

ECONOMIC UPDATE – August 2009

RECOVERY – Australia leads the World

It's nice to be able to bring some good news. A few stats to get things going from our observations of actual portfolios in the March to June quarter:

Australian shares returned about 20%

Small caps recovered up to about 40%

International has seen positive returns up to about 16%

Emerging markets picked up about 15%

We are yet to see anything positive in the Listed Property sector, particular in Australia. It appears this will be the slowest area to recover. The official stats say Australian listed property returned 15.17% and Global property returned 24.24% but we have not seen evidence of that yet. We are hopeful the next quarter will show better results for this under-valued sector.

While we can't promise there won't be any more hiccups, it looks like ***the recovery is under way.***

Has the Stimulus Worked? How will we afford it?

The Federal Government's stimulus package appears to have worked. Australia narrowly avoided going into recession, although some sectors have been hit harder than others. The biggest concern has been about the **deficit** the package has created. Australia has been one of the few countries in the world operating without a deficit, which shows very good fiscal management by the prior Federal Government. To put things in perspective we have included a quote from Chris Caton, Chief Economist of BT Investments, in his June Economic Report:

"It is true that bonds on issue are expected to expand from \$112 billion currently to \$301 billion in four years time, but the net Federal debt as a share of Gross Domestic Production (GDP) is expected to peak at 13.8%, a figure laughably low by international standards. Every other large country will have a Federal debt of at least 70% of one year's GDP once the recessions have passed."

So as long as the Government acts responsibly, Australia should remain in a very sound position – Not so for the rest of the world!

Director: M Franklin B Bus (Prof Acctg) (Dist), Dip Fin Planning, CPA

PO Box 1570 - 1/1 Dan Street, Capalaba, QLD 4157
T: (07) 3245 6666 F: (07) 3245 6611 W: www.mfranklin.com.au

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What about Unemployment?

Unemployment is tipped to reach around 8.5%-9% in late 2010. Youth are currently experiencing the highest rate with an unemployment rate sitting at about 12%.

The good news for small business is that good staff are once again becoming available at affordable rates of pay. Shelling has been mostly from Government and large companies looking for efficiencies and mining related industries.

TIP

Some **income protection** policies will give you a holiday from your premiums for up to 6 months if you lose your job. Please contact us if you would like to find out more about this.

Looking forward

Inflation is expected to sit around 2% for a couple years.

Business heavily dependent on the Qld State Government may be in for a tough time. The Government isn't expecting to recover from its downgrade and economic problems until about 2013. If you are in this sector:

- ✓ look to diversify away from reliance on State Government
- ✓ check your existing contracts with the Govt paying particular attention to payment terms and cancellation rights

Building Wealth – Technical Corner

Did you know that by putting a portfolio together a particular way, the risk of the portfolio can be significantly less than any of the individual assets alone? Holding just 1 of anything exposes an investor to the total risk of that market segment. Combining assets in a group can reduce risk, however there are some definite combinations that work better than others.

Firstly, the market is regarded as efficient. Just a quick glance at the Aussie stock market chart over the last 100 years shows how the trend is continually upwards. There are ups and downs in there, but the market has never returned to the base line. It can't as the economy has grown exponentially since Federation.

One popular and effective way of investing is to hold a portfolio of the entire market in a mini scale in exact proportions to the real thing. That is optimal diversification! However it would take a large sum of money to achieve directly and a lot of time to continually re-balance the portfolio daily. And besides, investors have other things to do. That is where an **Index Fund** comes in. Index funds move exactly in line with the market. Usually they hold the top 20 or 100 stocks as it would be very clumsy to try and incorporate every single little company in a fund.

Index Funds experience all the highs and lows of the market exactly. However as the market is forever expanding, the value of the portfolio will increase. *If you would like more information on Index Funds please speak with Craig or Ken.* There are many types of index funds including shares, listed Australian property etc.

...if Index funds are so good, why are there so many others?

