

Personal Wealth



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A Quarterly Newsletter for **Lifespan Clients**

The Importance of Sticking to Your Plan

We remain in a bear market as the effects of the liquidity crunch continue to be felt by global markets. Over the last 3 months the Australian equity market is down about 10% with most of the damage sustained by financial and property stocks. Despite the recent volatility, investors with a long investment timeframe are advised to ride out the market turbulence. As the chart below shows following a fall, the Australian

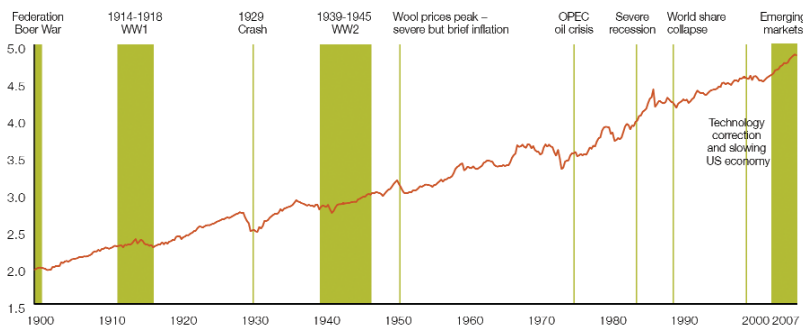
equities market has never failed to rise above the previous high point.

A lot of clients will be tempted to sell out of equities and time their entry back into the market. We think timing the market is extremely difficult and most investors will be better off in the long term by sticking it out. The chart below shows that the worst performing asset class is often the best performer the year after.

Dollar Cost Averaging

The constant in the markets is the credit crisis which is not over yet and markets are expected to remain volatile. However you can use this volatility to your advantage. For long term investors we recommend dollar cost averaging into the market, i.e. drip feeding funds on a regular basis rather than one large sum. Consider a situation where you invest the same amount into the market every month for 10 years. Also assume that the market doubles in a straight line over 10 years. Consider an alternate situation where the market doubles in 10 years but is down in roughly half those years (the chart below). In volatile markets that eventually go higher the second scenario (volatile markets) will generally outperform the first one, i.e. a steadily rising market. This is because you are accumulating assets at lower levels.

Australian Equity Market

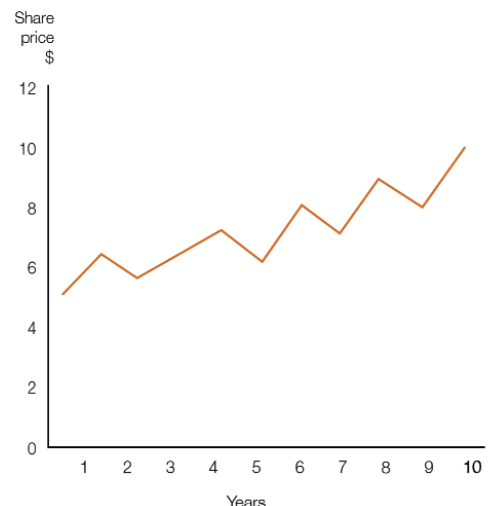


Source: Perpetual

Asset Class Performance and Ranking

Annual returns % pa	Australian shares (a)		Listed property (b)		International shares (c)		Fixed interest (d)		Cash (e)		Diversified Index (f)	
	Return	Rank	Return	Rank	Return	Rank	Return	Rank	Return	Rank	Return	Rank
December 93	45%	1	30%	2	25%	4	16%	5	5%	6	29%	3
December 94	-9%	6	-6%	3	-6%	5	-5%	2	5%	1	-6%	4
December 95	20%	2	13%	5	27%	1	19%	4	8%	6	20%	3
December 96	15%	1	14%	2	7%	6	12%	3	8%	5	11%	4
December 97	12%	4	20%	2	42%	1	12%	5	6%	6	19%	3
December 98	12%	4	18%	2	33%	1	10%	5	5%	6	16%	3
December 99	16%	2	-5%	6	17%	1	-1%	6	5%	4	11%	3
December 00	-4%	5	18%	1	2%	6	12%	2	0%	3	6%	4
December 01	10%	2	15%	1	-10%	6	5%	3	5%	4	-4%	5
December 02	-8%	5	12%	1	-27%	6	8%	2	5%	3	-6%	4
December 03	16%	1	9%	2	0%	6	3%	5	5%	4	8%	3
December 04	28%	2	32%	1	10%	4	7%	5	6%	6	17%	3
December 05	21%	1	13%	4	17%	2	6%	5	6%	6	15%	3
December 06	25%	2	34%	1	12%	4	3%	6	0%	5	16%	3
December 07	18%	1	-8%	6	-2%	5	3%	4	7%	3	7%	2
Average	14%		13%		8%		7%		6%		11%	
Highest ranking		1		1		1		2		1		2
Lowest ranking		6		6		6		6		6		5

Source: Perpetual



Source: Perpetual



Lower Rates, Currency and Commodities

Since our last note there have been some major shifts in some of the big picture factors influencing the market.

