

EQUITIES

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INTRODUCTION

By Alison Harrington

The past two months has seen much unpredictability in the share market with an overall down trend masked by strong daily positive and negative fluctuations. Our guest writers in this edition provide an overview of two sectors – the healthcare sector and Australian real estate investment trusts – as well as an overview of the market.

Rudi, from FN Arena, gives his overview using worldwide economic fundamentals combined with technical analysis of index movements to discuss a possible worldwide correction. His insightful and thought provoking comments will make you want to explore the issues more thoroughly.

Rudi also provides an in-depth look at the healthcare sector, exploring a number of stocks and outlining his reasons why the sector is over-priced.

AREITS were the darlings of the boom and then the shock of the GFC. Zac looks at the sector fundamentally and technically and discusses the opportunities in this area. He indicates some companies which are worth you researching as possible recovery opportunities when this sector regains market confidence.

Alison Harrington is an AIA Councillor and Coordinator of the AIA Queensland Committee.

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GOD BLESS YOU

By Rudi Filapek-Vandyck

Seven hundred years ago in Europe, whenever someone would sneeze people would instantly respond with "May God bless you". The social tradition has since spread around the world and remains in practice to today.

In modern times the practice has become a gesture of politeness, but back then, in the fourteenth century, things were different. If someone sneezed this could mean the person had caught a cold, which weakens the body and can cause severe discomfort. There was no social security in place, so any illness indicated bad news.

Sneezing could also mean the person was on route to develop a more severe illness, such as the flu or bronchitis. Under a worst case scenario, sneezing could be the first signal of having caught the black plague. This virtually always meant certain death.

It has been estimated that by the end of the fourteenth century the black plague had decimated the total population in Europe by up to 60%. It took the region 150 years to recover and the disease would remain as a threat until well into the 19th century.

It's not difficult to see why "God bless you" has remained a firmly entrenched social tradition ever since.

There is a clear parallel with what's happening in today's financial markets. As leading indicators have started to roll over, and with many kinds of problems and worries haunting major economic zones across the globe, few experts are still doubting the global economy has sneezed.

What does it mean? Will the world experience a rather mild form of a cold, or are we looking towards something more sinister?

Economist Lakshman Achuthan, who specialises in leading economic indicators, has sought extra-media exposure these past weeks as various leading indicators published by the company he co-founded, the Economic Cycle Research Institute (ECRI), continue to point towards a significant slowdown for the US economy from mid-year onwards.

Bottom-line, reports Achuthan, even though some of ECRI's leading indicators are now at levels last seen in late 2007, it remains yet to be determined whether the US economy will dip back into zero or negative growth later this year or in 2011. As things stand right now, ECRI is only prepared to forecast growth will dip significantly.

During his tour of US media, Achuthan also made one very important admission: it is impossible to know yet whether the US economy is heading towards a double-dip recession or whether the world's largest economy is simply experiencing a mid-cycle economic pullback from a stimulus-boosted GDP number late last year.

This is because all slowdowns start off in a similar fashion.

Hence my comparison with the bubonic plague in Europe: even though the plague peaked in the middle of the 1300s, and it never reached similar levels of devastating impact, this would not stop the disease from flaring up throughout centuries to come. More importantly, whenever someone sneezed until the 20th century, it was not possible to know whether the disease had made a comeback, or whether it was simply because of a cold.

For equity markets, the different possible scenarios represent all relatively predictable outcomes. If the global economy has merely caught a cold, share prices will likely hold up well and they might even regain their uptrend later in the year when it becomes clear that no major disasters await around the corner.

In case of any of the two other scenarios, however, bigger negative impacts should be expected. Last week, I calculated that earnings expectations for the companies that make the ASX200 (more

than 90% of total market capitalisation of the Australian Share Market) would have to decline by 6% on average to put the index on an average FY11 multiple of 14.

This suggests there would be practically no room left for capital appreciation, all else being equal. (Note: projected average EPS growth would have to fall to 13% from 19%).

