

EQUITIES

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COORDINATOR'S MESSAGE

By Brian Matthews

Exchange Traded Funds or ETFs are basically index funds that are listed and traded on a stock exchange. We publish below a letter from Owen Richards, long serving predecessor as coordinator, and a regular contributor to Equities. In his letter Owen takes issue with the article that appeared in the August edition of the *Investors Voice* - '*Now is not the time for indexing*' written by Dr Nigel Wilkin-Smith, Head of Strategic Research Unit, van Eyk Research Limited. A response from Nigel is published below Owen's letter. The exchange makes interesting reading.

Given that this form of listed security is said to be one of the fastest growing forms of investment products in the world and to perhaps assist with a better understanding, we are pleased to include an article titled '*Exchange Traded Funds*' by Jamie Nemtsas, Director of Lachlan Partners. This article first appeared in his firm's publication '*Investing Times*' in July 2009 and brings with it a cautionary note.

In our final article, Tejay Lovelock, Private Client Advisor with Kinetic Securities refers to a 31 years inflation cycle in the USA which he states last peaked in 1982 and is not due to peak again until 2013. He relates the peaks to precious metal prices and the potential opportunity a 2013 peak may present. In his article '*Trading Gold - A New Way*' Tony continues our Exchange Traded Funds theme with reference to two Gold ETFs listed on the ASX.

Brian Matthews is a member of the AIA.

LETTER TO THE EDITOR

By Owen Richards

The following is a letter submitted by an AIA member in response to the article 'Now is not the time for indexing' (<http://www.investors.asn.au/downloads/Voice/2009/08/0908IndexingWilkin-Smith.pdf>) published in the August Investors' Voice. As the next issue of the IV will not be published until early November we thought it more timely and appropriate to reproduce the letter in this Equities Bulletin. It is followed up by a response from van Eyk.

Dear Editor,

I was a little startled by the lead article in the August 2009 *Investors' Voice*, entitled 'Now is Not the Time for Indexing'. If I understand the article correctly, it is suggesting that investors (like me) that are getting out of, say, managed funds and into an indexed entity, such as Exchange Traded Funds (ETF), may be doing so at the wrong time.

This is apparently because, the writer says, the likely lower performance of future equity markets, which will have a greater volatility, will require investors to enhance their returns on growth assets. He adds that this will require adept active management focussed on quality stocks and with selection based on good fundamental research.

The author, Dr Nigel Wilkin Smith of van Eyk Research, may well be correct. However, one of the reasons that many investors are moving into indexed funds is the apparent inability of even professional fund managers to match the returns of indices, let alone to better them.

A case in point is van Eyk's own Licensed Investment Company (LIC), van Eyk Three Pillars, which trades on the ASX as VTP. This company's investments comprise three sub-portfolios, or 'pillars', that are 'drawn from the ASX 300 Index and are intended to deliver above market returns with an attractive dividend yield'.

The company has, by and large, delivered on the dividend part of its intention, at least until recently. However, like many other professionally managed offerings, it doesn't seem to have done quite so well on delivering above market returns. The following diagram is reproduced from the Australian newspaper's interactive charting facility:

<http://djcs.marketwatch.com/cxb/TheAustralian/InteractiveCharter/Default.aspx?symb=xao>



In this case, we are looking at the All Ords/ASX 200 over a five year period (blue lines) and we can reasonably assume that indexed investments, for example SPDR S&P/ASX 200 Fund (STW); formerly Street Tracks, are matching an index closely. However, VTP (red line) is operating well below the index for almost all of its length.

Now I can't guarantee that this diagram is necessarily completely comparing apples with apples, but there is a sufficient disparity between the two curves, based on the past, to query whether things will be all that much different in the future. If professional fund managers have so much difficulty in matching the indices, why should non-professional investors be able to do any better, either now or in the future?

I have moved a substantial part of our SMSF equities portfolio into ETFs, as a solid, diversified foundation, or 'core', for the portfolio. These are subject to active management, essentially for timing purposes. They are complemented by the active management of quality shares, based on their fundamentals. While this may not be the time for indexing according to the article, I am yet to be persuaded that there is a better alternative.

Yours sincerely,

Owen Richards,
AIA Member
7 August 2009

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VAN EYK RESPONSE TO OWEN RICHARDS

By Nigel Wilkin-Smith

Mr. Richards rightly points out that many active investment managers, particularly those who focus on equity markets, have failed to deliver on their objective of outperforming their benchmarks in recent times. Indeed, the skepticism he expresses about their ability to do so in the future is a sentiment to which I allude in the opening paragraph. Nonetheless, for the reasons that I outlined in my article (in particular the likely prospect of high macroeconomic volatility and the dampening impact of this phenomenon on the performance of capital markets), van Eyk believes that active management premised on sound, well-resourced fundamental research will be integral to portfolio return over the next investment cycle. While Mr. Richards uses a "core-satellite" approach to manage the equity component of his own SMSF, through the use of ETFs and a small actively managed portfolio of shares, we believe that the average retail investor would struggle to implement this strategy effectively in a challenging environment where the risk of capital loss is significant.

