

EQUITIES

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COORDINATOR'S MESSAGE

By Brian Matthews

Zac Zacharia, a Representative of Ord Minnett again contributes to Equities Bulletin, this time to critically examine an expression familiar to many: *"It's not timing the market that is important, it is time in the market"*. Zac refers to four stages of the market cycle and, using seasonal weather patterns as an analogy, emphasizes that there are times to sow, times to reap (and profit), and times to leave the fields fallow. The article provides guidance aimed at identifying what stage (or season) your investments are currently in, and strategies to enable you to make appropriate buy, hold, sell investment decisions.

Our second article *'An Introduction to the Elliott Wave Principle'* by Daniel Goulding is indeed an introduction, as this is the first of a series of articles by Daniel that will appear in future editions of *Investors Voice* and *Equities Bulletin*. In this article Daniel backgrounds the formulation of the Elliott Wave Principle, its foundation being the Fibonacci sequence, and notes that the Elliott Wave is considered by its proponents to be technical analysis in its purest form. It is contrasted with both fundamental analysis and orthodox technical analysis.

This introduction concludes with interpretations of current price action that may see a significant bear market rally prior to a bottoming of the S&P/ASX 200 at 2693 or 1358! Look for more from Daniel Goulding in the August edition of *Investors Voice*, which will also include a regular article by Robert Vagg - a highly rated presenter at AIA seminars and last years National Conference. And, keep this July introductory article by Daniel handy to facilitate understanding of his August *Investors Voice* article.

Brian Matthews is a member of the AIA.

TIMING DOES MATTER WITH INVESTMENT DECISIONS!

By Zac Zacharia

Ever heard the expression “IT’S NOT TIMING THE MARKET THAT IS IMPORTANT, IT IS TIME IN THE MARKET”? This is an expression that investors start to hear frequently from their advisors and in the media during times of market crashes and declines. In fact, we are hearing it more than ever lately. The question is, does this statement hold true?

“TIME IN” versus “TIMING”

An entire thesis can be written on this subject and how it is used in investment conversations between advisors and their clients and the media (and it would not all be complimentary!) The fact is that one cannot take the statement on face value and apply it to everyone’s financial situation because every investor’s financial situation is different, and so the answer will be different for everyone.

For shorter term traders, especially day-traders, timing the entry and exit of a trade is absolutely critical as the trading range for profit may be small, and especially in volatile markets, a profit can quickly reverse and turn into a loss. So timing is of the essence. For medium and longer term investors (such as Superannuation funds) who have the luxury of time in their favour, short term price aberrations can be endured, making a small drawdown tolerable as the investor awaits greater returns over time. But, the drawdown must be limited, even amongst investors, to a maximum allowable level to prevent a financial catastrophe.

If there is anything that investors will have learned from the performance of their investments in the sharemarket during the past 18 months, it is that the old “Buy and Hold” approach to investing can be a naïve and downright destructive influence to long term wealth. Investors should actively manage their investments with proven rules and an awareness of the overall trend to ensure that they never let a profit turn into a loss, and perhaps more importantly, never let a small loss turn into a larger loss!

The passage of TIME IN the market can and does indeed create wealth for an investor. TIME IN the market is certainly important for an investor – after all, the large capital gains are the result of staying invested with a longer term uptrend. But TIMING is probably more important – in other words, knowing when to be invested to take advantage of the majority of the growth and especially with regards to timing the selling down of that investment to lock in your profit! Recognising the warning signals to sell is one of the most important parts of the investment decision, as that is what will define and quantify the success or failure of the original investment decision.

One merely has to look at iconic companies like General Motors (GM) – a stock that has been around for generations, that is now sadly trading at a share price last seen more than 50 years ago! How many “buy and hold” investors are there who would have bought GM over 50 years ago and have never sold it despite the huge growth it achieved (and have now given back 50 years of growth)? There are too many other examples like this on our market as well.

THE ‘SEASONS’ OF THE MARKET

Astute investors understand that all markets move in cycles, similar to seasonal weather patterns. Taking this analogy with the seasons further, just like in nature, the stronger plants will start to bloom and flourish again once the Winter inevitably ends and turns to Spring.

