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Economic Review
2nd Quarter 2010

ECONOMIC REVIEW

2ND QUARTER, 2010

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1. Executive Summary

- Early in 2010, the anxiety about excessive debt levels spread from banks to numerous governments, including a number that bailed out their banks.
- The International Monetary Fund (IMF) has forecast that general government gross debt in advanced countries will rise, on average, from 75% of Gross Domestic Product (GDP) at the end of 2007 to about 110% of GDP by the end of 2014.
- Investors should remember that these issues are already reflected in the price of securities and that no investment is totally risk free, even government bonds.
- Recent events in Australia confirm the difficulty with forecasts. Only 12 months ago the Federal Government budget was expected to be in deficit until 2015 – there is now speculation the 2011-12 budget will deliver a surplus due to economic conditions being far stronger than expected.
- An academic review of Norway's sovereign wealth fund (US\$430 Billion) found no evidence that active forecasting fund managers could add value above the market rate of return despite their perceived skills and high fees. The review concluded that investors should instead focus on structure and asset allocation.
- Many investors do not appreciate the difference between absolute and relative risk and fail to acknowledge the role risk plays in investing. Risk is a factor that must be continually measured and addressed when investing.
- Our core investment philosophy uses a transparent, intuitive and rigorously academically tested framework within which securities are actively managed to ensure that investors capture risk premiums.

- A U.S financial market and media commentator who has tracked more than 160 financial adviser newsletters since 1980 found that none of these advisers were able to call any of the four major stockmarket turning points over the past decade.

If you have any concerns or wish to discuss your financial position or investments, please do not hesitate to contact us.

2. Economic Review

“Risk is the cause, return is the effect”

Eighteen months ago there was deep concern about the global debt levels of major financial institutions. Today, borrowing costs for quality companies are similar to or slightly below 2006 levels¹. This more attractive pricing has led to a gradual pick up in global debt issuance.

It is important to note that the majority of countries did not experience a banking crisis as such. Everyone was affected by the seizing up of markets in late 2008, but most were not afflicted with the sort of asset quality and capital issues that bedevilled a relatively small number of large US, UK and continental European banks that have (or had) internationally active businesses. This in turn meant that once the panic of September and October 2008 subsided, the banks in most countries were able to function effectively.

In early 2010, the anxiety about excessive debt levels spread from banks to numerous governments, including a number that bailed out their banks. Since the initial manifestation in late 2009 when Dubai World requested a six month standstill agreement on its debt repayments, Portugal, Ireland, Greece and Spain (PIGS) have attracted most attention.

There is little doubt that the financial crisis and subsequent recession in many developed economies have placed a heavy burden on the fiscal positions of some nations. **The International Monetary Fund (IMF) has forecast average general government gross debt in advanced countries to rise from 75% of GDP in late 2007 to about 110% of GDP by the end of 2014².**

In Greece, the government budget deficit for 2010 was forecast to be 12.7% of GDP – far above the 3% limit imposed by the European Union (EU) on member countries. Much of this deficit has been attributed to uncontrolled spending in the lead up to October 2009 national elections. Austerity measures have been introduced – namely reductions to pensions and public servant bonuses – in order to gain EU support for a financial rescue package. However, many of these savings are being offset by higher interest costs on new Greek Government bond issues, which are currently around 7% (or twice the German borrowing rate). The Greek Finance Minister recently conceded his Government can't afford to borrow at these rates for long.

Greece is a small country – accounting for just 0.5% of global GDP – but the significance of its problems is that it's a euro area country.

Member countries of the EU are currently trying to formulate a plan to bail out Greece. Unfortunately, markets are unable to devalue the Greek currency, which was replaced with the

¹ 'Recent Financial Developments speech', Glenn Stevens, RBA Governor, 26 March 2010

² John Lipsky, 'Three Post-Crisis Challenges', IMF, March 1, 2010.

Euro. Currency devaluation typically assists countries emerge from tough recessions from enhancing economic growth by making exports cheaper to the rest of the world, thereby boosting production and employment.

Latvia has adopted the Euro and has been in a recession for some time. Its inability to devalue its currency has resulted in a forecast 30% contraction in GDP from peak to trough³ – which almost qualifies as a world record.

