



Profile Financial Services

Investment Research Newsletter

November 2008

That time of the year

Good riddance 2008, bring on 2009...



The Reserve Bank of Australia finished the calendar year for 2008 with a nice Christmas present for those people that are borrowing money by dropping interest rates by a full one per cent. However, sadly on the other side, people that are dependant upon their savings generating an income are also going to see a drop in the return on their cash accounts.

As discussed at several recent review meetings, I feel that over the coming months, there will no doubt be a refocus by investors looking for opportunities that are going to generate a return above cash. We are starting to get to the impractical situation whereby cash in the bank is going to be paying a substantially less return than the fully franked dividends being paid out of the exact same banks.

Certainly 2008 will not be forgotten. It will be marked in history as one of the most

turbulent investment periods the world has ever seen. While I believe that 2009 will certainly continue to be volatile with rising unemployment and company distress, I think we can look forward to better times towards the end of that year.

The one thing I believe that that we should take heart in though, is that if you have your health and your family, it brings back to perspective the really important things in life.

With that, on behalf of Phillip, myself and all the team at Profile, we wish all of you and your family a very happy time over Christmas and a prosperous 2009. Until then, all the very best, and I look forward to seeing you in the New Year.

Garry Ohlsen
M Director

*'Research is to see what everybody else has seen...
... and to think what nobody else has thought'*
A Gyorgi



Index

➤ Feature Commentary

- 2009 and Beyond: Is it really different this time...?

➤ Global Markets

- Key global events over the month including movements in oil, gold and the Australian dollar...

➤ Sector Commentary

- What are the institutional market players saying and what are Profile's views on these comments...?

➤ Investment Analysis

- Analysis and review of current investment holdings and a summary of ongoing developments on 'pipeline' investments...

Feature Commentary

2009 and Beyond:

Is it really different this time...?



While the world sits back and watches in awe as the events around us continue to unfold, the question that remains on our mind is whether it really is different this time?

The current Cash squeeze being experienced across global markets is without a doubt a significant problem for the world economy. As firms cut discretionary spending wherever they can, the result is likely to be a corporate version of what John Maynard [Keynes](#) called the 'paradox of thrift'. While spending money might be in society's best interests, it is not necessarily in the best interests of company shareholders. This new cycle we are entering, which is focussed on saving, is not only motivated by the fact that Cash is hard to come by, but also that demand is falling for most firm's products. Households have also hit the 'pause' button and no-one knows when they will press 'play' again...

An article in the Economist summed it up well when it said 'what was once seen as evidence of

corporate fitness, for the moment looks like anorexia'. Increased padding, in the form of Cash at bank, will likely be necessary to secure a clean bill of health. I actually find it interesting to draw a comparison here to portfolio construction. What was formerly deemed as over conservatism in holding higher levels of Cash, versus being fully invested in the roaring markets, now appears to be the lifeline that many portfolios are falling back on. Cash is king, but for how long?

'What was once seen as evidence of corporate fitness, for the moment looks like anorexia...'

Companies will no doubt increase layoffs as earnings come under pressure, resulting in increased unemployment and thus a self fulfilling easing cycle. Company stock prices have fallen as the market attempts to gauge what the full impact will be in such an uncertain environment, but eventually markets will seek to recalibrate. As Cash rates continue their downward trend in line with easing Government monetary policy, focussed on stimulating growth, the appeal for stocks then producing sustainable single digit income returns will be revitalised. I don't think we will see the returns of the past three decades continue, but we will see markets return to their original role.

Markets were created to transfer the real growth of business between market participants at fundamental levels, and I would hope this functionality returns.

So in the short to medium term, growth rates will retract, unemployment will rise, inflation will ease, central bank interest rates will decrease and markets will attempt to price this in. Sounds like an ordinary cycle, but is it really?



While it certainly appears to be a 'normal' market cycle, for a lack of a better phrase, there are undoubtedly a few extra significant headwinds this time around that will change the course of economies going forward. Additional corporations will be in distress by mid 2009 and

for the majority that remain standing, they will need to significantly deleverage their balance sheets and [recalibrate](#) their business models to brace for an environment not so flush in credit. The consumer will also need to unwind heavy levels of debt and re-assess their own internal balance sheets. In the '[Sector Commentary](#)' section, I discuss Magellan's view on this current scenario and I think the stats quite clearly support the case that a change will be inevitable.