With respect to the criticism of van Eyk Three Pillars (VTP) Limited, Mr. Richards is correct to assert that the comparison he makes between the performance of the VTP share price and the ASX 200 or All Ordinaries Index lacks validity. Although there is an obvious relationship, the share price does not always accurately reflect the performance of the underlying portfolio, which has regularly outperformed its benchmark since inception. In addition, it is important to note that the share price does not include the considerable distribution from fully franked dividend payments over the last five years.

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S&P'S LATEST RESEARCH IN THE AUSTRALIAN MARKET

Percentage of Funds Outperformed by the Index

Fund category	Year to date	1 year	3 years	5 years
Australian shares	50.8	28.7	56.3	66.1
Australian share small cap	60.0	21.5	35.0	52.2
International shares	38.3	64.6	71.3	76.1
Australian bonds	25.8	87.9	94.1	97.2
Australian equity A-REIT	2.8	28.9	50.0	58.6

Source: Standard & Poors / Morningstar; There has been no deduction of expenses from index returns. Date to 30 June'09.

- Economic cycles will drive market performance and present different opportunities to different managers
- Question is not active or index; about building a portfolio core around indexing for cost control & risk management
- Understanding where active positions have the opportunity to deliver added value

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EXCHANGE TRADED FUNDS

By Jamie Nemtsas

Exchange Traded Funds (ETFs) continue to be the latest investment craze sweeping the world with Australia riding on their coattails. They are being touted as simple investment products, however they are actually quite complex in terms of their structure. For the last 18 months investors should have been simplifying their portfolios, concentrating on direct investments on the basis that complex investments can introduce a layer of risk that really is unnecessary.

Right about now there will be a lot of you saying that ETFs are extremely simple investments, that they are just baskets of direct shares that you can buy on a listed exchange, like the Australian Stock Exchange (ASX), and are mostly index-type investments. Yes they are simple from this perspective, but there is more detail and added complexity, which is contained in the prospectuses that ETFs are sold under, and which most investors will never read because retail investors don't buy ETFs through a prospectus.

Market makers

Although purchased on a stock exchange, ETFs have to be created first from the physical shares that they're made up of. A creator, also known as a market maker, pulls these shares together, creates the ETF shares, sets a market and then sits in the background supposedly acting as a buyer and/or seller of last resort. What this means is that if you own say 1,000 units of an ETF that you are trying sell, if no other mum or dad wants to buy your shares, then the creator steps in and buys them. Not ever being stuck carrying the can sounds like a boon right? Maybe it's too good to be true? Maybe, but it should be noted that events over the last couple of years have been the litmus test for many structured products and ETFs have passed with flying colours.

Let us state for the record that we are not against using ETFs; in fact, Lachlan Partners has been recommending them for more than a year. As usual though, we advocate understanding what you invest in before you invest. You should be comfortable with using ETFs in your portfolio if you are comfortable with the market maker process and are happy to trust the 'word' of the ETF issuer and all of the marketing spin that they will be there to buy your shares when you and every other ETF investor wants out.

If you think the 50% saving over wholesale index funds mitigates or justifies the risk of the market maker process unknowns, then again, you should consider using ETFs in your portfolio. At around 0.2% pa though, we certainly don't think the saving on an average size investment warrants switching out of your managed index funds into ETFs.

The Australian ETF menu

Vanguard have been offering ETFs in the US since 2001 and have recently launched their ASX ETF offerings, limited to three ETFs for now as per the following table:

Exchange Traded Fund	ASX code	Benchmark	Fees pa
Vanguard Australian Shares Index ETF	VAS	S&P/ASX 300 Index	0.27 %
Vanguard All-World ex-US Share Index ETF	VEU	FTSE All-World ex-US Index	0.25 %
Vanguard US Total Market Shares Index ETF	VTS	MSCI US Broad Market Index [#]	0.09%

The aggregation of the MSCI US Large Cap 300, Mid Cap 450, Small Cap 1,750 and Micro Cap Indices.

iShares are another option if you want exposure to international markets. Their S&P 500 ETF, ASX code "IVV", is one of the most popular investments. State Street Global Advisers also has three ETFs, called SPDRs ("spiders") that provide exposure to the ASX. Their ASX 200 Index

listing, ASX code “STW”, is certainly one investment that can provide very cheap index exposure to your portfolio.