Successful investing depends on identifying what Stage or “Season” your investment is currently in, and making your investment decision accordingly. Broadly speaking, one can identify four stages in any market cycle:

Stage 1 – Accumulation (Investors should BUY during this stage)

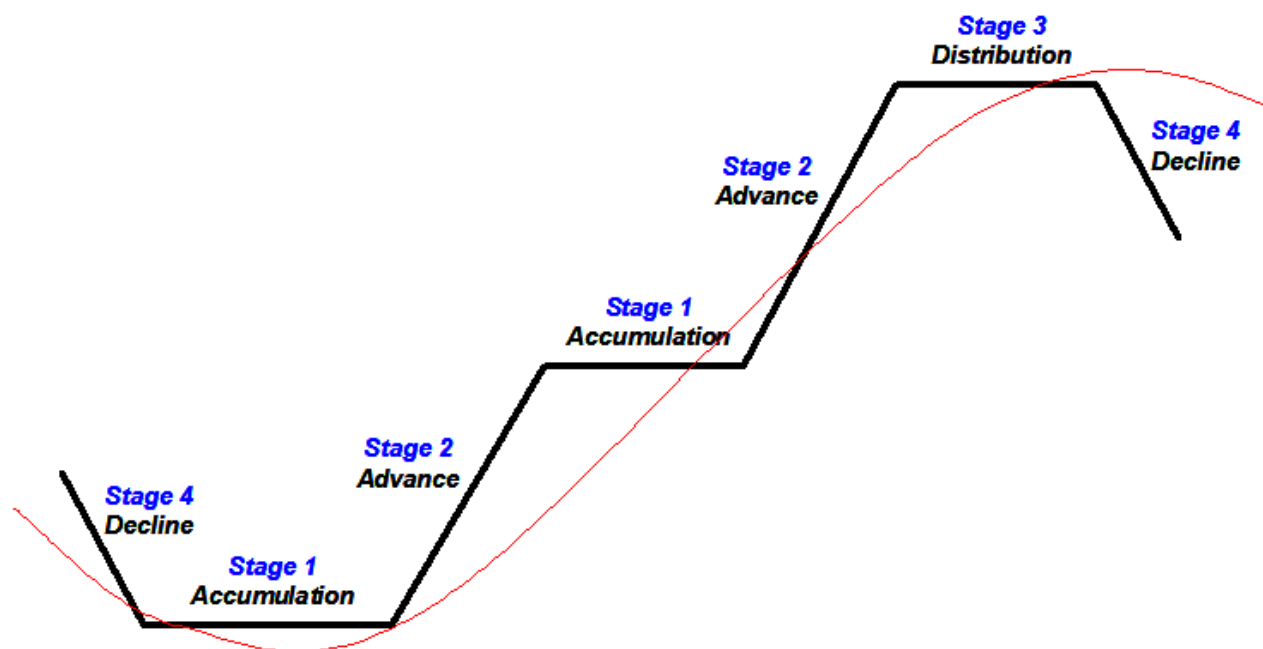
Stage 2 – Advance (Investors can ADD to their investment on price weakness during this stage)

Stage 3 – Distribution (Investors should tighten profit stops and exit at the sign of trouble)

Stage 4 – Decline (Investors should stay out of this market condition)

The chart in Figure 1 below is perhaps an overly simplistic way of categorising the investment cycle into four defined stages, and applying the “seasonality” theme for the purposes of the explanation. Note that it also shows the pattern of a 30-week Moving Average in relation to price during these stages.

Figure 1



Winter	Spring/Autumn	Summer	Spring/Autumn	Summer	Spring/Autumn	Winter
OUT	ENTER	IN	MONITOR	IN	TAKE PROFIT	OUT

In an ideal world, the market would move sequentially between Stage 1, 2, 3 and 4 and then back to 1 and so on. However the reality is that the market doesn't do this and is never as clear cut as the above example.

Stage 1 and Stage 3 may appear identical as they form, in that the market is in a consolidation phase or sideways trend during both stages, yet the difference is obviously significant when one looks at the subsequent stage that emerges from this consolidation. A Stage 1 leads into a bull market (or uptrend) whereas a Stage 3 leads into a bear market (or downtrend).

There are some subtle clues that investors should look for from a charting perspective, to determine the difference between the two stages. For example, Stage 1 is typically accompanied by higher volume as prices rise to the upper part of the range and lower volume on price declines to the support level at the lower part of the range. Stage 3 is quite the opposite – and typically shows higher volumes as prices decline to the lower part of the range and lower volumes as prices rise to the upper part of the range.