'Additional corporations will be in distress by mid 2009...'

Cushioning the global downturn will demand bold fiscal actions and will require a series of systemic issues to flush their way through the system including the flow of the currently gridlocked credit markets. While budget deficits may have been unheard of in Australia's recent history, they are a necessary 'evil' when economies face a recessionary environment. I think our comment in last months Research Newsletter sums it up well where we said that, going forward it's going be all about 'spending within your means...'

Jai Parrab

'...there are significant headwinds that will change the course of economies going forward.'

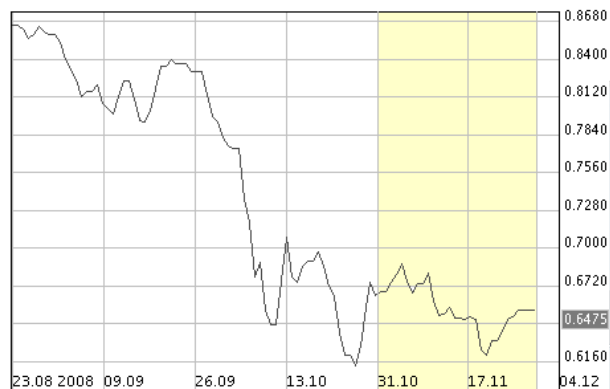
Global Markets



Key Events:

What's been happening in oil, gold and currency markets...?

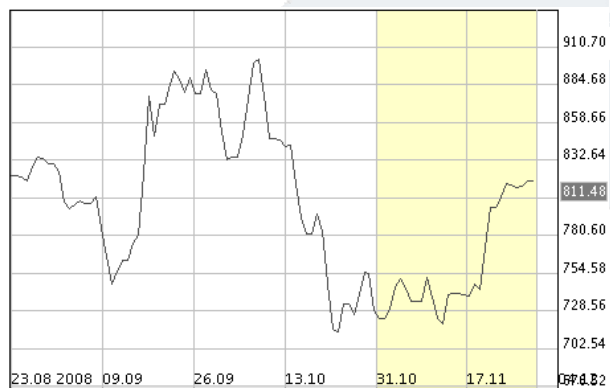
AUD/USD



As independent as Australia may seem geographically, the fact remains that globalisation has become viral.

The **Australian Dollar** [AUD] continued to weaken against the USD along with the lack of understanding by the broader market into the basis for the strength of the USD against all its major trading pairs [EUR, JPY, and GBP]. One plausible explanation is the amount of transacting currently taking place in financial markets [in USD denominated contracts]. Another theory is related to recent moves by the Chinese Central bank and their 'policy actions' to devalue the Renminbi, which in turn may have sent traders flurrying to cover their short USD positions. And finally, a highly practical solution relates to the repatriation of investments formerly invested in the emerging markets. The hard fact though is that the additional significant amount of base currency currently being 'created' in the US will come back to bite them in one form or another.

Gold [USD/oz]



Gold staged a rally in the second half of the month as investors maintained their concern over both the long term fundamentals of the over-performing USD and long term prospects on the broader economy. The precious metal settled the month out just above **US\$810/oz**.

Oil once again continued its downward trend as fears continue to persist that a global slowdown will dampen the demand for energy, closing the month out at just above **US\$53bbl**.

Oil [Light]



Sector Commentary



Presentations:

What the market said and what we chose to interpret...?

Martin Fischer said, 'Knowledge is a process of piling up facts; wisdom lies in their simplification'. Our goal is to seek out **the right information**, interpret that information, and then apply it to our ongoing portfolio construction process.

Magellan Financial Group Market Overview

What has happened...? What started as a run on non-bank financial institutions by hedge funds, ended up resulting in three major counterparty's in a fifty trillion dollar market collapsing, presenting the market with the real chance of a full systemic financial meltdown [AIG was the largest participant in the [CDS](#) market]. The Lehmann collapse was followed by a money market fund announcing an \$800m exposure, freezing redemptions and 'breaking the buck'.

'...three major counterparty's in a fifty trillion dollar market collapsed...'