However, it is feasible that were earnings expectations to decline by such magnitude, investors would likely respond by accepting lower multiples only, which would indicate overall support for the market would shift to lower levels.

Following recent profit warnings from companies including Caltex (CTX) and Macquarie Group (MQG), the underlying trend in earnings expectations for ASX200 companies is now firmly negative. Australia has been leading the rest of the world and earnings trends in other regions, including the US and Asia, have now equally reversed.

While this does not mean FY11 forecasts in Australia will be reduced by at least 6% on average in the year ahead, it does indicate share prices could well remain under pressure for a while to come. Historically, share prices do not tend to respond favourably when confronted with falling expectations for corporate earnings as well as falling forecasts for economic growth.

This was once again confirmed by the latest historical data analysis conducted by global market strategists at UBS. Taking guidance from the US manufacturing purchasing managers' surveys*, with the research going back to 1950, I have summarised the research done by UBS strategists into four simple and easy to understand rules:

- 1.) If the US ISM index is below 50 but expanding, buy equities
- 2.) If the US ISM index is above 50 and expanding, buy equities and commodities
- 3.) If the US ISM index is below 50 but contracting, cash and bonds are the better performers
- 4.) If the US ISM index is above 50 and contracting, cash and bonds are the better performers

Right now the US ISM index is still above 50, but the index is coming off readings above 60 and likely to continue trending lower. History shows, this is usually not a good time to bet on equities performing well.

Two important things need to be pointed out. While history shows equities tend to respond negatively to prospects of lower earnings and lower economic growth, even more important is the rate of decline. In other words, equity markets should still be able to move sideways or gradually higher in case of rather mild reductions in corporate earnings, economic growth and US ISM readings.

Secondly, history also shows the above is especially true when the US employment picture improves. This is why strategists, such as the ones at UBS, refuse to give up on equities altogether for the year ahead. Global market strategists at UBS believe we have entered a period when leading indicators have peaked, but labour markets should soon start improving. The net balance of the two, reports UBS, is that "risk" should still beat cash and bonds in the year ahead.

UBS strategists can fall back on historical data to support their view, but they cannot guarantee that yesterday's sneeze will not ultimately end up as something worse than just a cold.

*Supply managers' surveys in the US are conducted by the Institute For Supply Management, hence why everybody talks about the monthly US ISM index.

Rudi Filapek-Vandyck is the Editor FNArena. This story was originally written and published on Monday, 28 June, 2010.

HOW HEALTHY ARE AUSTRALIA'S HEALTHCARE STOCKS?

By Rudi Filapek-Vandyck

It hasn't exactly received much airtime thus far, but Australia has led the rest of the world into this post-April downturn. Shortly after global equity markets peaked in April, I observed that profit growth expectations in Australia had stopped rising. That was weeks before corporate earnings forecasts in the US, Europe and Asia went into decline.

Two months earlier, during the interim results season in February, market expectations for healthcare stocks had received some significant downgrades. Not that anyone knew at the time, but in hindsight, healthcare stocks were showing the way forward for the broader market.

The February results season has had a material impact on how investors in general perceive the healthcare sector in Australia. Not every healthcare company is equal and investors have since again learnt the value of successful stock-picking.

This may well be lesson number one from observing the healthcare sector over the past four months: when things get tough the weak get separated from the strong. No mercy involved. This means stock-picking, rather than sector-allocation, becomes all-important.

Earnings risk has again become a major feature for the share market. Lesson number two from the February experience is that healthcare stocks are not immune.

The latter is more important than one would be inclined to think at face value. Despite healthcare often being categorised as "defensive" by stockbrokers, it is not always appreciated by investors the sector historically commands higher multiples than most other sectors.

The reason behind these above-market Price-Earnings (PE) multiples is simple: companies such as CSL ((CSL)), ResMed ((RMD)), Cochlear ((COH)) and Ramsay Healthcare ((RHC)) have long grown at much higher speed than other companies. If there's one thing the share market does very well, it is rewarding companies for high growth performances.

