geared Australian shares rather than geared global, as per our advice of 17 October (refer <http://www.blapl.com.au/newsletter/documents>).

For those that wish to move back to a non geared fund, the switch can be made relatively simply. Importantly however, once this switch is made we would need to calculate the process by which you “dollar cost average” back to your long term position within geared funds.

Regardless of what action you decide on, please let us know so we can make the appropriate arrangements and note your records accordingly.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'S. J. Barnett'.

Stephen J Barnett CFP Bcom Mcom Dip FP
Director and Authorised Representative

A handwritten signature in black ink, appearing to read 'S. Lilley'.

Scott Lilley CFP, B Ccom, Dip FP
Authorised Representative