Within a week, US\$200bn had fled money market funds resulting in the 'seizure' of the commercial paper market. Given that commercial paper backup lines exceeded US\$5trn, banks started to hoard money in case of any obligations that may have ensued. The extent to which it developed was such that we were two days away from two major banks in Australia failing. The most recent response originated in the UK and involved a three pronged solution [government guarantee on banking deposits, a guarantee for banks to borrow in capital markets and forced [recapitalisation](#) on the banking system].

Following these actions, as well as other global co-ordinated efforts, Magellan believes that the risk they had primarily been worried about has dematerialised.

Where to next...? We are seeing the first signs of, and are going to continue to see a global synchronised slowdown in world economies. To date, 70% of GDP in developed economy's came from consumer spending being significantly funded by credit. The taps have now been turned off and will not be coming back on in a hurry. 50% of the funding market has gone to zero and the other 50% is the banking system which is on life support. While governments have attempted to introduce socialism to force banks to raise capital, they are still not lending. To put things in context, in the last recession [90-91] households were [geared](#) at 40%, in 2008 households are geared at 160%. Taking this another step, the AU\$10bn government stimulus package equals only 1% of Australia's GDP. The key focus going forward is that consumers will focus on paying down debt, not spending. This will have the effect of increasing unemployment and if house prices deteriorate further, we may see a longer and deeper slowdown. As uncertainty about the future continues to dominate sentiment, equity markets may remain volatile for another six to twelve months.

Economic landscape... As discussed, the rate of economic growth will be materially lower over the next fifteen years versus the last fifteen years in line with slower household consumption. If current levels of spending were maintained, household debt would have to go to 300% to maintain current growth pattern. While domestically focussed businesses in developed economies will need to have moderated earnings growth expectations, emerging markets and its emerging consumer will provide the countering demand force for those companies able to access those markets. Magellan expects the inflation rate in developed economies is likely to be higher than RBA band of 2-3% by 0.5-1.0% as the former productivity growth and capacity shifts in China which had led to years of imported deflation begin to tighten. The Chinese central government policy

has shifted to focus on lifting living standards to ensure wage increases are greater than CPI. However on the counter side, a production move to western China could sustain current 'cheaper' levels of production. Other supporting factors for the case of emerging economies as the countering forces is in China, where currently only 30% of GDP is from consumption thus presenting a significant potential for domestic demand based growth.

While picking the bottom is virtually impossible, the strategy will be to look for cheap, high quality names while taking moderated positions. Equity markets will move before the economy and therefore averaging the entry over the next twelve months will be the key.

So what if you don't pick the bottom...!

'Equity markets will move before the economy, and therefore averaging your entry will be the key'

European Investors Incorporated [EII]
Property Overview

Macro 'property' environment... Current market conditions remain challenging but several positives should support the sector when credit market stabilise. Looking at the demand-supply equilibrium, credit markets have all but eliminated any increased supply from new development and most major markets are currently operating below average vacancy rates. The crisis has further restored the balance in favour of prudent lending and less leverage reducing risk in the sector. The combined effects of de-leveraging and reduction/elimination of excess supply should result in a lower risk profile. Falling share prices of property companies have begun to attract investors away from direct property investment given that at current prices, investors can acquire portfolios of assets and management teams far more cheaply in the public market than are available in the private market. There is an estimated EUR200bn targeting European real estate which is currently waiting on the

sidelines for prices to settle. Governments are also playing their role with the Chinese government recently announcing incentives focussed on invigorating the property sector with similar efforts underway in many other markets

Property companies ... Currently seeing ongoing capital raisings at significant discounts as companies attempt to raise equity. Asset sales have been slow but are resetting expectations on valuations. Debt funding risks remain around the rollover of debt facilities. They are starting to see takeover activity given the low prices however financing remains limited. Furthermore a lack of volume and the subsequent spread has led to ongoing volatility. The hard fact is that global banks have shut down for the first time across the board in line with this new 'globalised' market. As an example, a large developer was formerly able to finance projects at 70-80% with interest at 60-100bps over [LIBOR](#). In the current market, the same developer is only able to finance 50% and at 600bps over LIBOR - **essentially a no loan.**