This easily explains why these stocks have been top of the list of favourites for many investors and stockbrokers: high earnings growth multiplied by high PE ratios makes for an almost watertight guarantee of high investment returns.

What is not always appreciated, however, is that high PE ratios become a time bomb when earnings growth stalls. This is what has happened to CSL over the year past.

I haven't exactly made myself popular with shareholders of CSL since I made the observation last year, and stuck by it, that the shares were too expensive. I do agree with almost everything that is being said and written in a positive sense about CSL, but I always end up adding: "but the shares are too expensive".

CSL's underperformance since March 2009 proves my point. CSL's share price held up well during the 2008 share market meltdown, but what is seldom mentioned (and so easily forgotten) is that the company managed to grow its earnings per share by nearly 35% in fiscal 2009 – this at a time when most companies saw their profits plummet.

At \$38 in March 2009, CSL's PE multiple had gone past 22, which by anyone's standards was more than appropriate. The problem that then arose, however, was that profit growth for the years ahead started to look bleaker and bleaker, especially after management had to give up on acquiring US competitor Talecris.

The combination of slower growth and thus a (deservedly so) lower multiple has made CSL one of the stand-out underperformers throughout what may well have been the strongest share market rally we will all witness in our lifetime.

I remain yet unconvinced the tide is about to turn for CSL. My motivation? At \$32-something CSL shares are still trading on more than 17 times projected consensus earnings for fiscal 2010. While

this is well below the multiple of 22 mentioned previously, one also has to appreciate that CSL - if it meets this year's consensus expectations- will only grow its earnings per share by 10% - less than a third of growth for the previous year.

What about fiscal 2011? Current consensus forecasts only assume 6.5% growth. One old standard rule for the share market is that investors better not pay for a higher multiple than what can be expected in terms of EPS growth. I acknowledge this is a rough rule, and it certainly not always applies to all companies under all circumstances, but CSL shares are valued at more than 16 times FY11 consensus EPS. That seems a whole lot to me for a company whose earnings growth seems in decline, and rather sharply so.

While many analysts are expecting major improvement from FY12 onwards, that is still such a long time away. In the meantime, dividend yield is around 2.5%. Sorry, but that's simply not enough for my liking.

My view on CSL is simply confirmed when I compare with valuations for other stocks in the sector. Ramsay Healthcare, for example, is trading at similar PE multiples but with projected EPS growth numbers of 12% and 10.5% for FY10 and FY11 respectively. Ramsay's anticipated dividend yield is 3% and more.

The real stand-outs, however, are Cochlear ((COH)) and ResMed ((RMD)). Both are trading on multiples well above 25, but have a look at what both should bring to the table in terms of EPS growth this year (FY10) and next (FY11): 19% and 12.4% for Cochlear; 33.1% and 20.2% for ResMed.

As things stand right now, Cochlear is slightly more expensively priced than ResMed, but the mentioned consensus growth projections suggest ResMed shares seem the better option.

At multiples above 25, however, I wouldn't be chasing any of these two, regardless of what future growth expectations might be. History shows that, in case of disappointment, the combination of weaker growth and contracting multiples can be devastating for the share price. Maybe the best strategy regarding both would be to wait for pullbacks and/or more certainty about future growth?

I note, for example, that Cochlear's present multiple seems high in relation to what is expected in terms of FY11 growth. Is this the next CSL in the making?

Glove and condom manufacturer Ansell ((ANN)) trades at a multiple not far below those for CSL and Ramsay, but at least earnings growth is expected to accelerate from 9% in FY10 to 15% in FY11.

Most other stocks in the sector, including Sigma Pharma (SIP)), Biota ((BTA)), Primary Healthcare ((PRY)) and Sonic Healthcare ((SHL)), are nowadays trading on lower multiples in line with sharply lowered growth expectations. The market is not expecting any growth from Healthscope ((HSP)) but take-over appeal is keeping the shares at relatively high multiples of 15-plus, indicating significant downside exists if nothing materialises.