Interest Rates Heading Down

There has been a major reversal in interest rate expectations over the last three weeks. The markets which had anticipated rising rates are now factoring in falling short term interest rates.

The reason interest rates will fall is not because inflation has been licked but rather the economy is slowing dramatically. There is now a perception that rates were in fact hiked too much. Recent evidence for a slowing Australian economy comes from weak retail sales, credit growth and housing starts. The Reserve Bank has recently acknowledged this by revising down (non farm) growth to just 1.75% in 2009.

The Reserve Bank announced a 0.25% rate cut on September the 2nd. We would expect a total of 0.5% by Christmas. By the end of 2009 we think the cash rate will be around 6.0%.

Australian Dollar weakness

The upward march of the Australian dollar has been halted. It has fallen more than 10 cents from its peak of 98 cents. The major drivers of the strong dollar, namely: a strong economy, rising interest rates and rising commodities prices have now turned negative. We do not think it is possible to predict the value of the dollar however we think it will trend lower. A lower and falling Australian dollar does however have its benefits:

- Global equities are more attractive as existing holdings are worth more in Australian dollar terms as our dollar falls
- Domestic companies with overseas earnings will get an earnings boost

In general a lower Australian dollar will provide a boost to our economy and insulate us to some extent from a slowing global economy.

Commodity Prices

Most commodity prices have turned sharply down since July. The most likely explanation for this is the realization that the world economy including that of China are slowing. Slowing economies mean lower demand for commodities.

UBS is forecasting world GDP growth to be just 3.1% in 2009 which is lower than the current year. China's 2009 growth rate has been revised down to 8.8%. China is perceived to be the major driver of commodities prices and the sentiment attached to it is currently bad. One of the main factors has been a slowdown in its export sector. However the Olympics have caused shutdowns in some industries and it will take several months to get a post Olympic read on the economy.

This may simply be a correction in commodities rather than the end of the cycle, the jury is still out. However corrections in the sector can be vicious and quite painful.





Investment Markets Outlook

Equities Look Positive

Australian and global equities look inexpensive using the most common valuation measure, the price earnings ratios (PE). The difficulty though is in predicting the level of earnings for companies going forward. Earnings estimates have been coming down particularly for financial stocks. Our best estimate is that Australian stocks are on a PE of 11 to 12 times 2009 earnings. This compares to a long term average of 14 to 15 times.

A major positive for stocks is that we are entering a rate cut cycle. This will help all domestic stocks especially interest rate sensitive sectors such as financials, retail, property and infrastructure. The 2 other positive factors for Australian stocks are:

- They are trading at a small discount to world equities, whereas last year they were at roughly a 10% premium.
- The lower Australian dollar will give an earnings boost to the equities market as a whole.

If the Australian dollar drifts down as we expect this will also help to boost the returns of global equities.

Listed Property Preferred

We do not think the short term risk/reward is compelling in property even though the forecast yields are very high. We expect that distributions will fall somewhat in listed property as they lower payout ratios. We expect weakness in direct property values as well. We think the best strategy is to wait a few months to get a better feel for the property market as a whole. Short term our preference is for listed property as market values are simple to determine. With direct property the scarcity of transactions means it is difficult to obtain current pricing information.

Lock In High Fixed Interest Rates

As we said we expect the cash rate to be about 6.0% by the end of 2009. The 10 year bond has already rallied and our best guess is that will be about 5.7% in 2009. We think there are good

opportunities in high quality corporate bonds. What this all means is that cash and bonds should provide roughly similar performance over the next year or so. Since rates are coming down we suggest that clients try and lock in Bank term deposits at around 8%. If you want to hedge against economic weakness then you might want to increase your bond allocation.

Summary

There is now some light at the end of the tunnel as interest rates are expected to come down and give a boost to equities. In particular, investors need to watch the price of oil as it is one of the major swing factors in markets. The lower the oil price the better markets will perform. However the markets will remain volatile and the news flow will remain negative for the period ahead. For those with a long term investment time frame this should be viewed as a period of opportunity.

Investment Returns to July 31 2008 (%)

Asset Class	1 Month	3 Months	1 Year	3 Years	5 Years
Australian Shares	-4.56%	-10.33	-15.60	8.70	14.44
Global Shares	-0.49	-8.68	-18.77	-0.56	3.03
Listed Property	-4.97	-22.97	-36.47	-4.20	4.41
Fixed Interest	1.79	2.19	5.58	4.40	4.93

Source van Eyk

Margin lending explained

A margin loan is a facility that allows you to borrow to invest using cash, shares and/or managed funds as security. When using a margin loan it is possible to use your existing investments as security or cash as an initial contribution. The amount you can then borrow is dependant upon on the borrowing limit applied to these existing investments and the investments you wish to purchase.