Another clue is provided by the behaviour of the 30-week Moving Average during the consolidation. The longer the period of the consolidation, the flatter the 30-week Moving Average will be. However, should the moving average start to rise, and price spends most of the time above it, it indicates a possible Stage 1. On the other hand, if it starts to fall, with price spending most of the time below its moving average, the stock could be in a Stage 3.

Either way, one will not know whether the sideways range is a Stage 1 or a Stage 3 until after the subsequent stage is confirmed by way of a breakout of the trading range, to the upside or downside, and accompanied by the 30-week Moving Average starting to rise or fall respectively.

Figure 2 below is a chart of Commonwealth Bank of Australia (CBA) on a weekly timeframe. It clearly shows the dominant Stages that the market was in over the last five years.

It must be remembered that there are also 'Stages within Stages' in any stock. And it is within each of these micro-stages that different investment styles and motives are found. For example, Stage 2 in the chart below of CBA shows several Stage 1's, multiple Stage 2 advances, and also several Stage 4 declines.



INVESTMENT POKER - WHEN TO HOLD 'EM, WHEN TO FOLD 'EM

Once an investor has identified at what Stage the market is trading, the decision on what to do becomes clearer.

Stage 1 - Accumulation

Buying a stock during Stage 1 is the most rewarding and profitable point to enter the market. Investors who purchase a stock during this stage will be well rewarded, provided they identify that a consolidation is indeed Stage 1.

This Stage is characterised by chart patterns resembling a "W" or a "V" pattern, or multiples of these. Whilst the stage is in formation, levels of support and resistance can be identified by the trading range, and the patterns of swing highs and lows being generally flat in trend.

The astute investor will "average-in" to the stock by buying a portion of the total investment every time the price drops (on low volume) close to the support level. However, a very strict "escape plan" for the entire holding should be implemented a reasonable distance below the support level.

An alternative entry strategy is to wait for the upper resistance level to be broken, signifying a breakout to a possible stage 2. This is a later, but safer entry point as it will catch the start of the new trend. The drawback is there may be some whipsaws while the trend establishes itself. To avoid any of these bear traps, one can wait for confirmation, and buy on the first or second pullback instead of the breakout.

Stage 2 - Advance

Once Stage 2 is confirmed, it is highly likely the investment will be in profit already. The start of Stage 2 can be volatile as nervous investors may not trust that a new bull market has indeed started. During this stage, the price will make progressively higher swing lows and swing highs, and the stock will rise and remain above its rising 30-week moving average.

Investors who purchased during Stage 1 should monitor their positions regularly, at least once a week, and raise stop-out levels to at least a break-even position. Remember, when it comes to investing, rule number 1 is to never let a profit turn into a loss.

An investor can also choose to buy more stock during this stage and add to their existing position. Alternatively, if the investor had missed the earlier entry points during Stage 1, then Stage 2 offers a very low-risk entry point during any period of price weakness, particularly while the new uptrend is just getting established.

Stage 3 - Distribution

Stage 3 is the precursor to a period of bearishness. This stage is characterised by “M” or upside down “V” chart patterns and a volume trend that increases on price weakness. The pattern of swing highs and lows will now be relatively flat. Investors should closely monitor their holdings during this stage, watching for a break in support to signal the start of Stage 4. At that point, investors should consider selling out of their position.

Stage 4 - Decline

Stage 4 is a period for investors to stand aside from the temptation of buying a share simply because it is “cheap”. During this stage, the stock will fall and remain below its falling 30-week moving average while making a series of progressively lower swing highs and swing lows.

Investors should seek to invest in alternative asset classes such as Fixed Interest or Property, or search for shares that are in sectors exhibiting Stage 1 or 2 patterns.

LEARNING FROM NATURE

Successful investors learn to recognise the right time to be invested in the market, or more specifically, a specific sector within the market. Because of the diversity of the stocks and sectors on our market, there is almost always a sector or a stock which is worthy of investing when all else turns bad.

Creating wealth is the driving motivation of investing. There is no point creating wealth if you don't take the time and effort to preserve the gains. There is nothing more heart-wrenching than seeing years of investment returns and capital growth wither away because the investor subscribed to the old adage that the longer they stayed invested, the larger the returns.

Just as farmers will sow their seeds during the late Winter and Spring, they will reap the fruits of their labour during late Summer or early Autumn. Any fruits that are still in the field during the Winter will more than likely wither and die.

So let us take this investment lesson from nature herself – learning that there is a time to create wealth, and a time to reap it.