All of the above are observations and conclusions based upon consensus forecasts, but we know from the February interim results that healthcare companies are not immune to profit disappointments. So where does this take us?

I believe the market has already made up its mind about which companies are more likely to disappoint and which ones carry less risk. This risk-assessment, I believe, is at present reflected in the triangle-combination of 60 days moving average, 200 days moving average and share prices for the companies mentioned.

For those not familiar with these tools: 60 M/A is usually used as a gauge for short term momentum, the 200 M/A marks the underlying, long term trend and if the first one breaks below the second one this is usually very bad news (it's called the "cross of death").

As such I observe that: only ResMed, Cochlear, Ramsay and Ansell are still trading (well) above their respective 200 M/A, suggesting the market maintains the longer term outlook for these companies remains healthy. This is in line with what PE multiples and consensus forecasts are telling us.

Shares of Sigma, Biota, Primary and Sonic, however, are not only trading well below the 200 M/A, the 60 M/A is also below the 200 M/A. This at least suggests the market is either suspecting more troubles, or the risks are simply too high.

For CSL, the picture is rather mixed. The shares are below 200 M/A, but 60 M/A is still above the long term trendline (but approaching). I think this means not everybody has yet given up on the potential for a positive surprise.

Some investors will hold on because of “nostalgia” (which the company shares with the likes of QBE Insurance ((QBE)) and Woolworths ((WOW))), while others will be hoping management will come up with a game changing take-over.

The following ten stocks were included in the analysis above: Sigma, Biota, CSL, Primary Healthcare, Sonic, Ansell, Healthscope, Ramsay, Cochlear and ResMed. All consensus data are daily updated and available at all times for subscribers on the FNArena website. This includes price charts showing 60 and 200 M/A (see Stock Analysis).

Rudi Filapek-Vandyck is the Editor FNArena.