Property by geography... **Asia:** Japanese banks are in a strong capital position but are still not lending. The Tokyo office market is suffering from a shortage of high quality space but global worries are still resulting in weak overall property market. In Hong Kong, vacancy is below 2% and rental rates are up nearly 20% in 2008. Albeit all this support, share prices are down 40% but companies remain conservatively leveraged [0-30%]. Furthermore, Japanese and Hong Kong based corporations have no debt and the businesses are more concerned about bank credit analysis to ensure their cash can be repaid. China's weak economic results have led to aggressive stimulation efforts but India remains over priced. Global: Stocks have priced in all the downside but are now bouncing on the bottom. Other factors will still need to filter through the macro environment before any traction is restored. US: Vacancy rates are currently below historical norms but it is unknown as to how bad it will be. There is no supply issue at 3-5% unless finance businesses begin downsizing and closing but this is currently below expectations. Negative employment and growth will impact office, industrial, apartments and retail sectors but healthcare fundamentals are holding up to date. Growth is expected to return by the end of 2009 and stocks lead by nine months. Europe: Given their economic focus on inflation,

EI believe that Europe will be 'late to the party'. Europe will therefore drag but is currently in a good property environment. London on the other hand, while the pipeline has been closed, is overbuilt.

'The hard fact is that global banks have shut down for the first time across the board...'

Rent in prime London was \$300pounds per foot but for the same space is now only \$65ppf with expectations that it will fall further to \$40ppf. While Paris and Milan's office markets are undersupplied, London's exposure to financial companies as tenants is high. Rental growth is not expected but under-rented assets could provide some uplift despite depressed market conditions on other cities. A big focus on retaining tenants will force rents down which will pressure valuations. While prices have already fallen across the board by 20%, stocks have fallen 90%. They believe the basis for this is that property is easy to see and touch and hence expectations and price reactions are immediate. In their view, the bad news has been priced but the market has further overshot by another 20-30%.

As expressed in our ongoing commentary, growth rates **will** slow in the short to medium term. This does not mean that portfolios will not generate returns, but simply means that returns will need to [recalibrate](#) to long term averages, and that new opportunities will need to be sourced out in order to provide alternative forms of portfolio insulation and growth.

Property continues to be an uncertain playing field in the current environment and our preference is to tread sceptically where fundamentals do not appear to be at the helm. While the sector is currently under review, we are continuing to explore its many forms of exposure in line with our overall portfolio construction objectives.



Investments



Analysis + Review

Where are current investments positioned and what's on the radar...?

Thomas Edison said, 'Opportunity is missed by most people because it is dressed in overalls and looks like work'. As part of our ongoing due diligence and portfolio construction process, we regularly meet with the underlying Investment Managers to discuss and evaluate the performance and strategy of the fund, as well as assess how it is positioned going into the forward economic environment.

Magellan Financial Group **[Recommended]** Global Fund

Note: Economic overview discussed in '[Sector Commentary](#)' section.

Since our last update, the fund sold 80% of its bank holdings in September with two of the four sales transacting at record historical prices. Magellan is continuing to look for global multi-nationals exposed to emerging markets. In the current fund's holdings, five out of the top ten holdings have greater than 30% of their earnings coming from emerging markets and very high returns on capital. Examples include YUM Brands which generates a 100% [ROC](#) and currently has 30% of its [EPS](#) derived from China. The company currently has three thousand KFC stores in China but is expecting to rollout twenty thousand which will increase its EPS exposure to 40%. PepsiCo is another example which has 60% of its EPS derived from China. Looking at other stocks, Magellan conveyed that Wal-Mart's management have been looking at aggressive expansion which he sees as an upside for the company. He also commented on AMEX changing their structural model to become a 'bank holding company'. In his view it was in the company's best interests as it allows them to now access the government's funding facilities on terms [duration and rates] much better than what is available in the market. Magellan

continues to outperform and in line with our views on indirect exposures to emerging markets, the fund continues to play an important role in current portfolios.

Abacus **[Recommended]** Abacus Property Group [ABP.ASX]

While the stapled company has been pummelled along with the rest of the LPT market from its peak of \$2.07 in April 2007, the underlying fundamentals continue to remain quite strong. The company has prudently cut its dividend to be sourced only from rental income going forward. They have made allowances for increased costs of debt and have cut any earnings expectations across their non core businesses to still reach a valuation at a significant premium to its current trading range. The company is also holding significant Cash at bank bracing for new opportunities to emerge and has independent debt structures established within the underlying funds. While there continues to be the equity risk associated with investor sentiment and limited liquidity, Abacus appears to be a case of the baby being thrown out with the bath water and therefore may present a suitable opportunity to re-enter the property market.