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Sources: 1. Charts - IRESS. 2. Darryl Guppy Multiple Moving Average methods

AN INTRODUCTION TO THE ELLIOTT WAVE PRINCIPLE

By Daniel Goulding

Once upon a time, the discipline of technical analysis was a magnet for ridicule from many academics who insisted that the market was efficient. It also served as the butt of many jokes. My favourite quip is the one about every ship at the bottom of the ocean having a set of charts. Despite constant barbs from critics, the popularity of technical analysis continues to grow, particularly in the current investment climate where the Achilles heel of fundamental analysis has been exposed. It pits the individual against the market, requiring the analyst to make assumptions about the future which could prove erroneous. The technical analyst on the other hand simply defers to the market. After all, the market is only ever wrong twice - at the top and bottom. Technical analysis, in contrast to fundamental analysis, does not attempt to second-guess the market.

Elliott Wave is considered by its proponents to be technical analysis in its purest form. It elevates price action above all else in contrast to orthodox technical analysis which tends to concentrate its energies on the first and second order derivations of price, trend and momentum respectively. The orthodox technician acknowledges at the onset the difficult and sometimes dangerous nature of catching tops and bottoms in the market. As a result, they usually reserve their focus to identifying the direction of the major trend. The Elliottician is not subject to the same limitation however. An excellent command of the manner in which price unfolds can identify potential reversal points before they occur in real-time. While secondary indicators that depict trend and momentum are utilised, they merely provide guidance as to the expected probability of a likely scenario or when price action itself is not conducive to determining a likely outcome. For the Elliottician, price is the most important indicator.

The Elliott Wave Principle (EWP) was formulated by an accountant, Ralph Nelson Elliott, in the 1930s. After spending countless hours studying the behaviour of the stock market, he concluded that the stock market was not chaotic but rather *fractal* in nature. According to Benoît Mandelbrot, a *fractal* is generally "a rough or fragmented geometric shape that can be split into parts, each of which is (at least approximately) a reduced-size copy of the whole." While Elliott never used the term *fractal*, he nevertheless believed that the stock market unfolded in repetitive cycles, reflecting rhythmic oscillations in public opinion across different but simultaneous timeframes. The crux of the EWP is that these rhythmic vacillations between optimism and pessimism result in specific price patterns that can be identified and used to forecast future changes in public opinion and in turn, the stock market. While Elliott was initially interested in the behaviour of the stock market, he concluded that the EWP was but one piece of a much larger law that governed the evolution of humankind and natural phenomena itself.

The foundation of the EWP is the Fibonacci sequence, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89 and so on, identified by the thirteenth century mathematician, Leonardo Fibonacci. A key ratio derived from this sequence is *phi*, commonly called the golden ratio. This ratio is determined by dividing any number in the Fibonacci series by its preceding number (n.b. this does not work with the first few numbers in the sequence). An intriguing concept derived from *phi* is the Golden Section, which is essentially any length that is divided according to *phi*. According to Peter Tompkins, Plato "went so far as to consider *phi*, and the resulting Golden Section proportion, the most binding of all mathematical relations, and considers it the key to the physics of the cosmos" (Tompkins, *Secrets of the Great Pyramid*, 1971). It is remarkable that the Golden Section is constantly found throughout nature, and in inanimate objects, such as the Great Pyramids. Indeed, the Golden Section, an integral part of the EWP, appears to be the universal principle that governs self-organising systems including humankind. The EWP has found some support from within the scientific community. Back in 1996, three physicists authored a paper for a Journal De Physique, entitled Stock Market Crashes, Precursor and Replicas. Their conclusion follows:

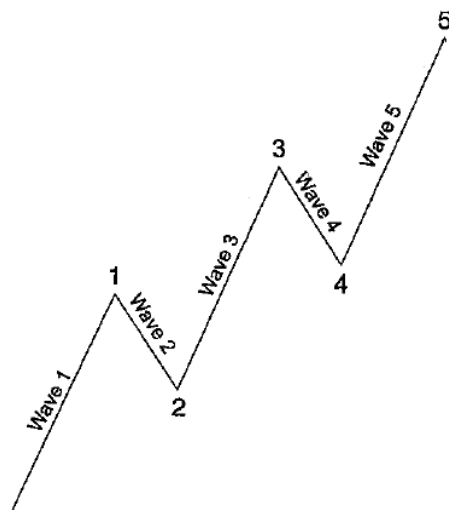
It is intriguing that the log-periodic structures documented here bear some similarity with the 'Elliott waves' of technical analysis A lot of effort has been developed in finance both by academic and trading institutions and more recently by physicists (using some of their

statistical tools developed to deal with complex times series) to analyze past data to get information on the future. The 'Elliott wave' technique is probably the most famous in this field. We speculate that the 'Elliott waves', so strongly rooted in the financial analysts' folklore, could be a signature of an underlying critical structure of the stock market (Sornette, Johansen & Bouchaud 1996, *Stock Market Crashes, Precursor and Replicas*).