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SPOTLIGHT ON THE AUSTRALIAN LISTED PROPERTY SECTOR

By Zac Zacharia

Overview

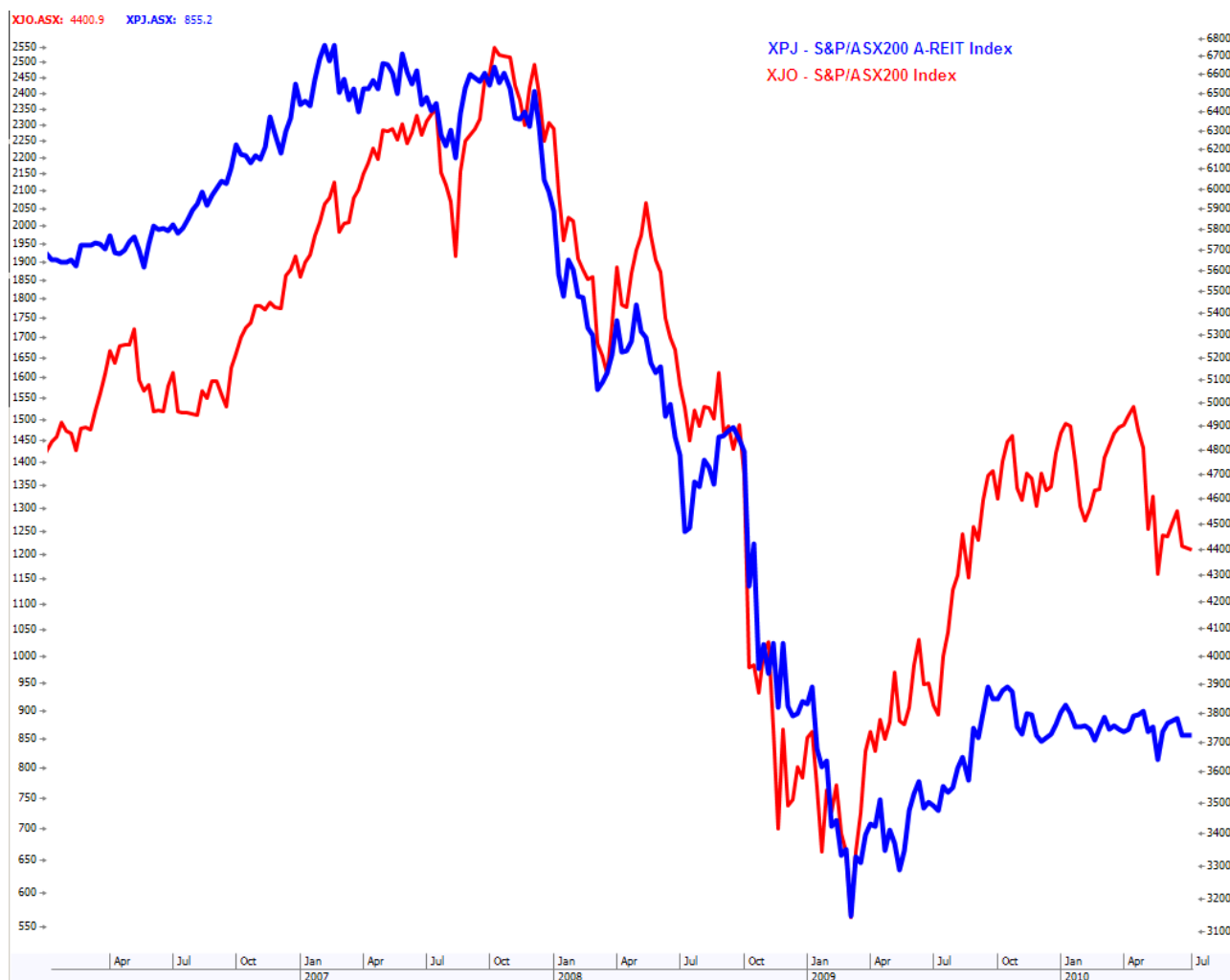
One of the historic strengths of the Australian listed property trust (A-REIT) sector was its disclosure levels. This historic sector strength became a weakness through the stapling of development/operating businesses to the traditional ‘rent collector’ model, changes in accounting standards, the debt-fuelled bull market and rapid offshore expansion. Disclosure levels have improved markedly of late and the most recent reporting season has seen even further improvements in this regard. We now have a better understanding of balance sheet issues and lending pressures than prior to the global financial crisis (GFC) and this has given investors some degree of clarity in the underlying businesses.

Generally balance sheet leverage is far more manageable now for the trusts and, despite rental yields having moved 19% higher, the sector’s look-through gearing, at 35%, is well below the pre-GFC highs. This is primarily due to the injection of substantial equity over the past year. However, the access to credit remains the weak link in the Australian REIT turnaround as it dampens the growth story.

This sector held its relative ground against the broader market over the past year and now represents 5.5% of the overall market (5.3% in 2009). Like most sectors in the Australian market it is dominated by a few select stocks, led by sector heavyweight Westfield Group (WDC), although it has lost considerable ground to the rest of the sector, and now represents 39% (52% in 2009!) of this total. A distant second, but still well ahead of the balance of the stocks in the index is Stockland Group (SGP) at 14% (13% in 2009). The third largest stock is, GPT Group (GPT) at 8%. At a similar of index weighting is Mirvac Group (MGR) (7%), Goodman Group (GMG) (6%), Dexus Property (DXS) (6%) and CFS Retail Property Fund (CFX) (6%).