Although many wealthy Greek individuals and companies have shifted an estimated \$14 billion of deposits (or just under 5% of all deposits in the Greek banking system) out of Greece in the first two months of 2010, the signs are that the Greek debt crisis will be resolved.

Even so, the situation has led some commentators to suggest that the financial crisis has transformed from a banking crisis to a potential sovereign debt crisis. There are a few observations for investors to note when considering this sentiment:

- **No investment is totally risk free.** Even sovereign borrowers with the ability to simply print money to finance interest payments *have* defaulted. That is why diversification is essential in fixed interest portfolios.
- **Markets have already made a judgement about rising sovereign risk** amongst the PIGS and other nations, as reflected in the prices of their government bonds. Just like in equity markets, investors have demanded a higher return from the PIGS for taking additional risk.

These relative prices can change quickly – following Greece's successful €5 billion bond offering in early March 2010 (which was twice oversubscribed), the yield on Greek bonds subsequently fell.

- **Not all sovereign borrowers are equally challenged in terms of their public finances.** Whilst the PIGS have attracted most attention, the debts of other major developed nations such as the US, Japan and Australia are relatively unaffected.

Several important countries were experiencing a trend increase in debt to GDP ratios even before the GFC occurred (though Australia is an exception). It is not unprecedented for countries to have debts that exceed 100% of GDP, however this has usually occurred during times of war. But whilst the Second World War was followed by a growing population and surging productivity to raise government revenues to reduce their debt levels, this scenario will not be easily repeated in many of the major countries.

We recently met with Professor Ken French from Dartmouth University in the U.S and a member of the Squam Lake Working Group on Financial Regulation, who has been providing guidance to the U.S and other national governments on reform of financial regulation following the GFC. When we

³ Ambrose Evans-Pritchard. 'Greeks sent packing', SMH 20 March 2010

asked Ken whether rising public debt in developed nations could impact real returns (i.e. returns net of inflation) for investors, he said it is almost impossible to estimate due to the number of moving parts. Ken reiterated that as these issues are in the public domain, markets have already priced their expectations into debt and equity markets.

In April 2010, the U.S Federal Reserve Chairman Ben Bernanke warned that the U.S Government needed to come up with a credible plan for tackling its budget deficits because ‘unless we as a nation demonstrate a strong commitment to fiscal responsibility, in the longer run we will have neither financial stability nor healthy economic growth’⁴.

It is important to note that budget forecasts change dramatically and that simple extrapolations of current trends, particular in U.S budget deficits and public debt, are fraught with danger. Take this quote from Alan Greenspan on the U.S budgetary position when he was the Chairman of the U.S Federal Reserve in January 2001:

“The most recent projections, granted their tentativeness, nonetheless make clear that the highly desirable goal of paying off the federal debt is within reach before the end of the decade. This is in marked contrast to the perspective of a year ago when the eliminations of the debt did not appear likely until the next decade”.

Not only had the forecast changed dramatically between 2000 and 2001, but we now know that Greenspan’s forecast of zero U.S Government debt by 2010 was inaccurate by about US\$10,000 billion. **Recent events in Australia confirm the difficulty with forecasts. Only 12 months ago the Federal Government budget was expected to be in deficit until 2015 – there is now speculation the 2011-12 budget will deliver a surplus due to economic conditions being far stronger than expected.**

No one knows for certain what the future will hold, which is why we advise our clients to hold a diversified fixed interest portfolio spread across a wide range of high quality sovereign, supra-national and corporate issuers, with limitations on exposure to any single issuer or country. **It is important to note that no securities issued by any of the PIGS are currently included or eligible for inclusion in our client investment portfolios.**

Is there Alpha⁵ in Norway?

One country unlikely to suffer the tribulations of Greece anytime soon is Norway. Due to taxes and income earned from its extensive natural oil resources, **Norway has one of the largest sovereign**

⁴ Ben Bernanke speech to Dallas Regional Chamber, Washington, 7 April 2010

⁵ Alpha is defined as investment returns over and above the market return. Some consider alpha reflects the knowledge and skill of the investment manager to identify and benefit from market pricing errors.

wealth funds in the world, with assets of US\$430 billion as of 30 September 2009 (which equates to about \$100,000 for each citizen)⁶.

