

EQUITIES

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INTRODUCTION

By Alison Harrington

Marcus Padley, the well known Stock Market features writer, commented, after attending our 2010 Conference, that AIA was an excellent place to find investors with empathy. I am sure all of those who are over 55 will feel empathy after reading the two members portfolio histories. For those who are younger it is an excellent way to see their journey and learn from investors who have tried many paths until they reached their own successful route. Please note how constant education is the basis of their current success and the foundation of their future investments.

John Abernethy has given an excellent warning of the rocky road ahead and reminds us to always be aware in our stock selection of both the larger picture as well as the value in an individual stock.

Alison Harrington is the National President of the AIA.

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SHARE MARKET OUTLOOK FOR AUSTRALIA

By John Abernethy

As I write this outlook, in late February, the world's markets and the Australian market in particular is suddenly confronted by severe headwinds. The year started so promisingly for markets and now in a few short weeks the Middle East, which is the epicentre of the world's oil production, has sparked up into a contagion of political unrest.

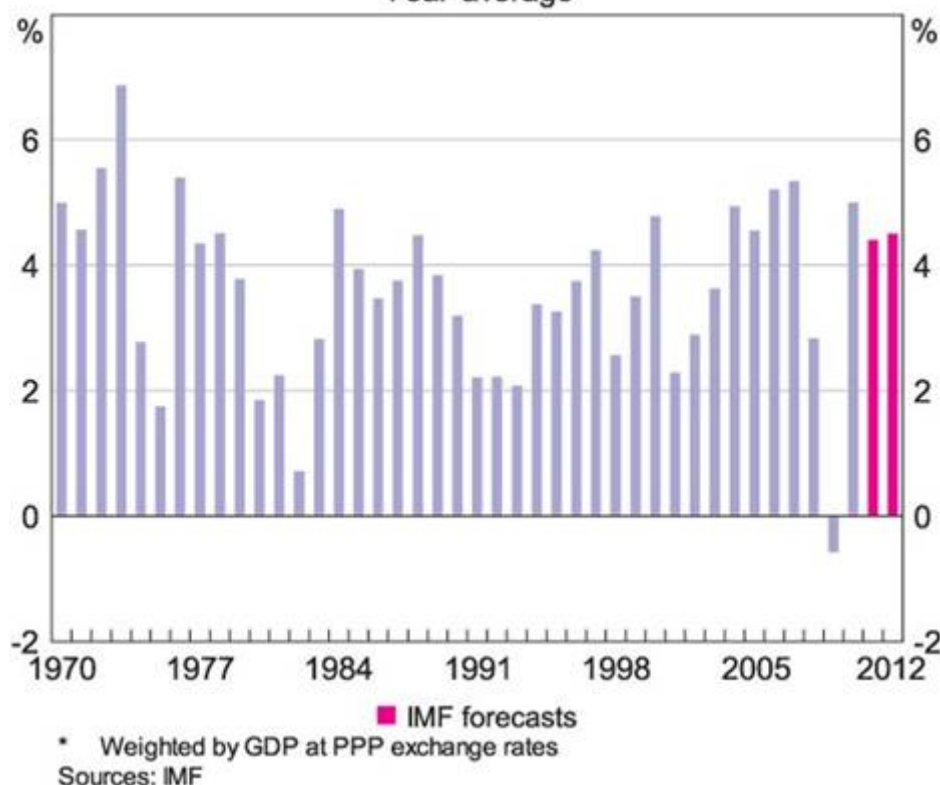
Is this important for markets? It most certainly is because the recovery of the world economy and thus its markets is built upon a most unstable base. That base has at its core the concoction of unproven and experimental economic policies. These include the maintenance of massive fiscal stimulation (huge government deficits), burgeoning government debt, unsustainably low interest rates and a multi continental quantitative easing regime (colloquially known as money printing).

All of these stimuli have been operating for so long - almost two years - that one may think this is the norm for world economic management. Indeed these economic stimuli have begun to create an environment that has induced investors to drift into another false state of exuberance. If you think this is a fanciful statement then recall that a mere four years ago investors on masse believed that the provision of excessive amounts of credit to poor people to buy houses created a sustainable economic environment in the US!