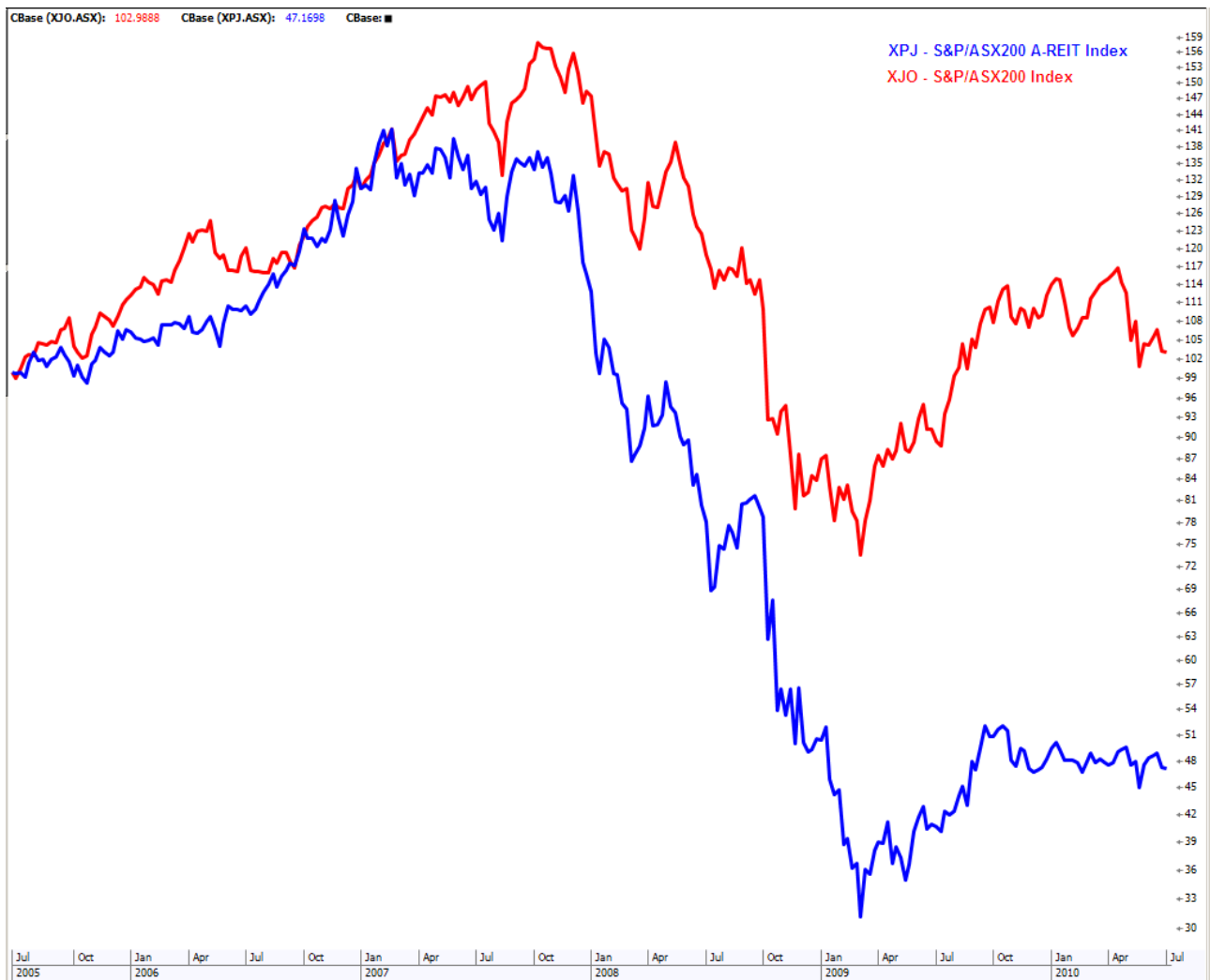
Comparison of A-REIT sector to the Market

The chart below shows the weekly price trend of the A-REIT sector (blue line) overlaid against the S&P/ASX 200 Index – (red line). The chart clearly shows how the A-REIT sector had bottomed out at the same time as the overall market, but hasn't followed the recovery with the same strength as the broader market since the lows in March 2009.



* Source: IRESS. Past Performance is not to be relied on as an indicator of future results.

