

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



RESEARCH REVIEW | JUNE 2008

Global Economy: The In-House Think Tank

➤ Currency: **To Hedge or Not to Hedge**

- Key Views: | **Issue** | Currency is a perpetual issue we face here in Australia investing in a global economy and one we constantly discuss at R&D days both internally and with investment managers. The effect on international asset returns to AU\$ is so significant it can be as big an influence as the performance of the asset itself. Unfortunately for the last five years it has all been one way traffic [AU\$/US\$ going from \$0.45 - \$0.98]. | **Considerations** | Hedging costs effect performance and inadvertently you can end up with a double or neutralising hedge, which can negate your hedging strategy.

For example, a US based company may export a significant % of its business offshore and therefore needs to convert its income back to US\$. Assuming the company itself doesn't hedge [another issue in itself] and the US\$ falls dramatically in value, that company is a beneficiary of the falling US\$. Therefore its US\$ share price should increase on this variable alone, which would offset to a degree the currency fluctuation for internationally based investors.

Another hedging issue is the risk of indiscriminate hedging [hedging at the wrong times]. If you were fully unhedged over the last few years, you would have to have a very strong view of a currency to start hedging the AU\$ at this stage. The fear is that the AU\$ would reverse and depreciate against other global currencies and then miss out on the currency appreciation back into AU\$. | **Outcome** | The best investment managers in the world struggle to consistently make correct currency calls. The International equity exposure Profile recommends via the van Eyk Blueprint series uses partial indiscriminate hedging [up to 25%]. Over the years, this has been marginally positive for the exposure. International property and fixed interest exposures are generally always hedged because of the different investment dynamics. Profile will continue to monitor and debate the merits of hedging or not, however at this stage there is no directive to change policy. Next month we will continue to discuss hedging [part ii] in relation to the costs of living theory and direct investment portfolio hedging decisions.

➤ Gold: **Demand, Supply and Inflation**

- Key Views: | **Issue** | Gold has been a very hot topic of late and many analysts, economists, commentators and marketers are putting forward some very strong thoughts on its potential movements. | **Considerations** | From both speculation to hedging strategies, it is a pretty easy sell in the midst of the fear that is gripping the market and world economies, that gold will be anything from a strong defensive play to a huge windfall. Our internal discussions concluded that there is no sudden shortfall in gold supply. It could be argued it is a good store of wealth in high inflation conditions and/or the collapse of the US\$. However if you look at gold as a return over the last fifty years it's been terrible, not even keeping pace with inflation. It could very well have a run over the next year or so but market sentiment and behaviour will likely be the main driver. | **Outcome** | Client portfolios already have more gold exposure than investors probable realise, through the Alternatives Fund (approx 10%) and resource companies such as BHP and RIO [even if not held directly - Australian Equity managed funds have significant exposures to these companies]. We do not believe there is any compelling reason to take additional exposure to gold at this stage.

Sector Specialist: Profile's Takeouts and Overlay

- van Eyk Research
 - Topic: [Australian Equities](#)
 - Key Takeouts: Overview of the performance of the various Australian Equity sub sectors; **1 Material and Energy stocks have been the significant contributors** to the index performance with Financials representing the key detractors **2 The small cap sector has outperformed up until the latest correction** which seen a significant downturn relative to a large cap index [incorporating a higher level of volatility] **3 Growth stocks have also significantly outperformed value stocks over the preceding period** **4 The MSCI Global and MSCI Australia Indices are now trading well below their long term average price / earnings ratios** **5 Extension strategies should outperform in the period going forward as index managers will find it hard to add alpha in the current environment.**
 - Profile's Overlay: With consensus on the general view that Australian equities have a tougher road ahead, we are **pleased with our current allocation** to the Perpetual Share Plus [Long/Short] fund and will continue to monitor and review other 'extension strategies' in this sector.

- NEXT Financial
 - Topic: [Australian Equities](#)
 - Key Takeouts: Australian stocks are looking cheaper than ever; from a **quantitative analysis** point of view **current valuations appear to be at a bottom** and can suddenly turn with strong momentum and trigger a run. General view that equity markets will turn sooner than later. Also covered was capital protection with the summarising comment that it has emerged as a new founded point of focus for investors and has expanded in both its capacity and opportunities.
 - Profile's Overlay: **Unlike some historical market bounces**, we believe that this time around both Australian and Global equities are in for a tougher road ahead with what may be a **longer-term protracted recovery** via a structural recalibration. While our 'core' stocks continue to look attractive from an underlying business perspective, we prefer not to use quantitative measures to analyse entry and turning points but rather **invest on long term company fundamentals**. Therefore, we believe an allocation to Australian equities is justified at present but we are not actively recommending building on existing exposures.