Having made this point we must not forget that the world is growing and it is projected to grow or recover for the next few years. Economic growth is positive for equity markets but sustainable growth is even better. We would contend that the growth in the developed world is currently propped up by unsustainable economic policies. Thus, unless growth occurs, concurrent with the withdrawal of these economic stimuli, then the growth in the developed world could be shortlived. The emergence of a rapidly rising oil price is an unwelcome event for the world. It really has the potential to upset the outlook seen in the table below.

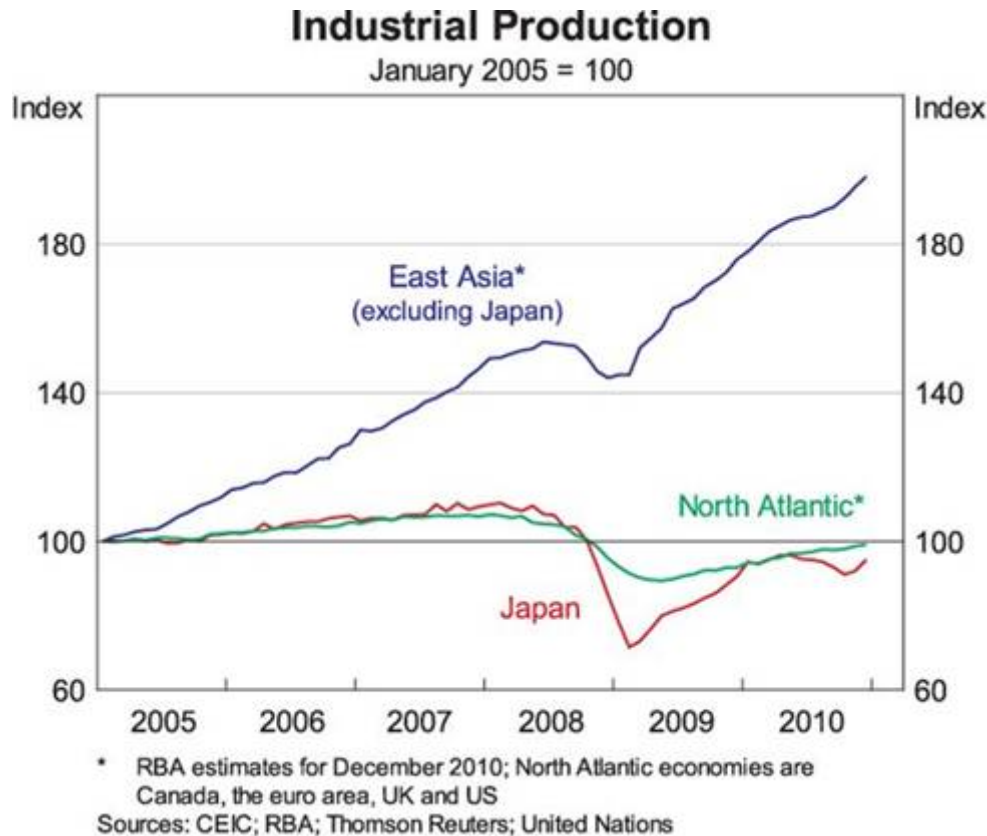
World GDP Growth*

Year-average



The world's growth is not even. The developing world, which is dominated by China, Brazil, India and Russia is growing at a great rate. The developed world dominated by US, Germany and Japan

is recovering but the growth is very modest when these countries are combined with the economic calamities unfolding in Southern and Western Europe.



A spike in oil prices, emanating from an upheaval in the Middle East has an immediate affect on the outlook for the world economy. Should oil prices find a higher plateau and average over US\$100 a barrel, then the cost imposts for China would be immense. Further, the inflationary pressures on the US would occur at a most undesirable point in their recovery. This is because the foundation of the US recovery is the massive fiscal stimulation, via excessive government expenditure and low taxes, funded by the issuing of massive amounts of government bonds, issued at extremely low interest rates, backed by the US Federal Reserve purchasing bonds (quantitative easing).

China had been supporting the economic recovery settings by exporting deflation to the world and this helped to hold US interest rates down. With oil spiking (following huge lifts in bulk commodity prices) and with China importing 55% of its rapidly growing oil consumption, then it may well now begin to export inflation to the world. Add this to direct energy inflation in the US, then you see a real risk that US bond markets may tumble and yields begin to rise. That turn of event would not be good for the US economic recovery and would require more quantitative easing.