Elliott's work has been taken up by others, most notably Robert Prechter, Jr who pioneered the field of socionomics. A key insight from this discipline is that the social mood (also known as public opinion), governs the behaviour of economic, social and cultural developments, rather than the reverse. While this conclusion may attract the ire of sceptics, it does explain why the stock market is an efficient discounting mechanism – the future is merely a reflection of the present social mood. The controversial nature of socionomics and the insights that have been generated from this discipline are however outside the scope of this article.

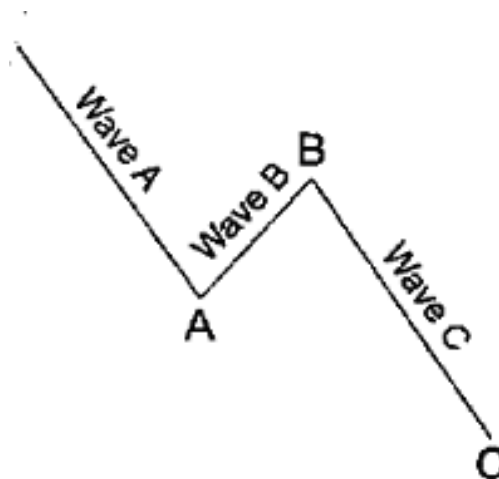
With respect to the stock market, Elliott observed that it alternated between five and three waves at different degrees of the trend. A rising market unfolds in five waves, labelled 1-2-3-4-5, at the largest degree of trend, whereas a declining market unfolds in three waves, labelled A-B-C at the largest degree of trend. Figure 1 depicts a motive wave which consists of five waves in total. Waves 1, 3 and 5 head in the direction of the trend while waves 2 and 4 move counter to the trend. Figure 2 depicts a corrective wave which consists of three waves in total. As its namesake implies, it corrects the prevailing trend. Waves A and C head in the direction of the countertrend while wave B moves in the opposite direction (the same direction as the prevailing trend).