The simple answer is because most fund managers and individuals, for that matter, believe they can do better than the index. A large part of the investment industry runs on this belief. People buy properties or shares they think will go up quicker than others, or give a better return than others etc. Investors are continually looking for the edge. That leads us to **Active investing**.

Active managers aim to outperform benchmarks (indexes). For the most part, we recommend active management. Within the active realm, there are various styles as well (top down, bottom up, value etc). One of the strong points with this approach to investing, is that managers are able to take advantage of opportunities that pop up without the constraints faced by Index manager who have to hold a share even if they would rather trade it. ABC child care centers provides a perfect example of this situation. The Australian Index managers had to hold the same amount (pro-rata) of ABC shares even though they could see it was in trouble and they probably wished they could sell it as they had to stay true to the Index; however the Active managers could sell out as soon as they realized ABC was in trouble, thereby minimizing the loss. The same applies to shares in rapidly growing companies – Active managers can stock up while the Index manager must stay true to the Top 20, 100, or whatever the charter is for their fund. ***If you would like more information on Active Managed Funds or direct share portfolios please speak with Craig or Ken.***

The keys to successful investing and wealth creation remain the same:

- ❖ Diversification. Research shows an Investor needs to hold about 20 stocks to have an adequately diversified portfolio. There are statistical ways of measuring whether stock returns are correlated (ie which shares will respond the same way to the same stimulus).
- ❖ Independently rating of shares and Managed funds. All the Managed funds we recommend are independently rated by Van Eyk. Fund managers have the time and resources to compile properly diversified portfolios.
- ❖ Independent valuations for property with strong likelihood of obtaining stable rental returns and future capital gains.
- ❖ Invest in companies with strong balance sheets, good past history, and strong future prospects for direct Shares
- ❖ Invest for the long term or at least match the likely investment time frame with appropriate investments
- ❖ Have regular reviews of your portfolio and adjust as required

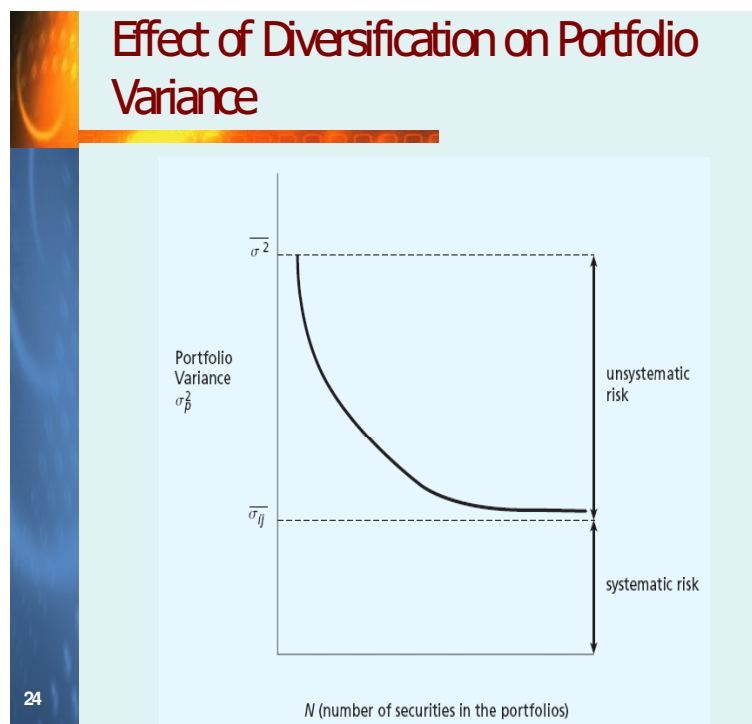
Figure 1

Graph Note: TIP

Market risk is also known as **Systematic risk**. Eg interest rates, inflation, consumer confidence etc. This risk **cannot be reduced through diversification**.

Risk peculiar to any asset is called **Unsystematic risk**. **Can be diversified**.