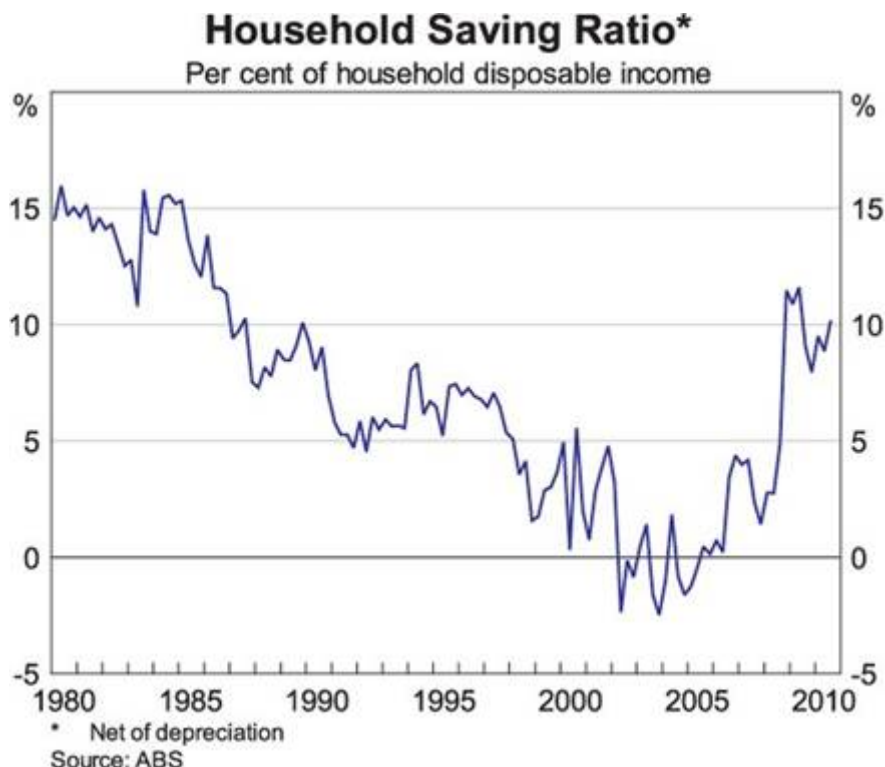
Up until these recent events the outlook appeared to be reasonable for overseas equity markets with economic settings highly supportive of rising equity prices. Think about it this way - if all you can get in the bank is 0.5% p.a. or all you can get from the government is 2% p.a. (for five years) then investment capital will be forced into the equity market. Thus speculative capital moves into the market, prices rise, sentiment improves and the outlook appears good. That is where we were a few short weeks ago.

Where to now?

As always the immediate outlook is hard to predict. We would maintain that it is prudent at this point for investors to be realistic in their assessment of likely stock market returns over the next year.

In our view a total return of towards 10% should be regarded as good but to achieve this result will require judicious stock selection and a focus on yield. Why do we think this? Well have a close look at the following table which measures the savings ratio of Australian households. It points to a

difficult outlook for many Australian industrial companies and explains why the recent interim results were generally disappointing.



It is clearly apparent that Australian households have reigned in consumption and increased debt repayment since the GFC. Those households with high levels of debt prior to the GFC were most likely the people who were consuming above their means. Australian households amassed over \$1 trillion of debt prior to 2008 and this swamped household income of \$700 billion. The ratio of debt to income of 150% was virtually the highest in the world. In Australia we created an “aspirational society” who consumed beyond their means. This led to excessive credit growth and the requirement for our banks to borrow offshore to fund household credit growth. Whilst not all households are in debt there is a large group who are and they have been shocked by the GFC into paying debt back.

Looking at the above chart it is arguable that a savings ratio of 10% of household income could be the norm. Thus, it highlights a difficult outlook for the following sectors:

- discretionary retailers who are already affected by the competition from growing internet sales;
- retail landlords who will struggle to lift rents;
- banks and credit suppliers who will struggle to grow assets; and
- the government who will struggle to balance budgets without the introduction of new taxes (thus the carbon tax and RRT)

From a share market perspective this suggests that some sectors of the Australian market will see profit growth slow despite a booming economy. It thus becomes an absolute requirement for an investor to have a realistic approach to valuing companies. Whilst the outlook is difficult it does not mean that the sectors noted above are overpriced if the market has already adjusted for the outlook.