For example, an investor with \$100,000 of his own to invest may borrow another \$200,000 via a margin loan facility to invest in managed funds which have a 70% lending ratio. This means that the facility allows you to borrow up to 70% of the total invested (in this case \$300,000) so long as you put up at least

30% of the total investment (in this case the investor has put up \$100,000 or 33.33% giving a 66.66% loan to valuation ratio or LVR ie., \$200,000 loan divided by total valuation of \$300,000. The maximum LVR must be observed at all times. The lender has a right to call in the loan if that LVR is not maintained.

Margin Calls

The downside is that if the value of the investments falls the lender may issue a margin call. A margin call is a demand for you to top up your capital or margin. To avoid margin calls many investors only borrow 50% of the total value of investments or valuation. Because of market volatility the market value of a

geared portfolio will fluctuate daily causing the LVR to rise and fall. To avoid making margin calls every time the LVR exceeds the maximum the lender will generally impose a buffer before a margin call is made.

In relation to the above example, we have assumed that a buffer of 10% is in place. If the portfolio value fell from \$300,000 down to \$250,000 the loan to valuation ratio (LVR) would rise to 80% and the lender would then invoke a margin call. The investor would then be required to either:

- lodge additional acceptable security to the value of approximately \$35,714 to return the lending ratio to 70%.

Continued on page 4



Continued from page 3

- elect to pay \$25,000 to reduce the outstanding loan amount to \$175,000 (70% of the \$250,000 investment).
- Alternatively, part of the portfolio may be sold to restore the margin. Because the investor plans to have only 30% equity in the portfolio they would have to sell assets to the value of \$83,333. This would be a forced sale at reduced prices which may trigger a capital loss. This would reduce the loan to \$116,677 and the value of the portfolio to \$166,667 which equals the required LVR of 70%.

The time for meeting a margin call can be as little as 24 hours. Failure to meet a margin call will result in the lender selling a portion of the investments to restore the loan to security value which may crystallise a capital loss.

To avoid selling assets during a market downturn a reasonable cash reserve should be maintained to meet margin calls.

Maintaining a lower LVR also reduces the risk of a margin call. If the above investor maintained a 50% LVR and only borrowed only \$100,000, the value of his investments would have to have fallen by 40% (\$125,000) before a margin call was invoked which highlights the benefits of maintaining a more conservative LVR.

Other things to be aware of:-

- when using an investment gearing facility you will incur interest expenses. Although interest is tax deductible it is still an expense and you should ensure that you maintain sufficient cash flow to meet the regular interest costs.

- an increase in interest rates may impact upon your cash flow and therefore your overall investment strategy.
- gearing is viewed as a long term strategy so changes in personal circumstances or objectives may have an adverse effect i.e. loss of income due to illness or redundancy. It is imperative that adequate risk protection cover be established prior to the implementation of an investment gearing programme to ensure your asset base is adequately protected.
- to be successful, it is essential that one only gear into investments that are thoroughly researched and which can be reasonably expected to provide substantial capital growth in a low inflation environment in the medium to long term. In the case of shares and managed funds, one should ensure adequate diversification and quality investment management.
- successful and well managed gearing also involves the use of adequate life insurance and income protection insurance to protect the investor and his / her dependants by ensuring that the investor is likely to be able to meet interest repayments and margin calls at times when sickness, accident or death halts regular income.

- an investment gearing strategy should be regarded as a long term strategy in order to ride out any adverse market conditions which may apply over a minimum recommended investment term of at least 5 years for a balanced investor (60% exposure to growth assets), 7 years for a growth investor (80%

exposure to growth assets), or 9 years for a high growth investor (100% exposure to growth assets).

The advantages of margin lending are summarised as follows:-

- with a larger investment base you have greater potential to increase investment returns and build wealth faster. The principal goal is to ultimately have the value of your investment (growth plus income) exceed the total after tax costs of borrowed funds.
- all income distributions accrue to the owner of the investments including the portion generated from borrowed funds. Re-investing distributions can assist in reducing the LVR which may reduce the risk of a margin call.
- under current legislation the interest on the loan is tax deductible if borrowed monies are used to buy income producing assets. (If the asset fails to produce an income, the tax office may disallow the tax deduction - in this case it may be possible to add the interest costs to the cost base of the asset thus decreasing the effective capital gains tax payable when finally selling the asset).
- the Australian share component of your portfolio may give rise to imputation credits which will reduce your taxation liability further.

As demonstrated, maintaining a conservative LVR of around 50% reduces the risk of a margin call which may make borrowing to invest via a margin lending facility a viable investment proposition for those investors who have a growth risk profile and who are not adverse to carrying debt.



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