Since the Fund was established in 1996, Norway has gained a reputation of sound stewardship for managing this wealth for future generations. The Norwegian Ministry of Finance has the responsibility of determining the investment strategy and ethical guidelines for the Fund, which is then implemented by the Norwegian central bank using a combination of internal staff and external active forecasting money managers. The current asset allocation target of the fund is 40% fixed income and 60% equities (diversified across 46 countries).

The Fund is an unusually sophisticated market participant. **With no current distribution requirements and a time horizon measured in generations, the Fund is the quintessential patient investor, and with its ample resources, it can afford to hire the best and brightest managers the world has to offer.**

The Fund devotes considerable effort to the process of hiring external money managers, seeking out not just successful organisations but specific individuals within those organisations with desirable characteristics. Combined with the traditional Scandinavian virtues of thrift and thoughtful analysis, the fund would appear well-positioned to achieve its ambition "to be the best managed fund in the world."

Following a disappointing performance in 2008 (the fund fell 23.3% for the year, trailing its benchmark by 3.37%) the Ministry of Finance engaged an international team of experts to evaluate the Fund's investment strategy. There was particular concern about the absolute (or total) loss experienced, given that the investment strategy was thought to be low risk.

The resulting 220-page report by Andrew Ang (Columbia Business School), William N. Goetzmann (Yale School of Management), and Stephen M. Schaefer (London Business School) provides an unusually detailed examination of a sophisticated institution's investment experience over the past 11 years.

The conclusion? The **authors' key finding is that despite having an internal staff of 249 and hiring hundreds of external money managers, "to a first approximation, the Fund is actually not an actively managed portfolio"** (Ang, Goetzmann, and Schaefer 2009). Echoing an earlier academic paper by Brinson, Hood, and Beebower (1986), they find that **the Fund's results are almost entirely explained by exposure to systematic risk factors rather than active management bets due simply to the broad market exposure of the portfolio.** "The overall behaviour of the Fund is therefore very similar to an index fund with a small overlay of exposures to systematic factors such as credit, value-growth, liquidity, volatility, etc."

⁶ 'Norway's Pension Fund', The Economist, 6 February 2010

The majority of active forecasting fund managers effectively take a position on which securities they believe will outperform the market – they believe that markets have incorrectly priced stocks based on available information. As a result their portfolios are very concentrated (often including a maximum of 40 to 50 securities) and often quite similar – few managers are prepared to stray too far from their competitors should it result in significant underperformance. As a result, if a portfolio contains a large number of active forecasting managed funds, the net result is effectively a market portfolio but with significantly higher costs than an index fund.

Based on their finding that the average active return from January 1998 to September 2009 was statistically indistinguishable from zero (i.e., for every manager who outperformed the market, another underperformed the market as investing is a zero sum game), the authors suggest that the Fund could benefit by targeting various risk factors more explicitly and taking advantage of the Fund's unusually long time horizon to earn appropriate returns as compensation for risks that other investors might be unable or unwilling to bear.

In short, active managers do not provide extra profit over time, so the focus should instead be on structure and asset allocation, which is the methodology FYG Planners employs to construct our client portfolios.

Applying this finding to our equity investment philosophy, it means having higher exposure to small and value companies in the Fund's equity portfolio.

This still raises the question of how the Fund previously managed to beat its benchmarks before the Global Financial Crisis occurred. The report showed that it was not due to clever stock selection, but rather the Fund was exposed to assets with higher inherent risks than its benchmarks. For example, the Fund invested in lower credit quality fixed income securities or securities with hidden risks. Consequently, there is no evidence that 'alpha' was ever actually achieved, despite the extensive time and cost invested in selecting fund managers⁷.

⁷ Some information in this article was provided by Weston Wellington, DFA LP

Risk Dimensions Deliver for Patient Investors

The Norway example is a reminder that there is a difference between absolute performance and relative performance.