However, it is apparent that investors need to focus upon the resource sectors of the market for real solid and strong growth. History suggests that resource stocks are highly cyclical and have rarely sustained rallies for longer than say a few years. However, this Chinese growth cycle appears unique in history and it certainly looks to be a long resource boom for Australia. Thus, our recommended focus remains with the major resource companies and we retain a judicious watch on suppliers and services to the resource cycle.

Summary

Thus is summary. Investors need to be cautious in investing in the equity market at present. Overseas markets have had a strong rally since the middle of last year and are susceptible to unforeseen shocks. The recent oil price spike is an unwelcome development.

The Australian market remains hostage to overseas sentiment shifts. The high currency level, high relative interest rates and an uneven two speed economy mean that the Australian market will not bound ahead as suggested by some commentators. A focus on sustainable yield will be rewarded and investors should keep an eye on market corrections which throw up buying opportunities.

John Abernethy is the Chief Investment Officer of Clime Investment Management, MyClime and Clime Asset Management are part of Clime Investment Management (ASX:CIW). MyClime is an online stock valuation service.

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MY EQUITIES PORTFOLIO

By Brian McErlean

Profile: 56 year old male professional retired from full time work, living in Perth, married with 2 children at university.

The genesis of my stock market activity lies in antiquity, some 25 years ago. Struggling to pay a mortgage and pay off a business loan, I was very successful in creating a barren savings environment. The mood was set for some fast money.

I found a trendy young broker with a luxury car and bought speculative mining stocks. It was the only time in my life I raced out of bed in the morning. I just had to get a newspaper and finger through the mining stocks. Moody days. When the broker rang I raced to the phone. It was addictive but the cost of addiction went up as the commodity cycle went down.

Another way.

So then I gave money to “friends” and invested in primary production and IPOs. There were also tips and financial advice from friends. More tears.

There had to be another way.

I borrowed money for managed funds. Glossy quarterly reports with camouflaged fees lay on the coffee table. Crikey, they were experts at explaining the misfortunes of the world. This year it was the Japanese stock market fall. Next year it was the currency rise or fall or the macro and micro economics of failure.

Strangely my house went up faster in value than my investments and I wasn't letting anyone fiddle with my house.

There had better be another way.

It was then I elected to be an arsonist with my own money instead of paying someone else to do it.

Simple - find the best investors and copy them. So I started a new addiction of reading investment books and magazines. Ben Graham's “Intelligent Investor” lay dog eared beside the bed for years. It has been read at least five times, two to three pages at a time. There was a progression to John Neff, Peter Lynch, John Train, Warren Buffett and many more.

I was saved in 2008 when I saw the P/Es get beyond 40 for some stocks. “This time it is different” rang the exit bell.

Two thirds of my investments are in Australian stocks and one third in investment property. One quarter of the stocks are in a wrap super fund where fees are 1% and I select the stocks.

Maintaining investments in my own name, family trust, investment company and super wrap fund means that if the super or tax rules change again there is hope. My greatest fear is that a rule change in superannuation forbidding the withdrawal of lump sums could throw us all into allocated pensions forever. The precedent lies in other countries.

Here is my personal approach:

1. Never pay a P/E more than 15.
2. Never buy an IPO as the track record is usually absent. Who knows if it can handle growth?
3. Try and preserve capital at all costs. Boring stocks are often survivors.
4. Pick companies that have been around for 10 years. Write their EPS down once a year on excel and draw a log graph. As soon as that graph starts to level off or dip, get out.
5. Be reluctant to buy companies with debt over 20% and if they start doing takeovers get out until the debt is back under 20%. Never buy a company with debt to equity greater than 40% and sell if they do it.
6. Pick the right industries that will be around for a long time e.g. banks, food, health, mining services. Avoid airlines, telecommunications, agriculture, single commodity miners, single product companies, single jockey companies.
7. If you cannot understand the annual report don't buy the company. Read annual reports.
8. You need ROE greater than 15 and preferably greater than 25. High ROE is more important to me than high dividend.
9. I buy Martin Roth's "Top Stocks" book every year. The tables are at the back. Pick out around twenty companies with the highest ROE and the lowest debt. Great place to start.
10. Stick with growth industries. I don't believe newspapers are a growth industry despite being the best investment of the last century.
11. Find a long term graph of the market and only buy below the long term median for the All Ords and start selling if it races above the long term median. At the moment the long term median for 2011 is around 7700 so I am still happy to buy value when it appears.
12. I calculate Roger Montgomery's intrinsic values according to the tables in his recent book "ValueAble."
13. Sell when the P/Es get too high, the market shoots above the median or the company gets way ahead of its intrinsic value.
14. What do I own?

