



Profile Financial Services

Investment Research Newsletter

August-September 2008

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



Content:

It's the information on the inside that counts...

➤ Feature Commentary

- The American Twin Deficit: What is it and why is it such a significant factor in the current economic environment...?

➤ 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...

Note: Profile's Investment Committee recently held a series of Portfolio Construction meetings with external Research Houses to pro-actively seek out sustainable investment opportunities and simultaneously position portfolios for the challenging market ahead. We will be providing further details on these outcomes in a special report in the near future.

The American Twin Deficit:

What is it, and why is it such a significant factor in the current economic environment...?



‘Ballooning U. S. deficits present real challenges for the U.S. and world economies. Management of debt costs and hedging against currency risk will be imperative until the twin deficits are tamed.’

When we refer to the so called ‘twin deficits’ we are referring to the Fiscal deficit [or Government Budget deficit] and the Current Account deficit [or Trade deficit].

A trade deficit is created when the aggregate imports of a country exceed its aggregate exports. A country with a trade deficit must compensate for that deficit either by reducing its capital reserves or by attracting foreign capital. In other words, the inflow of foreign capital allows a country to import more, yet still finance its trade deficit. **The size of the trade deficit has made the U.S. dependent on attracting foreign capital.**

A budget deficit on the other hand, is created when a government’s expenditures exceed its revenues. ‘The brief surplus of the Clinton Administration has been replaced by the deficit of the Bush Administration. Tax cuts to stimulate the economy were followed by increased government spending on the wars in Afghanistan and Iraq’. **To finance this deficit, the U.S. Government will have to issue Treasury securities. The size of the budget deficit presents a drain on both domestic savings [capital] and foreign capital.**

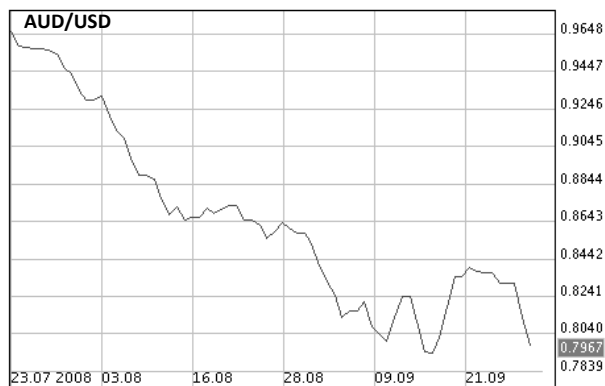
The real question that lingers in our minds, is how long the rest of the world, and primarily China, will keep buying US treasury securities in order to fund the US. We believe that as long as the US keeps demanding from China, then by continuing to fund the US, China is literally underwriting its own growth. As the world decouples [and we are supporters of the [decoupling](#) theory], China will eventually pull the plug and the great powerhouse that once stood proud by its flag, will cease to be such a great power after all [only to be replaced by the new emerging economies known as [BRIC](#)].

Global Markets



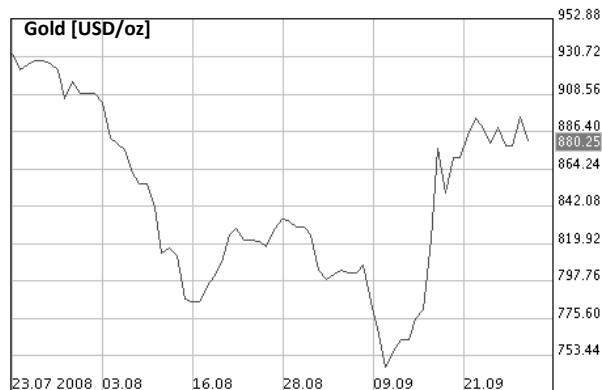
Key Events:

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



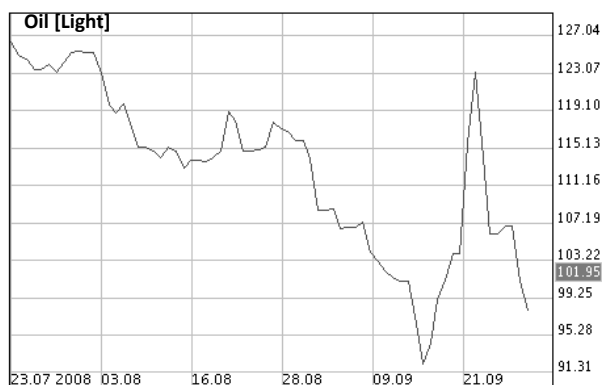
As independent as Australia may seem geographically, the hard fact is that we are part of global economy and are subject to the underlying macro-economic current it tows along.

As the Federal Reserve in the US announced a proposed US\$700bn financial bailout package, it sent a ripple effect through financial markets. With the expectation of surplus amounts of US Dollar [USD] flooding the market, investors fled to the safer haven of **Gold** sending the rare metal up to just under \$900oz.



Gold has a tendency to act as a hedge against the depreciation of a domestic currency and hence a store of value.

This fear of a depreciating USD, as well as a rise in commodity prices, supported the **Australian Dollar [AUD]** which paired some of its recent weakness against the USD to climb back to just over US\$0.83 before falling again to close the month at US\$0.79.



A big shakeout also came in the **Oil** Market in late September as the months futures expired resulting in a short squeeze that saw oil spike to just over US\$123bbl. Oil recalibrated the following day to close a bumpy end of month out at US\$101.95.

Given the very tight supply and demand curves in the oil pricing model, any shift on either side can send a significant shockwave through to the end market price.