Absolute performance is the total return produced by a portfolio, whereas relative performance measures the portfolio's returns relative to the amount of risk the portfolio is exposed to. If for example Michael invests 100% into Australian shares and Gemma invests 100% into fixed interest securities, then comparing Michael's absolute return of 10% pa over the past 10 years to Gemma's 7% pa absolute return over the same period is not an apple with apple comparison. Instead, Michael should compare the relative performance of his portfolio to the ASX 300 Accumulation Index, which is an accepted proxy for the Australian share market, and Gemma compares her performance to a bond index.

Many investors don't appreciate this difference and fail to acknowledge the role risk plays in investing. Risk is a factor that must be continually measured and addressed when investing. Over time, the risk preferences of most investors change as does the need for them to take on additional risk as the value of their portfolio grows.

Our investment philosophy starts with the universe of securities available to investors and:

- **eliminates those securities which do not offer sufficient returns for the level of risk exposure; and**
- **tilts the portfolio towards securities that offer a higher expected rate of return for an acceptable level of risk.**

For example, our fixed interest strategy does not invest in bonds with a duration that exceeds 5 years as research shows that investors are not adequately compensated by returns for the additional risk they take on by lending funds for periods exceeding 5 years.

Our core investment philosophy uses a clear, transparent, intuitive and rigorous academically tested framework within which securities are actively managed to ensure risk premiums are captured as markets make them available.

Research clearly shows us that there is no proven methodology for determining which asset class, stock or country will perform best in the short term. However, the research does show us which risks are worth taking over the longer term. So what are they and how often do they appear?

Those familiar with our investment philosophy will know that Small and Value companies offer a higher expected rate of return compared to Large companies as they are riskier assets to hold.

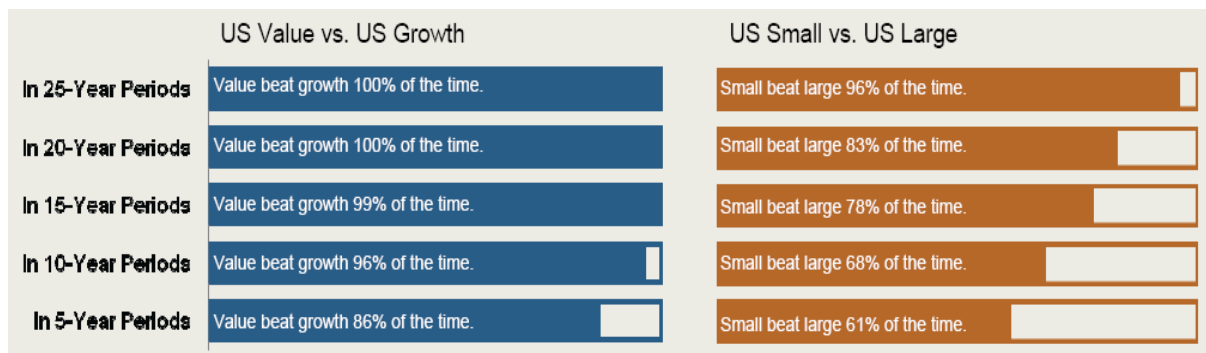
As an example, the table below illustrates the performance of our Australian Large, Small and Value strategies over the 10 years to 31 March 2010, together with the performance of the ASX 300 Accumulation Index over the same period:

Australian Equity Strategy	Return p.a	Excess Return p.a	Additional 10 yr Portfolio Value
ASX 300 Accumulation Index	8.86%	-	-
Large Companies	9.43%	+0.57%	+5%
Small Companies	10.39%	+1.53%	+15%
Value Companies	14.87%	+6.01%	+71%

Source: Returns Program

The Small and Value return premiums consistently occur over the longer term, but may not always be present in the short term. A recent study by Dimensional Fund Advisers demonstrates how frequently these return premiums are evident.

In Australia we only have performance data available back to 1980, but in the U.S data is available dating back to 1926. Using the U.S data, we can see how often the Small and Value premiums have historically occurred in the U.S stockmarket and how frequently stocks have outperformed US Treasury Bonds:



Period: **July 1926 to December 2008**. Periods based on rolling annualised returns. 691 total 25 year periods, 751 total 20 year periods, 811 total 15 year periods, 871 total 10 year periods and 931 total 5 year periods. Performance based on Fama & French Research Factors

As is the case in Australia, the Value premium compared to higher priced Growth companies is strong and frequently evident. For example, over the past 80 years the Value premium was evident in 86% of any 5 year period selected. Over 15 year periods or longer it was almost always evident.