Winton [On the Radar]

Global Alpha Fund

Description | Winton is a specialised futures manager that focuses on achieving absolute returns through statistical research into financial markets seeking to identify and profit from market trends. The fund trades share indices, currencies, interest rates, bonds, soft and hard commodities in over one hundred different futures and forwards markets over several continents.

Performance | The fund has produced strong returns in both bull and bear markets over its eleven year history and also displays a low correlation with traditional asset classes. Since inception the fund has a monthly win/loss ratio of 60/40 with average gains exceeding average losses by 1.63%. To the end of October the fund generated a return of 15.9% and has a compounded annual return since inception of 18.95%. During the worst ten months in global equities over the past ten years [including Russian debt crisis, 9/11 and the initial shock from the sub prime crisis], the fund was able to generate solid positive returns in nine of the ten months with a negligible loss incurred in the tenth.

Strategy & Risk Management | The fund operates on the philosophy that markets are not perfectly efficient and price movements do not follow unpredictable 'random walks'. The fund diversifies across the range of sectors with quantitative daily rebalancing and integrated risk control. The quantitative analysis inputs are composed of fixed correlation estimates, market volatility and return forecasts and transaction costs to formulate an optimal portfolio. Risk is controlled by capping the maximum level of forecast volatility on the portfolio; if volatility goes up then position sizes must reduce; if correlation goes up, position sizes must reduce. To put it in perspective, since 1997, the fund has generated an annualised return of 19% with risk of 20%, while the S&P500 index generated an annualised return of 0% with a [standard deviation](#) [risk] of 16%.

Outcome | With adequate absolute historical performance returns, and an uncorrelated relationship with beta markets, the fund is certainly on our radar. Our concerns at the moment however continue to revolve around the application of these strategies in what we believe to be uncharted market territory. Given the high reliance on Manager skill, the fund would only be included as a minor satellite exposure. We will conduct our comprehensive due diligence process before making any formal recommendations.

K2 Asset Management [On the Radar]

Australian Fund & Select International Fund

Description & Strategy | K2 is a relatively small Australian based absolute return manager. Their absolute return approach to investment management, allows them to generate market returns regardless of market direction. The fund is able to do this through its ability to take both long and short positions in the market, as well be fully weighted to Cash if it cannot source out opportunities in the market. The fund targets a 65% average net long exposure over a five year investment cycle with a range from 100% net long to 40% net short.

Performance | The Australian fund has had an average [net equity](#) exposure of 65% over the 2001-2006 period while generating a return since inception of 13.4% per annum to the end of October 2008 versus the All Ords of 8.4%. The fund has also outperformed the All Ords during the tougher early 2000's while only slightly underperforming during the bull market that followed. The Select International fund has only been open since 2005 and has generated a return of 9.5% pa to the end of October 2008 versus the MSCI of 1.5%pa.

Outcome | While the fund possess all the initial attributes we are seeking, our concerns revolve around the ongoing regulatory changes that are taking place in markets which may impact a funds ability to navigate its short positions. We will continue to monitor the fund in light of any new developments with further due diligence to be conducted in the New Year.

Credit Suisse [On the Radar]

Alternative Investments: Private Equity

Investing in 'private equity' involves buying equity in privately held companies or taking companies listed on public stock exchanges private [off market]. It is generally accessed by investors through specialised private equity funds. The objective is for the manager to provide strategic assistance to the companies, with investment holding periods being over a relatively longer time horizon [five years plus].