If we overlay the 2 charts using a common base of 5 years ago, one can gain a better appreciation for relative performance of the A-REITS to the market. Clearly the A-REIT sector was savaged more than the overall market through the GFC, and also it has recovered less in relative terms. Given the improving fundamentals this supports the view that the sector has upside potential.



* Source: IRESS. Past Performance is not to be relied on as an indicator of future results.

Outlook for the A-REIT sector

Fundamentally, the sector as a whole is still facing a number of headwinds, not so much in terms of overall financial stability, but in terms of growth from this point. In the near-term we have what appears to be a Mexican stand-off. Margins of 2.5-3.0% for new debt are very high relative both to historic levels and the level of risk the banks are factoring in against the trusts balance sheets.

Many trust CFOs appear to be holding off on working through extending debt expiry profiles, waiting either for bank lending conditions to improve or bond markets to re-open domestically, or a combination of both. The effect of this is to dampen the growth prospects of the sector until more acceptable funding parameters are visible.

We have seen two substantial shifts over the last two years in the portfolios that make up the A-REIT sector. Firstly there has been a rapid shift back to Australian exposure versus offshore, with Australia now representing 63% of total assets, and secondly a substantial overweighting in Australia to shopping centres (60% of the domestic assets). These are important shifts, both of which have favoured our preferred long-term real estate exposures.

Commercial property valuations underpinning listed property trusts make a lot more sense now than at any point in the last 3 years and are set up against de-risked balance sheets. With debt levels now well under control and conservatively placed for the majority of the Trusts, now is the ideal time in the cycle for investors to gain exposure to the property trust sector.

From a technical perspective, the chart below shows the consolidation of sector since September 2009. The recent price trend is clearly sideways and occurring in a technical chart pattern known as a flag. Generally, the longer the consolidation period takes, the more sustainable the new trend will be when it breaks out.

A new trend will be confirmed once price breaks out of this flag pattern and has confirmation with momentum and volume. An uptrend is confirmed if it breaks upwards through resistance forming higher highs and lows and positive momentum and positive volume, and a downtrend is confirmed on a downward break of support forming lower highs and lower lows with negative momentum and negative volume. The volume trend during the consolidation however suggests a strong possibility that an eventual breakout will be to the upside.



Summary and Preferred Stocks

The A-REIT sector clearly has been oversold following the GFC, and has recovered less than the overall market (the banks and mining companies in particular). With the fundamentals for the sector slowly turning positive, it is going to be just a matter of time before the prices are re-rated to reflect confidence in the prospects for sector.

Amongst the large cap names our preferred trusts are Westfield Group (WDC) and CFS Retail (CFX) amongst the shopping mall operators, and Dexus Property (DXS), ING Office (IOF) and Charter Hall Office (CQO) (the new name for MOF) for their office exposure.

Alternatively, an investor seeking exposure to the sector (to diversify their risk across all the shares in the sector) may also consider investing in an exchange traded fund product such as SPDR S&P/ASX200 Listed Property Fund (SLF), rather than an individual share.

Below is a table that compares the stocks within the Property Sector that we research to show their fundamental relativities.

