

EQUITIES

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COORDINATOR'S MESSAGE

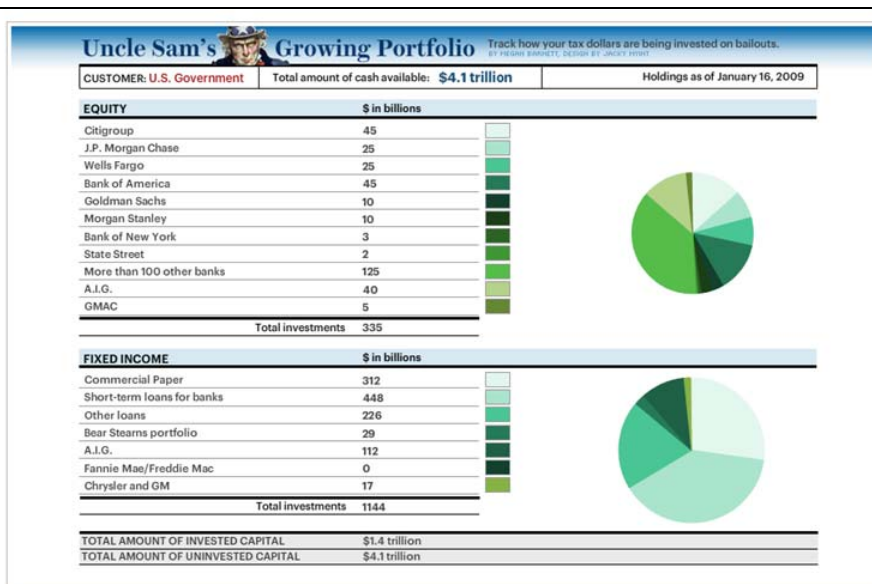
By Owen Richards

We have taken a different tack in this issue of the Equities Bulletin by moving away from the longer essays to a summary of articles or blogs that have caught our attention recently.

A reference is provided if you would like to follow up the extract by reading the full account. Some minor editing or text changes may have been made and underlining has been added occasionally to provide emphasis.

Bailouts

Bailouts are the craze du jour. Here's one example of the sheer size of the bailout for what is already the most indebted nation on earth (with much more to follow!):



Business Interactive Features - Diagrams - Illustrations - Portfolio.com
<http://www.portfolio.com/interactive-features/2008/12/US-Portfolio>

The Causes of the Crisis

Here's an extract from an article which neatly summarises the causes of the current crisis in the US (and its flow on to Australia and elsewhere):

Some of the causes of our contemporary crisis are well known by now. There were governmental errors: monetary policy that was too loose; government monitoring agencies that were too lax; and government policies specifically intended to encourage home ownership among African-Americans and Hispanics that had the unintended but quite anticipatable effect of extending mortgages to those who lacked the ability to repay them.

There were perverse alignments of market incentives, incentives that put personal interests at odds with corporate interests, and corporate interests at odds with the public interest. There were principal-agent problem *within* firms, where traders were remunerated with bonuses for selling collateralized debt obligations without regard to the long-run viability of the underlying assets. Rating agencies were corrupted because they were paid by the sellers of the goods they rated, offering unreliable evaluations that redounded against the purchasers of mortgage-backed securities.

Large profits were made by companies that packaged and sold mortgages and mortgage-backed securities without needing to be concerned with their ultimate viability. It turns out that intermediation of risk reduces the incentives for adequate risk management: so long as risk is intermediated, from a mortgage loan broker to a commercial bank to an investment bank to an investor, there is really no incentive, at each stage of the game, to have adequate risk-managing policies in place.

Our Epistemological Depression — The American, A Magazine of Ideas –
<http://american.com/archive/2009/our-epistemological-depression>.

The same article has an interesting lead-in on socialism and capitalism and their respective forms of failure. These comments have a particular relevance in the face of some commentators spouting nonsense about the 'death of capitalism':

The history of socialism is the history of failure—and so is the history of capitalism, but in a different sense. For the history of socialism is one of *fundamental* failure, a failure to provide incentives and an inability to coordinate information about supply and effective demand.