1st Tier: FWD, MND, ARP, BHP, IRE, CSL, WOW, SOL, CBA, REH, MTS

I bought them at their lows in 2010 but would be reluctant to buy any of them at current prices (mid Feb). These are what Buffett calls "sleep at night stocks" and if you went to Mawson's Hut for 5 years they will probably be still there when you get over the frost bite.

2nd Tier: FGE, MCE, MIN, NVT, DTS, DWS, ORL, JBH, CNA, ANG. These are the ones I have to watch and sell if they get overheated. They are my insomniac stocks. Don't go on holidays if there is no internet access. Again last year was a great opportunity to buy them.

Before you race out (after getting financial advice of course) to buy any of the above stocks just remember 2010 was the year to buy them low and that 2010 prices may not reappear. Remember MND around \$13, BHP at \$36, ARP at \$5.50?

I use leveraged equities to fund a margin account and buy through Macquarie. It provides access to leverage when I need it – now. My current leverage is around 30% and will drop as the market rises. My thinking has become inverted - little debt when the market is high and some debt when the market is low.

After a stock market crash most of us become fundamental or value investors. The hardest thing is to stay that way when others become growth investors or price followers or chartists when all the charts are heaven bound.

In coming years a new generation of young financial managers, oblivious to adversity, who were teenagers in March 2009, will come out of their cocoons. They will spread their wings, charge their phones, write their powerpoint presentations, join golf clubs, and promise us the stars. That's when I will be selling my stocks on P/Es above 30 and waiting.

Brian McErlean is a member of the AIA.

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MY EQUITIES PORTFOLIO

By an AIA member

Background: My wife and I live in Sydney and we have two adult children. I am in my early 60s and recently retired but my wife still enjoys working in a professional position.

My move to retirement means that I no longer able to rely on my 'human capital' (ie earning power), and our investment portfolio must provide the bulk of our income for the next 30 years or more. Thus the move to retirement raises the stakes considerably. For retirement planning we take a conservative position of assuming a long-term return of around 3% – 5% above inflation.

We started investing in equities 30 years ago, initially in managed funds and selected shares. We have remained fully invested in the market, moving between asset classes and 'following the herd', and like many others developed the uncanny skill of buying and selling at precisely the wrong time. We have learnt much over the last 10 years, and the AIA (and American AIA) have provided a rich source of ideas and educational material. Until the GFC I was a buy-and-hold investor, but now take a much more active approach to protect the downside.

Asset allocation: Our asset allocation at present is 60% Australian equities, 15% international ETFs, 15% boutique funds and 10% cash. Three-quarters of these investments are held inside super (we started a SMSF several years ago and both draw minimum pensions) and the balance outside super.

Holdings: We currently hold 27 stocks ranging in value from 2% to 6% of our portfolio.

Strategy: Larger blue chips with reliable dividends form a core of around half the holdings, and we have started investing in hybrids to provide a supplementary income flow. We find that small and medium-cap stocks offer greater growth potential but with the downside of increased volatility. To offset downside risk we decide on a stop-loss strategy at the time orders are placed. Entries are usually based on momentum (rising share prices and solid fundamentals) or promising smaller growth stocks with high ROE and deep value.

For peace of mind during holiday periods, we sometimes purchase put options over the index or larger stocks, effectively taking out insurance against market crashes at a cost of 1% to 2% of the portfolio value.

Education: We subscribe to a number of newsletters, services and blogs. Among our current favourites (besides the AIA) are the *Australian Financial Review* and *Business Spectator* (news and current information), Colin Nicholson (sound and robust philosophy), Alan Hull (complementary ideas), Marcus Padley (always entertaining), Clime (company valuations) and the *Eureka Report* (varied and sensible commentators). Favourite authors are Nassim Nicholas Taleb (Fooled by Randomness & Black Swan), Peter Thornhill (Motivated Money) and Colin Nicholson (everything he writes). The ATAA offers exposure to a different part of the brain and alternative approaches. The AIA sharemarket course is well worth attending.

What we have learnt:

- Don't follow the crowd; understand investor psychology and your own hot buttons
- Don't overestimate your own skill and ability. Keep learning.
- Decide on stop losses and implement them unemotionally.
- Make investing a lifelong journey and enjoy the ride.

This article was provided by an AIA member.

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