- Association of Financial Advisers and BRIC+ [Dr Xisu Wang]
 - Topic: [China](#)
 - Key Takeouts: Dr Xisu Wang described the evolution of China's political background and what had brought it to where it is today. The key driver behind China's ongoing growth has been its political structure in that decisions are made and implemented in one step. These decisions are made on the **"for the greater good"** pretence. Going forward the view is that China will continue to grow as the **domestic population grows in individual wealth**. His belief is that China will remain on track as a global powerhouse with a long-term view to **supersede the US as the dominant global power** [this view is supported by many global economists along with their views on India].
 - Profile's Overlay: We continue to have a **long-term bullish outlook** on China and the support role it plays in the growth of the Australian economy [driven by the resource sector]. While we believe there may be short periods of retraction along the way, our long-term view on the sector remains strong and we continue to **maintain an exposure** to the region through resource stocks and satellite managers.

Investment Analysis: What's on the Menu

Review: Profile's Approved Product List

- Babcock and Brown Communities Group [BBC.ASX]
 - Basis: [Sector + Investment Review \[Property\]](#) – Debt and Valuations
 - Commentary: Several events have unfolded around BBC this month: **1 BNB have reiterated that BBC's debt facilities are separate and independent of BNB's + geared at 38% and no refinancing required until 2010 (weighted avg 6 years)** **2 Lend Lease have taken a stake of over 5% in BBC (and since to >7%)** **3 BBC have cut distributions for FY 2008 to 6.3c [forecast was 8.4c]** to "strengthen the balance sheet" during this tough property and credit market environment.



- Analysis & Outcome: | **Analysis** | Debt | While gearing levels may appear on the high side, they are in line with other Listed Property Trusts; The disassociation from BNB's financial issues are reassuring which is further supported by the lack of short term refinancing requirements. | Lend Lease Stake | This is strategic from numerous perspectives but most significantly appears to be positioning for a takeover. This is supportive of both the assets being undervalued in the market and the growth dynamic of the retirement living sector. | Distribution Cut | While not pleasant, it is a responsible action taken by management in order to focus on managing debt more tightly given very difficult credit conditions and is prudent for longer term shareholder value | **Outcome** | Profile still believe the Trust's assets are of a high quality and exposed to strong growth opportunities, and furthermore are trading at a significant discount to the underlying value – maintain **hold**

van Eyk: Blueprint Diversified Funds


- Basis: **Investment Review** – Underlying Investment and Strategic Changes
- Key Points: van Eyk recommended a **tactical currency hedge of 25%** for the International Share Fund. A risk of a spike higher in the Australian dollar was perceived, given undervaluation of the Australian dollar against the current level of commodity prices and a near-term rate hike if inflation pressures were to persist


van Eyk also sees a clear case to further '**de-risk**' portfolios away from asset classes favoured by recent speculative activity; **reducing exposure to gold, commodities and associated currencies** (such as the A\$ even though it is benefiting from renewed US\$ weakness). Australian LPTs' valuations appear to be still lagging the worsening economic environment in the US and leveraged trusts are exposed to a further tightening in global monetary conditions. Proceeds of these recommended asset sector reductions should primarily be put into cash but there is some scope to invest in fixed income macro managers as the renewed widening credit spreads are likely to provide selected trading opportunities.


Thumbs Up

- Suncorp Convertible Preference Shares [SUNPB.ASX] 
 - Description: The issue is being made as part of Suncorp's ongoing capital management strategy, with the CPS proceeds being used to repay existing debt, finance new loans and for other general corporate purposes.
 - Analysis & Outcome: | **Analysis** | Under the offer, Suncorp CPS will pay investors a non-cumulative, quarterly floating rate dividend which is fully franked. The dividend yield has been set at 3.20% above the 90 day bank bill swap rate. Suncorp CPS have received provisional investment credit grade ratings of 'A-' from Standard & Poor's, 'A2' from Moody's and 'A-' from Fitch Ratings. On 14 June 2013, Suncorp CPS will convert into a variable number of Ordinary Shares, unless the Mandatory Conversion Conditions are not satisfied. | **Outcome** | Profile has not taken part in several hybrid issues in the last six months on the pretence that dividend margins would increase. This offer substantiates this theory and represents a suitable return for the respective credit rating. Furthermore, conversion at maturity facilitates a capital guarantee as long as the issuer does not default - Profile will continue to monitor the capital adequacy of Suncorp in this regard.
- Macquarie Convertible Preference Shares 
 - Description: The issue is being made as part of Macquarie Group's ongoing capital management and funding strategy, seeking to maintain sufficient capital for growth over the medium term and provide the ability to take advantage of opportunities as they arise – increase their capital base.
 - Analysis & Outcome: | **Analysis** | Under the offer, Macquarie CPS will pay investors a non-cumulative, unfranked, semi-annual fixed rate dividend until June 30, 2013. The dividend yield is expected set at 3.50% above the 5 year swap rate. Macquarie CPS have received provisional investment grade credit ratings of 'BBB' from Standard & Poor's and 'Baa1' from Moody's | On 30 June 2013, Macquarie CPS will convert into a variable number of Ordinary Shares, unless the Mandatory Conversion Conditions are not satisfied. | **Outcome** | Profile has not taken part in several hybrid issues in the last six months on the pretence that dividend margins would increase. This offer substantiates this theory and represents a suitable return for the respective credit rating. Furthermore, conversion at maturity facilitates a capital guarantee as long as the issuer does not default - Profile will continue to monitor the capital adequacy of Macquarie Group in this regard. The additional benefit to holding a fixed rate note is that if government interest rates are reduced over the holding period, it should provide a further capital kicker to the listed security.