Figure 1: A Motive Wave



Source: Adapted from Frost & Prechter 2005, *Elliott Wave Principle*, 23

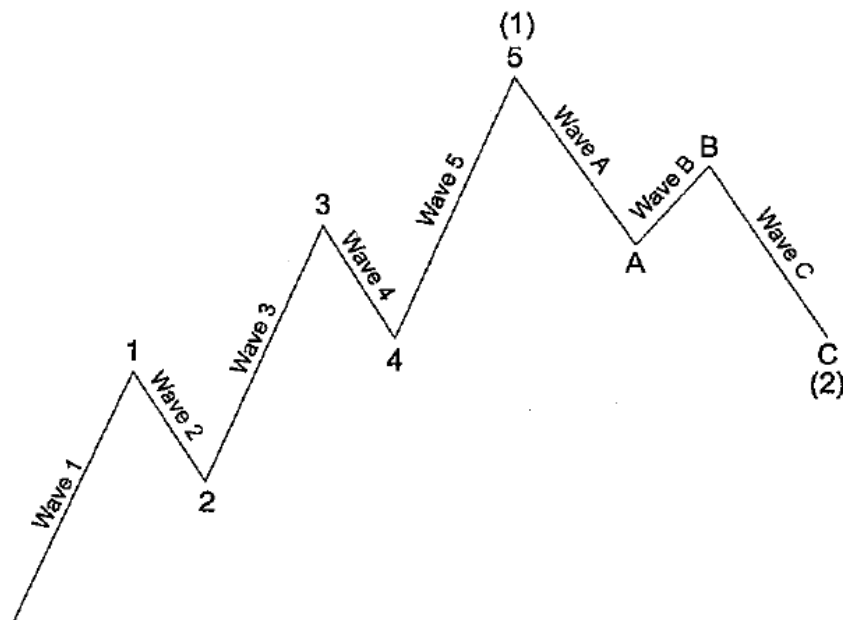
Figure 2: A Corrective Wave



Source: Adapted from Frost & Prechter 2005, *Elliott Wave Principle*, 23

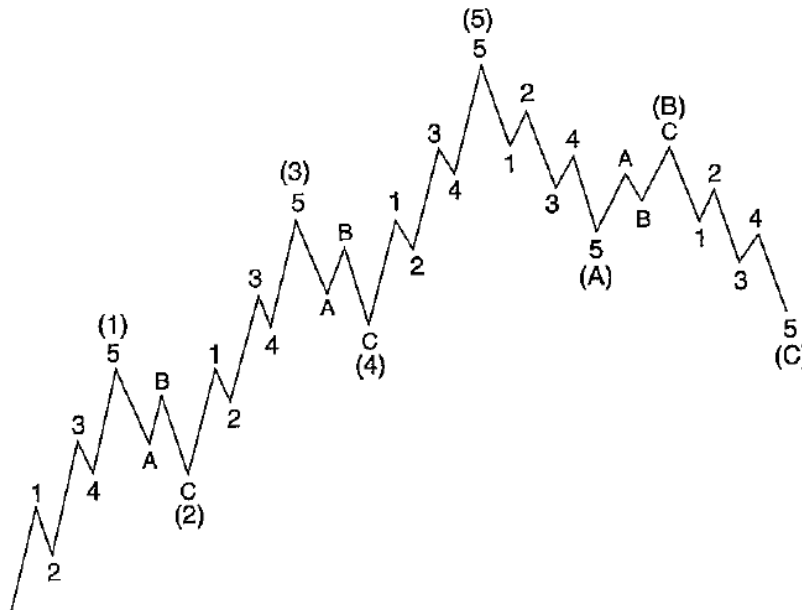
A complete motive wave (1-2-3-4-5) is followed by a corrective wave (A-B-C), which corrects some portion of the prior motive. The complete motive wave and corrective wave form waves 1 and 2 of an even larger motive wave. Figures 3 and 4 depict the fractal nature of the market. The repetitive cycles identified by Elliott continue to replicate on successively larger timeframes, underpinning the ever expanding nature of the stock market.

Figure 3: A Motive Wave followed by a Corrective Wave



Source: Adapted from Frost & Prechter 2005, *Elliott Wave Principle*, 23

Figure 4: The Fractal Nature of the Market



Source: Adapted from Frost & Prechter 2005, *Elliott Wave Principle*, 24

While motive and corrective waves play out as five and three waves respectively at the largest degree of trend, this does not apply to the smaller increments of each wave, which can unfold in either three or five waves depending upon the exact position of social mood and the consequent price pattern.

To interpret the price action and in turn quantify the social mood, the Elliottician defers to a number of rules and guidelines that dictate how a particular price pattern should be counted. The complete set of rules and guidelines fall outside the scope of this article however. For those readers interested in pursuing further information on this topic, the ASX has a web page that goes into some detail covering the basic tenets of the EWP. For a full exposition of the rules and guidelines, *Elliott Wave Principle*, penned by Robert Prechter, Jr and Alfred Frost is a candidate. A few basic tenets are essential however for the reader to decipher my outlook for the S&P/ASX 200 below.

The few tenets I consider essential for the layperson to remember are:

- i) Wave 3 is never the shortest wave.
- ii) The terminus of wave 4 does not occur within the price territory of wave 1
- iii) Wave 2 can not terminate beyond the origin of wave 1
- iv) Wave 3 must move beyond the terminus of wave 1.
- v) With respect to waves 1, 3 and 5, at least one but never more than two waves subdivide or extend into their own set of five waves (my chart of the XJO below reveals an extended third wave).

One last tenet that should always be kept in mind by the layperson is that corrections and bear markets tend to terminate within the vicinity of the prior wave 4 of lesser degree (I had developed this insight myself long before I ever picked up a book on the subject. When I saw it articulated in *Elliott Wave Principle*, the subject had my undivided attention). With respect to the final bottom for the XJO, I have two targets in mind:

- i) 2693, the low from March 2003, the bottom of the last bear market.
- ii) 1358, the low from November 1992, the bottom of the last significant bear market (most Elliotticians count the price action from 1987 to 1992 as a triangle terminating at 1358).