The history of capitalism, by contrast, is the history of *dialectical* failure: it is a history of the creation of new institutions and practices that may be successful, even transformative for a while, but which eventually prove dysfunctional, either because their intrinsic weaknesses become more evident over time or because of a change in external circumstances.

Historically, these institutional failures have led to two reactions. They lead to governmental attempts to reform corporate and financial institutions, through changes in law and regulation (such as limited liability laws, creation of the FDIC, the SEC, etc.). They also lead market institutions to reform themselves, as investors and managers learn what forms of organization and which practices are dysfunctional. The history of capitalism, then, is the history of success through dialectical failure.

Our Epistemological Depression — The American, A Magazine of Ideas
<http://american.com/archive/2009/our-epistemological-depression>.

Local Bailout Package

Not surprisingly the local bailout arrangements have attracted their own share of comment:

... the Rudd Government... wants to be able to show that it has saved Australia from the Global recession.

It is trying to do this by borrowing from beyond the next election to spend now. Fortunately, the Australian Government's balance sheet is in good shape. Thanks in part to the previous resources boom, the commonwealth has no net debt.

Unfortunately, the household sector - which ultimately owns the government balance sheet - is in bad financial shape. Over the past decade, the debt burden on Australian households doubled to 160 per cent of household income. This splurge of debt-financed household spending was encouraged by the widespread notion that the China boom had made Australia a permanently richer nation. While China will recover, the ongoing bounty will be considerably less than we previously thought. As a nation we are poorer, with the loss of wealth most obvious to those Australians living off their devalued nest eggs.

Over-borrowing and overspending got us into this fix. It stretches the paradox of Keynesian economics to believe that even more borrowing from a less bountiful future to consume now provides the solution, even if the stimulus comes from the Government on behalf of households, rather than from households directly.

Dash of Friedman needed | The Australian

<http://www.theaustralian.news.com.au/story/0,25197,25031392-7583,00.html>

And just to remind you where we are at:



As at 10 February 2009 (original updates each market day).

The main character in our continuing drama of the "Four Bad Bears" is the current bear, now 16 months old. If, however, the November 20th low turns out to be the true bottom, at some point in the future we'll adjust the age on the death certificate.

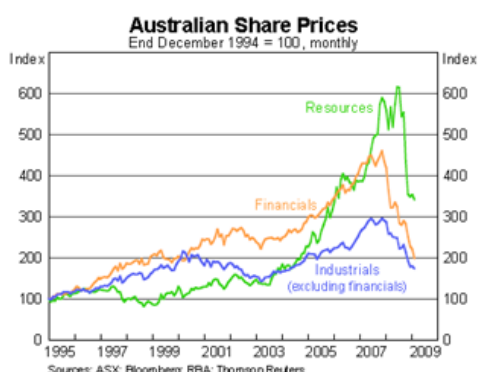
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<http://dshort.com/charts/bears/four-bears-extended-large.gif>



<http://www.rba.gov.au/ChartPack/index.html>



What Next?

It's a while since we've heard the word 'decoupling' bandied about. This was the notion that demand from China for resources would push through any downturn elsewhere. Australia would 'decouple' from other economies and from the US market in particular. However, since the relentless global downturn and the recognition that China is also slowing, the only decoupling has been for shareholders from their share value.

The ASX still remains linked to US markets and we continue to sneeze whenever the SPX and NDX have a cold. For this reason alone, it's relevant to keep a watch on what and when recovers in the US as some guide as to how we should proceed locally; at least in the absence of similar information here. For this reason, here is some recent advice on what companies and sectors did best after the Crash of 1929.

With the losses of last year and this year it can't hurt to learn what separated the winners from the losers back then. The good news is that some stocks and industries did indeed do much better than average. The bad news is that the average was ghastly, and even the best stocks had three rotten years in a row.

To find a major sector with significantly positive returns (it was necessary) to stretch our measurement period into a fourth year, 1933, when the market finally rebounded partway from its earlier losses by rising a record 54%. Even then, out of 120 industries, only 13 managed to generate gains from 1930 through 1933.