Thumbs Down

- Macquarie Cash XL 
 - Description: Macquarie is offering an alternative cash fund (Cash XL) to the Macquarie CMT, which pays a higher yield (intro rate of 7.75%) relative to the CMT (currently 6.82%).
 - Analysis and Outcome: | **Analysis** | The core difference is the CMT is a trust which owns cash and fixed interest securities which in turn earn interest. On the other hand, the Cash XL fund is simply held on deposit by the Macquarie Group (MQG). The CMT is rated S&P AAA, whereas the new cash account is not rated specifically, however MQG has an S&P rating A-1/A/stable. | **Outcome** | Given the current market turmoil around credit issues we do not consider the additional return being offered is commensurate with different risk dynamics.

- Bris Connections IPO 
 - Description: The Trust will build, own and operate a motorway linking Brisbane's CBD to the airport and northern suburbs. Annualised distribution yield for the first year equal to 14% on initial instalment, converting to a tax deferred yield of 8% for the remainder of the 6 year fixed distribution period on full investment.
 - Analysis and Outcome: | **Analysis** | **Pros:** Attractive valuations in current environment; IRR of 17%; **Cons [Risks]:** Construction delays; Overzealous traffic forecasts; 45yr lease relative to 99yr norm; Single asset trust; Initial distributions are paid from capital while current trend is to move away from this structure; Additional design and construction project commitments; **Neutrals:** Relative Valuation to peers ie MIG,TCL,CEU; Debt is well structured | **Outcome** | Given Sydney's last two private consortium infrastructure tollways have gone bankrupt [cross city and lane cove tunnels] - primarily due to overzealous state government traffic projections - extreme caution must be taken. On the flip side the public offer is being made in a tough environment where the project has to be very attractive to raise the capital. While Queensland's growth profile is the best in Australia, higher oil prices are affecting traffic numbers to some degree. While this appeared attractive on an 8% tax deferred yield (14% IRR), other established infrastructure investments have been significantly sold off thereby offering equivalent if not better returns without development risk or forecasted traffic number risk.

- [General] Income Orientated Equity Strategy Funds 
 - Description: In the midst of extreme capital volatility and negative sentiment, income oriented strategies come back onto many investors radars.
 - Analysis and Outcome: | **Analysis** | We have witnessed over the last seven years, up until markets turned in August 2007, yields becoming very compressed through capital appreciation of what traditionally were low capital growth/high yield instruments. As a result, a significant number of investors were piling into yielding instruments expecting continued high growth without much regard for their fundamental drivers. Those that chased these returns have been the hardest hit by the correction that has occurred in the market triggered by the sub-prime and the global credit crisis. Such assets have now been repriced where they are now representing in the most part very healthy yields again albeit with a fair degree of risk while wider credit issues are still being sorted. | **Outcome** | At Profile we are not about chasing returns, but more matching investors needs and risk tolerance with an investment blend that represents strong fundamentals. Unless we were targeting yield as part of the specific investment strategy, we focus on total returns, hence rather than switching our top of mind focus to yield oriented strategies, we are vigilantly monitoring our recommended fund managers [and direct investments] with a focus on sourcing out opportunities that represent good risk return trade-offs.

GENERAL ADVICE WARNING

This is issued by Profile Financial Services Pty Ltd (ABN 32 090 146 802), holder of Australian Financial Services License No 226238. This information might contain unsolicited general information only, without regard to any investor's individual objectives, financial situation or needs. It is not specific advice for any particular investor and is not intended to be passed on or relied upon by any person. Before making any decision about the information provided, an investor should consider the appropriateness of the information in this document, having regard to their objectives, financial situation and needs and consult their adviser. Any indicative information and assumptions used here are summarised and also may change without notice to you, particularly if based on past performance. This notice must not be removed from this document.