Some investors worry that once Value companies have performed strongly, they've missed the boat. However, this assumption is not correct for the following reasons:

- The definition of Value companies we use is based on ranking all eligible stocks by book value (i.e. net equity value on their balance sheet) compared to their market value (i.e. share price) with some necessary adjustments and then invest in the 20% of stocks with the highest book to market ratio. Over time, this basket of stocks changes, so investors aren't relying on the same stocks to deliver the returns. For example, in 2009 turnover in the Dimensional Australian Value Trust was 38%. This turnover reflects the fact that over time many Value stocks assume the

attributes of Growth stocks as their share price increases and some Growth stocks become Value stocks as their share price falls.

- We are focused on the relative return of Value companies compared to Growth companies rather than absolute returns. Over time, whether Growth companies have provided high or low returns, Value companies have still typically provided a higher return.
- The Value effect exists due to differences in returns between stocks. If we expect Stock A to have a higher return compared to Stock B, then simple arithmetic shows that Stock A must have a relatively lower current price. Unless all companies have the same expected rate of return, the Value effect must exist. Since 1980, the Value premium in Australia over the ASX 300 Accumulation Index has equated to approximately 5.89% pa⁸. This means a portfolio invested entirely in our Value strategy in January 1980 would today be worth 3.7 times a portfolio that tracked the ASX 300 Accumulation Index.

For Small companies, the premium over Large companies is frequent but not as regular as the Value premium. However, when the Small premium does occur, it provides strong returns.

This is the type of research we consider when constructing portfolios for our clients to ensure their returns are maximised for a given level of risk. We hope to have similar data available for the Australian market later in the year.

Market Timing is Hard

We already know that market timing is extremely difficult, but just how difficult?

With the benefit of hindsight, it's easy to say that the stockmarket in March 2000 was wildly inflated by tech stock valuations and ready to plunge. The same goes for the end of the downward trending market in March 2009 – the S&P 500 Index had fallen by almost 40% over the preceding 12 months. But it's quite another thing to predict these major turning points at the time.

In the U.S, financial market and media commentator Mark Hulbert has been tracking more than 160 financial adviser newsletters since 1980, so he has a large factual database.

There is no exact definition of what 'calling' a market top or bottom involves. However, in order to **see how many of these 160 advisers were able to call any of the four major turning points over the past decade**, Mark employed a reasonably relaxed definition as follows:

- Instead of moving 100% from cash to stocks in the case of a bottom, or 100% the other way in the case of a top, he allowed for an exposure change of just 10% to qualify; and

⁸ Source: Returns Program for period January 1980 to February 2010. Calculation uses actual data from July 1999 to February 2010 and simulated data from January 1980 to June 1999.

- Rather than requiring this change to occur on the exact day of the market's top or bottom, he looked at a one month long trading window starting before the market's juncture and extending two weeks thereafter.

The graph below illustrates the four major stockmarket turning points over the last decade.



The result? **Not one of the 160 market timers was able to call any of the four turning points over the past decade⁹.**

This doesn't stop some financial advisers from trying however. Some get lucky. Others don't. A number of Australian advisory firms recommended that their clients move approximately 80% of their portfolios into government bonds in early 2009. From 1 March 2009, the ASX 300 Accumulation Index rose by 52% to the end of 2009. In contrast, the UBS Government Bond Index rose 0.6%. This is a ruinous investment experience for their clients.

This demonstrates the difficulty in consistently picking changes in the direction of financial markets and why discipline is essential. If your investment strategy going forward is dependent on you anticipating major market turning points, your chances of success are extremely low.