Given that both of these levels are prior wave 4s in my analysis, they both make the cut for the short-list for the final bottom. While I do not want to be guilty of second guessing the market, I am optimistic that the former of these targets will hold the market. Not only is it a prior wave 4 of some significance, it also represents a Fibonacci 61.8% retracement of the rally from 1974 to 2009 and an approximate Fibonacci 61.8% decline from the all-time high. This level should therefore act as a gravitational pull on the market. While I am optimistic that 2693 will hold, we should remain cognisant of the fact that if this level is breached decisively, the next technical target of merit is 1358.

As long as one remembers the few brief tenets listed above as well as the fractal nature of the market, one should be able to follow an Elliott Wave count without too much difficulty. For the sake of simplicity, I have not delved into the standard labelling system for the different degrees of each wave because this will likely confuse the layperson, rather than making it easier. I tend to use a simple system whereby relatively larger degrees of wave are accompanied by a greater font size. Within the body of this article, any reference to a wave that is found on any of my charts will be underlined to distinguish it from other grammatical devices.

My principal count for the S&P/ASX 200 (XJO) is depicted below in Figure 5. Kindly note that this is but one interpretation of the price action. I have other possible counts, albeit I consider less likely (it is usual to have more than one possible count because the market does not unfold precisely in a textbook manner and because waves can continue to subdivide much to the frustration of the Elliottician). My other counts call for new lows in the marketplace, albeit at different times. This may beg the question from readers: is it possible the market has already traced out its final bottom? As far as I am concerned, such a development is extremely unlikely. Price action does not lend itself satisfactorily to such an interpretation. Moreover, the volume accompanying the rally has a bearish signature, rather than the characteristics of the initiation of a new bull market. This technical view is affirmed by sentiment. Typically, the point of recognition (when the general populace become cognisant of a new trend) occurs at wave 3 of 3 (the third wave usually subdivides into its own set of 5 waves), which is usually located around the mid-point of the entire bull market. According to my propriety sentiment indicators, such recognition occurred within a few weeks of the bottom. As such, price action in conjunction with volume and sentiment tends to preclude any possibility the market has traced out its final bottom.

With respect to my principal count, I am looking for the market to fall in 5 waves to constitute A, the first downleg in this bear market. This bottom will be followed by a significant bear market rally, constituting B, taking the market back to 4285 or 4775 over the course of six to nine months. The final downleg, constituting C, will then kick off, targeting either 2693 (the low from 2003) or 1358 (the low from 1992) over the course of one to two years. The possible future progression for the market is depicted in Figure 6.

While this count is my personal favourite, not all Elliotticians concur. There is the possibility that the March low was wave 5 rather than wave b of 4, and that we have already commenced the significant bear market rally, B, that I am looking for in the future. While I am open to this possibility, I believe the probability of such a development is on the low side given the nature of the price action into the low and the level of sentiment associated with the move. Another objection to my count, which I find plausible, is that I have incorrectly identified the nature of the waves. Essentially, what I have labelled as waves 1-2-3-4 should in fact be labelled A-B-C-X-A-B-C-X with one last A-B-C to come to complete what is called a triple zigzag. This is depicted in Figure 7. This is my second favourite outcome for the market. If this count is in fact a valid representation of reality, the next low will prove the final bottom for the market.