Graph note: Notice how risk reduces as the number of shares in the portfolio increases, but only to the level of what is happening in the economy (the systematic risk line)

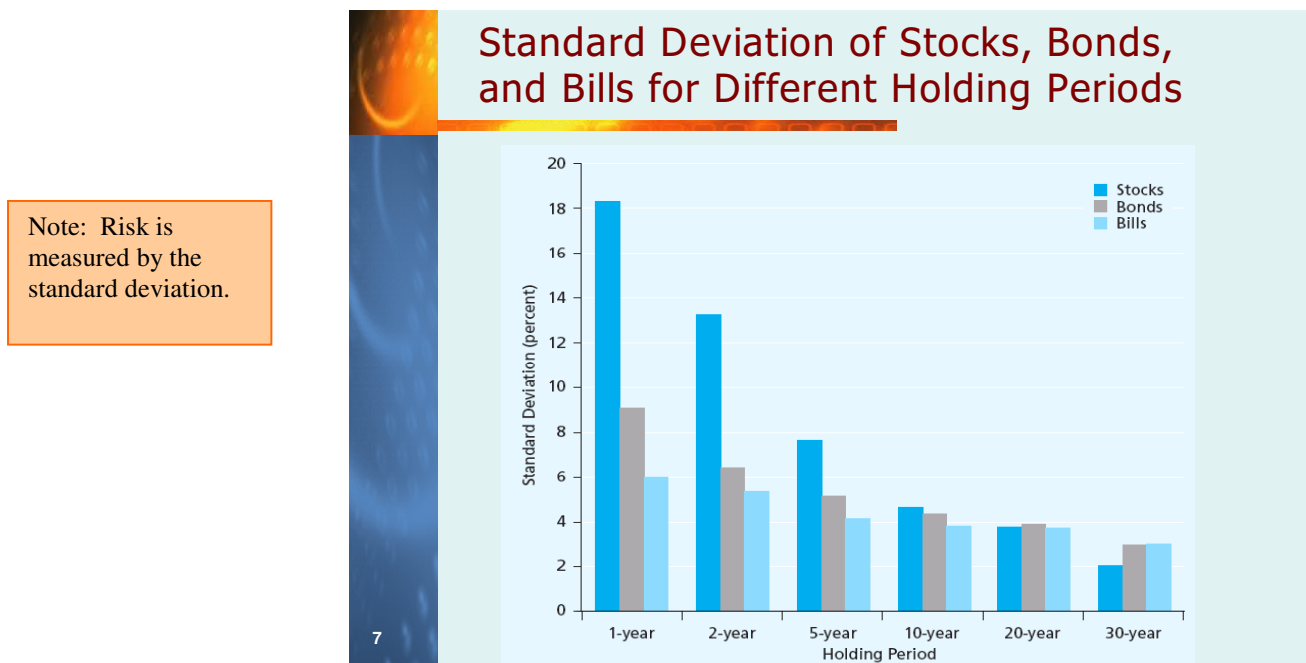


How can I minimise risk?

We are obviously not talking about gambling. As Financial Planners, we have the time, skills and access to the research to build portfolios with you to grow your wealth. Time is the key. Nothing can be done about market fluctuations, such as the one we have just had. However a good portfolio will recover strongly when the market influences have abated. Investors simply need to hold through. The key is whether the underlying investments were sound in the first place.

The safest assets are Government Bonds. They are regarded as 'risk free'. The next chart may surprise you therefore as it shows from historical data (US stock market) that *shares held over the long term will be a safer investment* (less risk measured by the standard deviation) than assets traditionally viewed as conservative. They will also *yield a much higher return than conservative assets*. The key is in the length of time the portfolio is held.

Figure 2 For different holding periods between 1802-2001 Source: *Smart, Corporate Finance, 2007*



You can see how relevant this is for superannuation especially, as it tends to be locked away for a long time. We trust you have enjoyed this Update and look forward to speaking you soon to help you achieve your investment goals.