Real Estate		FY10						FY11					Market Cap \$b
		Price	PE	EPS	DPS	Yield	Franking	PE	EPS	DPS	Yield	Franking	
AAD	Ardent Leisure Group	\$1.05	8.3	12.6	10.5	10.0%	0	7.4	14.2	13.0	12.4%	0	\$0.32
ABP	Abacus Property Group	\$0.41	10.8	3.8	3.2	7.7%	0	11.3	3.6	3.3	7.9%	0	\$0.55
AEZ	APN/UKA European Retail Trust	\$0.03	0.9	3.3	0.0	0.0%	0	0.8	3.8	0.0	0.0%	0	\$0.02
AJA	Astro Japan Property Trust	\$0.33	3.5	9.3	5.7	17.5%	0	4.2	7.7	4.4	13.6%	0	\$0.17
ALZ	Australand Property Group	\$2.44	11.2	21.9	20.7	8.5%	0	9.9	24.7	22.3	9.1%	0	\$0.58
BWP	Bunnings Warehouse Property Trust	\$1.90	15.2	12.5	12.5	6.6%	0	14.5	13.1	13.0	6.9%	0	\$0.63
CDI	Challenger Diversified Property Group	\$0.51	9.4	5.4	4.2	8.2%	0	10.2	5.0	4.0	7.8%	0	\$0.24
CDP	Carindale Property Trust	\$4.27	15.4	27.7	27.6	6.5%	0	14.7	29.0	28.5	6.7%	0	\$0.30
CER	Centro Retail Group	\$0.19	2.8	6.6	0.0	0.0%	0	2.7	6.9	0.0	0.0%	0	\$0.23
CFX	CFS Retail Property Trust	\$1.93	15.4	12.5	12.5	6.5%	0	15.3	12.6	12.6	6.5%	0	\$3.96
CHC	Charter Hall Group	\$0.59	14.2	4.2	3.4	5.7%	0	11.6	5.1	4.5	7.7%	0	\$0.55
CNP	Centro Properties Group	\$0.16	1.0	16.0	0.0	0.0%	0	1.0	15.6	0.0	0.0%	0	\$0.14
CPA	Commonwealth Property Office Fund	\$0.96	13.4	7.2	5.6	5.8%	0	14.3	6.7	5.4	5.6%	0	\$1.90
CQO	Charter Hall Office REIT	\$0.26	8.5	3.0	1.8	7.2%	0	9.3	2.7	1.7	6.7%	0	\$1.07
CQR	Charter Hall Retail REIT	\$0.57	8.0	7.1	5.2	9.3%	0	10.3	5.5	4.6	8.1%	0	\$0.73
DXS	Dexus Property Group	\$0.80	10.8	7.4	5.1	6.5%	0	11.3	7.0	4.9	6.2%	0	\$3.71
GMG	Goodman Group	\$0.64	11.9	5.4	3.2	5.0%	0	11.1	5.8	3.4	5.3%	0	\$4.08
GPT	GPT Group	\$2.89	14.2	20.3	15.7	5.4%	0	13.9	20.7	16.1	5.6%	0	\$4.98
IIF	ING Industrial Fund	\$0.39	9.5	4.1	1.6	4.1%	0	9.7	4.0	3.2	8.3%	0	\$0.98
ILF	ING Real Estate Community Living Fund	\$0.05	1.2	4.3	0.0	0.0%	0	2.5	2.1	0.0	0.0%	0	\$0.02
IOF	ING Office Fund	\$0.59	10.7	5.5	3.9	6.5%	0	12.1	4.9	3.9	6.6%	0	\$1.68
LLC	Lend Lease Corp Ltd	\$7.42	11.4	64.9	33.0	4.4%	100	11.6	63.7	33.0	4.4%	100	\$3.78
MGR	Mirvac Group	\$1.37	14.5	9.4	8.0	5.8%	0	13.2	10.4	8.2	6.0%	0	\$4.52
MIX	Mirvac Industrial Trust	\$0.04	1.1	3.5	0.0	0.0%	0	1.2	3.3	0.0	0.0%	0	\$0.01
SGP	Stockland	\$3.68	12.3	29.8	22.5	6.1%	0	11.5	32.0	24.4	6.6%	0	\$8.82
TSO	Tishman Speyer Office Fund	\$0.42	3.1	13.4	0.0	0.0%	0	3.6	11.6	0.0	0.0%	0	\$0.14
VPD	Valad Property Group	\$0.10	187.7	0.1	0.0	0.0%	0	25.1	0.4	0.0	0.0%	0	\$0.21
WDC	Westfield Group	\$12.37	16.2	76.4	64.0	5.2%	0	14.9	83.0	67.5	5.5%	0	\$26.07

* Source: Ord Minnett Research Stock Universe. Intraday Prices as at 28 June 2010.

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All charts courtesy of IRESS.

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