The only clear winner: cheap vices. Among the sectors with positive returns were cigarettes, cigars and tobacco, sugar and confectionery products, and fats and oils, which each gained between 1.6% and 7.5% annually. Those gains were better than they look, because deflation raised their purchasing power by an annual average of more than 6% over this period. It seems there was good money to be made investing in guilty pleasures that people could afford even in the hardest of times: sweets, smokes and fried food.

1930s Lessons: Stocks for After a Crash - WSJ.com

<http://online.wsj.com/article/SB123456259622485781.html#articleTabs%3Dcomments>

Most of the comments that accompany the previous article disparage any suggestion that history will repeat itself; and it's difficult to see tobacco products making any sort of comeback although perhaps casinos might be worth keeping an eye on! However the next article provides some more contemporary guidance with, 'Hints of Which Sectors Will Weather the Storm'.

But one distinction this year may turn out to be significant: the various sectors of the stock market have not all been moving in tandem. The market is starting to sort between the winners and the losers, rather than pushing everything down as if it were a monolithic asset.

For example, managed funds that concentrate on technology have gained 2 percent on average this year. Health care funds rose 3 percent, while energy funds lost 1 percent and utilities funds fell 3 percent. These are all much better performances than the decline of more than 8 percent in the S&P 500-stock index this year.

What do these four sectors have in common? They all enjoyed year-over-year profit gains in 2008. Though overall earnings for companies contracted by an estimated 12 percent last year, energy and health care earnings grew 21 percent and 7 percent, respectively. Utilities grew an estimated 3 percent, while technology company earnings expanded by 2 percent in 2008.

Telecommunications was the only other sector for which earnings grew. Funds that specialize in those stocks are down roughly half as much as the S & P 500 this year.

Fundamentally - Hints of Which Sectors Will Weather the Storm - NYTimes.com

http://www.nytimes.com/2009/02/15/your-money/mutual-funds-and-etfs/15fund.html?_r=2

Hedge Funds

But at least no-one now seems to be holding either Hedge Funds or Short Selling as the principal villains any more:

Sophisticated investors who ran hedge funds were touted for their ability to beat the market with secretive strategies that could not be revealed to the general public at the risk of ruining those wonderful returns. These “black box” investment programs created the allure of the unknown, making those who reaped the benefits somehow special in their own right – in other words, they too assumed the mantle of “sophisticated investor.”

The impetus to maintain the aura of secrecy around hedge funds seems to be breaking down as we now learn that they are hardly any better than many plain vanilla managed funds. And unlike a managed fund or an exchange-traded fund, you can't always get your money back, even if you have to continue to pay the annual fees on the amount invested.

That a person has a high net worth is hardly an indication of investment savvy, and calling your investment vehicle a “fund of funds” seems to mean only another layer of fees in many instances. Perhaps the term “sophisticated investor” should be understood to mean “I get mine first and the hell with the rest of you.”

...We have come to learn that hedge funds are hardly immune to the market's travails, and the immunity the managers of these vehicles enjoyed is likely to end with greater regulatory control and disclosure of trading strategies.

Politically correct stupidity <http://www.politicallyincorrect.me.uk/stupidity1.htm#PH>.

AUSTRALIA'S short-selling ban on financial stocks is draconian and damaging to the country's reputation as a trading destination, market-watchers now say.

Analysts contend the short-selling ban has hurt liquidity in the marketplace, where total value of trades has fallen 57 per cent in the year to last January.

The ban is also longer than any other imposed in a global market centre and, importantly, has not effectively protected the stocks of major banks and investment firms from losses over the past six months.

ASIC recently extended the ban until March 6, the second such extension, saying its approach has been “consistent with many other jurisdictions”.

Yet, no other major market centre - be it London or New York, Singapore or Hong Kong - has such bans in place anymore. The head of the US Securities and Exchange Commission even expressed post-mortem regret about the imposition of the short-selling ban in the US market - and the ban in the US was only in place for a matter of weeks.

Short-selling ban labelled dangerous to share market | The Australian
<http://www.theaustralian.news.com.au/story/0,25197,25016628-643,00.html>

And a final thought. In a period where a young Australian digger was awarded the Victoria Cross, the nation's highest award for valour, and many thousands of volunteers fought bush fires to the point of utter exhaustion, the following comment is offered (although clearly not applicable to everyone):

It has been a long time in this country since the ideals of sacrifice, honour, courage, and integrity were both admired *and* aspired to by the common man. What is admired now is fame and its idiot cousin, celebrity, and wealth and its bastard offspring, money-for-nothing.