⁹ Mark Hulbert, Wall Street Journal Digital Network, 10 March 2010

3. Investment Market Review

Following the GFC, the stockmarket recovery commenced on 6 March 2009. Since then, it is no surprise to see that 12 month returns to 31 March 2010 have been particularly strong:

- | | | | |
|-----------------------|------|----------------------------|------|
| • Australian Shares | +42% | • Global Shares (unhedged) | +15% |
| • Australian Property | +42% | • Global Shares (hedged) | +46% |
| • Emerging Markets | +37% | • Global Property | +44% |

The 30% appreciation of the Australian dollar against the U.S dollar over the past 12 months resulted in investors with unhedged global share portfolios receiving lower returns than investors who employed a hedging strategy. The Australian dollar has only traded at current levels for around 3% of the time since being floated in 1983. Predicting currency movements is the ultimate fool's game, but if in time the Australian dollar drifts down towards its longer term average of between 60 and 80 US cents, then unhedged investors would benefit from the currency depreciation.

Given the economic woes of the U.S economy, many may be surprised to learn that the U.S S&P 500 Index (largest 500 listed U.S companies) rose 50% over the past 12 months. Whilst 2008 was the second worst performing calendar year for the U.S since 1926, 2009 in contrast was the 18th best performing year.

This is all a reminder that stockmarkets *anticipate*, rather than simply reflect the current economic environment. The economic outlook for the U.S continues to improve, despite high unemployment (9.7%) and a depressed housing sector.

Stockmarkets have stabilised as reflected in the VIX Volatility Index which measures price volatility of the S&P 500 Index. This index has fallen from an all time high of 89.53 on 24 October 2008 to 17 at present. The average volatility since the index was established in 1990 is around 19.

The 10 year performance of global shares remains negative. Whilst this is disappointing news for investors, it is important to put this in a historical context.

Over the past 84 years, the U.S market has experienced positive returns in almost 75% of calendar years, meaning the past decade for global shares remains an irregularity.

For most investors, global diversification has been and will continue to be very important. It should be noted that 48% of S&P 500 company earnings are derived from outside the U.S and also that Australia represents only 3% of the global stockmarket.

4. Historical annualised returns of major asset classes to 31 Mar 2010

Asset Class	3 Months	1 Year	5 Years (p.a.)	10 Years (p.a.)
Cash (UBS Bank Bill Index)	1.0%	3.5%	5.8%	5.6%
Australian Fixed Interest (UBS Aust. Comp. Bond Index)	1.3%	2.7%	6.0%	6.3%
Global Fixed Interest (hedged) – Citigroup World Govt Bond Index (1-5 yrs)	2.1%	5.7%	7.1%	7.8%
Australian Shares (S&P/ASX 300 Acc Index)	1.3%	41.9%	8.0%	8.9%
Australian Shares – Large (S&P/ASX 100 Acc Index)	1.5%	40.8%	8.3%	9.1%
Australian Shares – Small (ASX Small Ords Acc Index)	-1.6%	58.1%	5.8%	6.6%
Australian Real Estate Trusts (S&P/ASX300 Property Index)	-1.6%	42.0%	-7.2%	3.6%
Global Real Estate Trusts (UBS Global R.E Investor Index)	2.9%	44.3%	-1.2%	6.9%
Global Shares (unhedged) – MSCI World ex-Australia Index	1.1%	15.3%	-0.4%	-3.9%
Global Shares (hedged) – MSCI World ex-Australia Index	4.9%	45.8%	1.6%	-1.3%
Global Value Shares (unhedged) – Value (MSCI World Value Accum. Index)	1.3%	17.9%	-1.4%	-1.9%
Global Small Shares (unhedged) – Small (MSCI World Small Cap Price Index)	5.4%	31.1%	0.8%	2.2%
U.S Shares – S&P 500*	5.4%	50.0%	1.9%	-0.7%
Emerging Markets (unhedged) – MSCI Emerging Mkts Index	0.4%	37.1%	11.8%	5.3%

Australian Dollar/US Dollar	2.1%	29.5%	3.5%	4.2%
Inflation**	0.5%	2.1%	3.0%	3.2%

*Returns are in the local U.S currency (effectively a hedged strategy)

**Underlying annual rate 3.2% (trimmed mean CPI) for December quarter. March quarter results due 28 April 2010.

Note: Accumulation indices used which assumes reinvestment of dividend income.