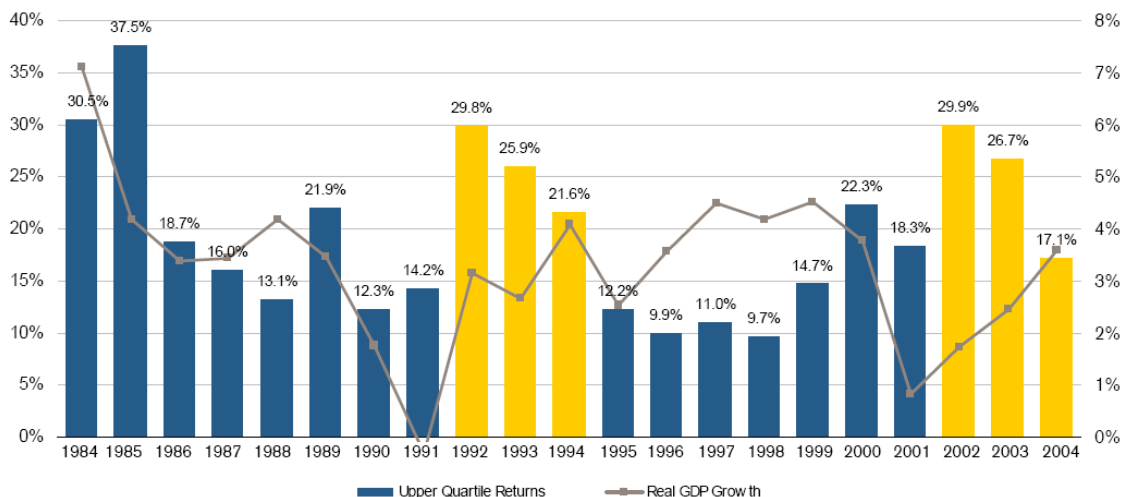
The Profile Investment committee have identified Private Equity as a very attractive sector to invest some additional exposure to.

Why? 1. Historically, periods of distress and recession in the market environment have led to a positive influence on returns from private equity. Since 1990, the best periods of returns [absolute and relative] coincided with recessionary and/or distressed economic cycles. [Refer to the Chart below] **2.** As debt from credit markets has become increasingly limited and more expensive, coupled with more stringent credit covenants, it is more difficult for private equity firms to rely on leverage to generate returns. However, there are several other drivers behind potential strong returns. Larger equity contributions are likely to occur and the managers will need to earn their pay cheque through their ability to add significant operational value. In addition, we would expect that in this environment, private equity

managers should have a greater range of deal opportunities to select from in the near term and at cheaper valuations in. Better managers will also still be able to access debt, and thus will be significantly advantaged over their competition. **3.** The "private" aspect of this sector, allows company management to operate with greater emphasis on long term value creation rather than short term performance measurement. This neither pressures nor diverts as much of their resources toward frequent highly regulated reporting requirements, relative to their "public" counterparts. **4.** The longer term nature of private equity is more conducive for a good manager to be able create very attractive returns. They can control the time horizons of initiatives without short-term shareholder demands and the exit timing out of the investment, thereby potentially dampening the impact of short term public market volatility. **5.** Has historically outperformed other asset classes, as well as reduced portfolio volatility. Over ten and twenty year periods, private equity upper quartile returns have significantly outpaced the public equity markets.

Outcome: Due to the "closed" fund and illiquid nature of Private Equity investing, opportunities are fewer and further between. Profile has expressed interest in the sector with several reputable firms in this space and will be reviewing upcoming opportunities on a case by case basis.

Historical Private Equity Upper Quartile Benchmark vs. GDP Growth



Source: Thompson VentureXpert as of August 31, 2008.

Glossary

Financial Terms:

In real terms...

CDS | Credit default swap - an over-the-counter contract to transfer credit-risk in which the buyer of protection pays a premium

BPS | Basis Points – one hundredth of one percent or 0.01%

EPS | Earnings per Share - a company's net profit figure divided by the total number of shares outstanding

Gearing | A measure of the debt ratio, which is the amount of borrowing compared with the equity in an asset

Keynes | English economist who advocated the use of government monetary and fiscal policy to maintain full employment without inflation

LIBOR | The London Interbank Offered Rate Index is an average of the interest rates that major international banks charge each other to borrow US dollars in the London money market.

Net Equity | The net position of their long and short positions taking into account Cash holdings within the fund



Recalibrate | To create and sustain a change

Recapitalisation | Restructuring a company's debt and equity mixture often with the aim of making a company's capital structure more stable.

ROC | Ratio that measures how effectively a company is utilising its capital [debt plus shareholders equity] invested in the business

Standard Deviation | A statistical volatility measure indicating the dispersion of returns