As you can see, ETFs are cheap. But before you cash in your index managed funds, we urge you to ensure you understand the exposure and benchmark index that each is trying to replicate, so you know what ‘apples’ you are buying. For example, don’t buy “VTS” if you want exposure to the S&P 500 index as you will actually be getting approximately 3,900 US companies, which is roughly 99.5% of the capitalisation of the US equity market.

We believe ETFs are here to stay and their popularity will ensure they are widely held as investors continue to seek ways to reduce the cost of their portfolios, while also trying to simplify them. In simplifying them though, we hope that investors are not inadvertently, or even unknowingly, introducing complexity and risk. Even if you currently use ETFs, if this article gets you to take a fresh and deeper look, then we will have succeeded in our aim here.

Jamie Nemtsas is a Director of Lachlan Partners. This article first appeared in the Investing Times in July 2009.

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TRADING GOLD – A NEW WAY

By Tejay Lovelock

The last time the 31yr US inflation cycle peaked, gold rallied 773% in 41 months and silver 1,132.8% for the same period.

This 31yr US inflation cycle (research available upon request) is not due to peak until 2013, so how can you potentially capitalise on this investment opportunity?

Typically Australian investors would look to listed gold companies; however there are several disadvantages/risk to this approach:

- Do you have the ability to select the correct gold stocks?
- Capital raisings could affect capital performance
- Company could go broke even though gold prices move as expected

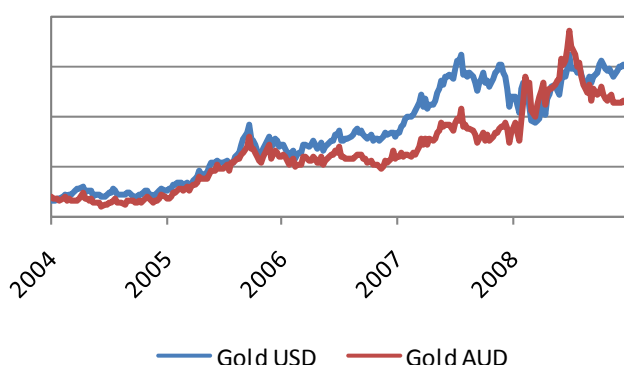
The good news is, these variables can be removed by simply investing into Gold ETFs – Exchange Traded Funds.

On the ASX there are two Gold ETFs:

- Gold Bullion Securities Ltd (GOLD) - This ETF invests directly into physical gold and is accepted by margin lenders with a LVR of around 60%
- ETFs Precious Metals Basket - This ETF invests directly into gold (42%), silver (26%), platinum (20%) and palladium (12%)

It's important to point out here that historically other precious metals such as silver have outperformed gold during periods of rampant inflation and thus holding a diversified portfolio of precious metals using ETPMPM has its merits however leveraged exposure is currently only available on the GOLD ETF.

Therefore by using ETFs as your investment vehicle to capitalise on precious metal price movements, you can do away with the risks associated with precious metal companies... apart from one - currency exchange rate movements.

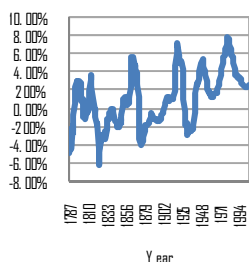


Because gold is priced in \$USD, movements in the AUD/USD exchange rate can have a significant impact on your investment returns in Australian dollars. The graph on the left highlights this with comparison of gold prices in \$AUD compared to \$USD.

As it can be seen, there are times of significant divergence between the actual price of gold in \$USD and investor returns in \$AUD. This can be corrected using a simple Foreign Exchange (FX) Rate hedge – contact us for more information.



Over the past 16 months the USD gold price has hovered around \$900 resulting in some investors turning a blind eye to the investment opportunity that gold and other precious metals could offer. A key point to note is that commodities normally move rapidly away from a peak and not hover around the same level some 16 months later. To me, this is an indication price action over the past 16 months is consolidation, not a peak and could potentially be the half way point in the precious metals bull market.



Underpinning this view point is the 31yr US inflation cycle which is not due to peak until 2013, the last time this inflation cycle peaked in 1982 was when precious metal prices rallied 773% and 1132% respectively over a 41 month period.

My view is that as global economies improve, government stimulus and bailout packages are likely to fuel inflation, despite potential reserve bank attempts to control this risk. Evidently the timing of these stimulatory measures feed perfectly into the 31yr inflation cycle.

In summary, ETFs are a new investment vehicle for Australian investors to capitalise on precious metal price movements without the risks and headaches associated with direct stock investment. In addition by using a simple currency hedge, returns from precious metals in \$USD can be more accurately reflected in Australian dollars providing Australian investors with a near perfect precious metals investment solution.

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