<http://epicureandealmaker.blogspot.com/2009/01/choice-of-herakles.html>

Now following is a cautionary tale in one of the My Equities Portfolio series by AIA member Steven Robinson. Thank you for an excellent story, Steve. We suspect that that there may be plenty of other members on your investment island, Robinson (sorry, feeble pun intended!).

Owen Richards is a member of the AIA.

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MY EQUITY PORTFOLIO

By Steve Robinson

As the share market tests new five year lows (written of Feb 21), my principal concerns as a small investor are how to minimise further losses in the short term, how to position ourselves with reasonable prospects of healthy returns in the long term, and how to balance these possibly conflicting objectives. My wife and I hold our investments in a self managed superannuation fund which receives technical, legal and accounting services through a financial advisor, but in recent years they have not provided investment advice, and I have made all investment decisions myself. I accept full responsibility for the state of our affairs, which has seen the fund drop in value by 45% in the past 16 months, after paying our account based pensions.

When we established the fund six years ago most available data suggested that Australian shares had performed better than other asset classes in the long term, and I could see no reason for this to change. So, planning on a genuinely long term investment horizon of some 30 years, I invested about 90% of the fund in Australian shares. We enjoyed 4 ½ good years, and now 16 very bad months, with an average return since inception of the fund still positive but less than bank interest. With no prior investment experience, we initially invested in Listed Investment Companies (LIC's), and we still have over 50% of the fund in LIC's (Australian Foundation, Australian United, Choiseul, Milton, Mirrabooka, Platinum, Whitefield), seeking diversification and expertise at low cost. Other substantial holdings include BHP, Leighton, Woolworths, Westfield and an unlisted property trust, and even in retrospect these still appear to me to be safe, sound, long term investments. Obviously I was wrong to place so much confidence in Australian shares, or we may have to wait a long time to be proved right.

As I try to plan for the future, I am trying to understand the investment environment; to what extent has the established financial order changed and what will any "new financial order" look like? Is it realistic to hope that sound companies will survive and return to prosperity, that dividends will continue to flow, and markets will rebound? What is the risk that the enormous injections of cash by many governments will lead to inflation or hyper-inflation? Will the developed world, and especially the Anglo-Saxon world, be saddled by foreign debts and increasingly obliged to respond to the demands of those who have funded our mistakes and our excesses? I am not sure that anyone has conclusive and convincing answers to these and other simple but vital questions, yet our investment decisions must be based on explicit or implicit assumptions on such issues. As I cannot describe and define any new financial order, I can find no better assumption than that we will return in a year or two to something close to the old financial order, but I have limited confidence in this assumption.

In the short term, we have aimed to preserve capital, and we do not intend to sell shares held by the fund at present low prices, which would simply be realising losses. To ensure we maintain adequate cash balances, we have cancelled all dividend reinvestment plans, and have cancelled our pensions for the rest of this financial year based on the February 18 announcement from Treasury. So far, early in the February reporting season, our dividends are holding up well, and even with reduced expectations of dividends for the next two years, we hope we will not have to sell any investments for several years to pay our pensions and the fund's operating costs.

Looking further forward, our plan is to stay mainly invested in Australian shares. I find it hard to believe that in the long term, say 10 years or more, any other asset class has a reliable probability of performing better; investments in developed world economies seem to be threatened by unfathomable debt concerns; investments in the developing world have substantial governance risks; bonds, cash and quasi-cash may be threatened by inflation; and investment in direct property would place an unreasonable proportion of our portfolio in one investment. I fully recognise these are only my very fallible opinions, but doubt that any rigorous data-driven quantitative analysis would provide a reliable guide to a very uncertain future, when many of the old rules may no longer apply.

So in two words our plan is to 'do nothing', whilst we try to ensure that financial stress does not result in undue emotional strain, and we live in hope that any new financial order will be benign to Australian small investors, including self funded retirees.

Steve Robinson is a retired engineer living on the coast of Victoria, with most investments held in a self managed superannuation fund which he shares with his wife.

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