Figure 5: Weekly Chart of the S&P/ASX 200 Source: Iress



Figure 6: Weekly Chart of the S&P/ASX 200 (Logarithmic) Source: Iress

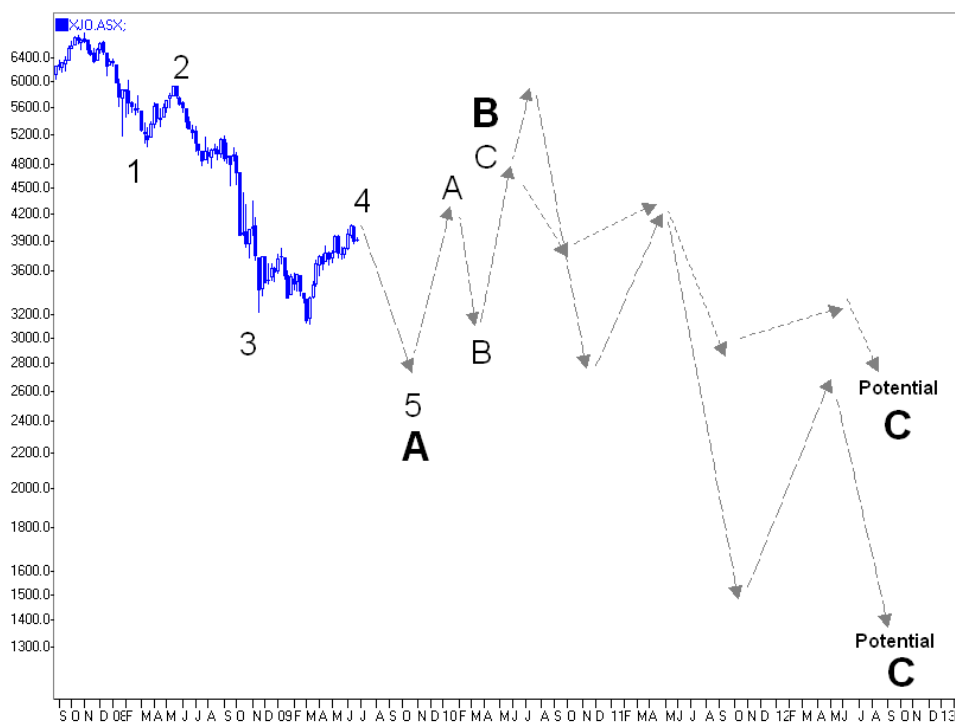
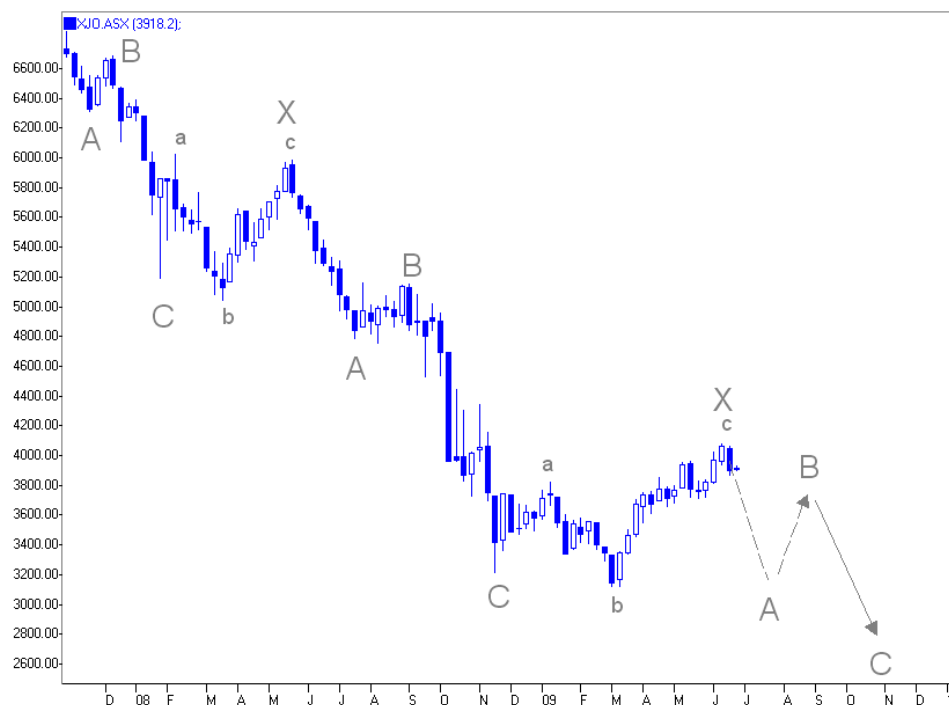


Figure 7: Weekly Chart of the S&P/ASX 200 Source: Iress



Kindly note that I have used Elliott's original labelling for the pattern above to illustrate that the decline is unfolding via a series of 3s (short-hand for 3 waves).

As time unfolds, the stock market will continue to shed further light into which of the scenarios painted above is the correct one. It is possible that the move off the November low (which I consider to be the true intermediate-term low to date, not the recent March low) will morph into something much more complicated, frustrating both bull and bear alike, and proving the source of headache for the Elliottician.

The counts presented above should be used as a guide as to what the future may hold for the investor. It should be remembered that Elliott Wave, like technical analysis, is not about prediction, but rather probabilities. As the quip asserts, forewarned is forearmed. An investor who is prepared will fare much better than one who makes knee-jerk reactions. A satisfactory understanding of the EWP will enable the investor to discern potential outcomes and to position oneself accordingly in line with their investment objectives. While EWP is not an easy discipline to master, then again, nothing worth doing is ever easy.

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