Global banking events were covered in a recent investor update sent out in mid September.

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.

Deutsche Bank

Market Outlook

Chum Darvall, CEO Deutsche Bank, Australia/New Zealand provided insight into the extent of the credit crises and a view on the rate of recovery. Chum indicated that securitised debt for the six months prior to the crisis [July07] totalled US\$48bn. The six months immediately following saw securitised debt only totalling US\$2bn. **A more robust securitised debt market is required for any recovery to occur.** The Federal Reserve "bail out" of Bear Stearns was the first time the Fed has extended financial assistance since 1933. This helping hand will have strings attached, with some suggesting that the major investment banks may need to conform to strict Federal Regulations in order to receive assistance. If they do not wish to adhere to regulations, then no financial assistance will be forthcoming. Similar examples have been witnessed in Germany with IKB Deutsche and England with Northern Rock. The Fannie Mae and Freddie Mac are also examples of the Federal Reserves commitment to maintain financial stability in the markets. The view expressed was that there will be more shoes to fall off before any sustainable recovery can take place. Commercial Property was seen to be the next sector to "revalue" as finance contracts mature and the possibility that they may not be renewed [thereby forcing sales] may set a benchmark of revised capitalisation rates and hence lower market valuations.

China, India and Russia are seen to be resilient economies, however, not totally immune to the US's current and future economic issues. This credit crisis is more severe than any seen in the recent past and as such, makes it difficult to assess the inflexion point and the rate of recovery. It was noted that "write ups" can just as easily be made to balance sheets if write-downs on loans in the US are less than anticipated. **Recovery signs to look out for are increases in securitised debt, rights issues being successfully placed and deployment by sovereign funds and private equity firms.** Remember, Private Equity has traditionally made its name by turning undervalued companies into successful companies using leverage. This will be undertaken on a far more conservative basis than prior to the credit crises as banks lend 1x compared to up to 8x during the boom.

Pacific Prospect
Economic Outlook

Several leading economists presented their case on the current economic situation with the S&P Chief Economist commenting that the US was in for a long but mild recession. He noted that the 'stimulus package at the time [January 2008] merely provided a short term support mechanism but did not carry any longer term market support. He further commented that the strong export growth we were witnessing in the US off the back of the weak USD would slow as the USD strengthened [now starting to come through]. With housing prices in the US down 18% at the time, he expects a further 10% correction [although potentially an overcorrection]. The key problem lies in the oversupply of housing in the US with expectations it will take close to eighteen months to clear.

Inflation was another key talking point with a view by Macquarie's Senior Economist that it is now 'yesterday's story'. If you exclude oil and corn, year on year core inflation figures are quite reasonable. **The inflation outlook has also been seen to moderate under the pressures of slowing world growth rates and the on flow effect of rising unemployment.**

On the home front, it was commented that Australia's net economic position would be dependent on the speed of RBA action as well as support from our terms of trade. It is the general view that Australia's banking sector is in better shape than our US and European counterparts and hence could accommodate growth.

While we agree that our banking sector is in better shape, the path ahead is not in our view paved in gold by any standard. Australian banks will feel the global squeeze as they face pressure on wholesale funding costs [very exposed to borrowing in overseas markets] and a slowing loan book as the domestic economy potentially slows. However we don't see the significant write-down's and large scale financial exposures that several US banks have been privy too.

Australian housing prices are now also at global highs with Australian capital city's average house prices at 9x household income. While we are not subject to the same factors the US housing market faced [construction boom + non-recourse loans], Australian housing may still have to come back to more reasonable levels driven by different underlying currents.

Goldman Sachs JB Were
Investment Update

I think the heading of the presentation summed it up well, 'A Compelling Case or Continued Caution'. The update focussed on four key components governing current markets: financial stability; inflation expectations and management; commodity prices; and earnings risk. In regards to financial stability the outcome was that constrained lending would restrict free cash flow for all company's which is clearly evident in the current market. We would also see more equity raising and fewer buybacks resulting in lower EPS growth. Therefore cash flow generating companies deserve a premium. In regards to Australia, while income and **dividend growth may be lower than currently forecast, Australian banks look reasonable relative to many others.**

On the commodity front they believe there is a **long-term structural bull market in the running.** However in the short run [twelve months], they see economic weakness in the OECD crimping on demand growth and hence recommend investment exposures to commodities for which supply is struggling to keep pace with the demand [coal, copper, iron ore, oil and platinum]. Further along these lines, they have also

recommended avoiding direct 'pure-play' exposures to commodities that have moved into surplus [lead, nickel and zinc]. The key is that today's prices must be viewed in the context of a) rising production costs and b) a weak USD [although strengthening in the interim].

Their views on inflation were viewed in the context of a tale of two sides. **1** Short lived phenomenon theory: Prices are due to structural issues; one off reset to drive investment and increase supply; demand will be destroyed through excessive prices and wages are generally under control [although Australia is more susceptible given shortage in labour]. **2** Multiplier effect of price rises yet to come [eg higher iron ore prices yet to be reflected in cost of cars to consumers]; monetary policy too accommodating.

We believe that inflation will continue to be a concern but believe it will moderate in the near to long term. Assets that should outperform in this environment include energy, commodities, health, utilities and food manufacturing. We are pro-actively researching adequate investments in these spaces in line with our long-term expectations.

The view on equity markets is that they will continue without direction and dominated by volatility. This is evident through by moderate participation by major investors; hedge funds and short selling activities [although recently curbed]; patchy volumes; uncertain overnight news flow, profit banking to lock in performance; valuation measures and earnings risk.

With the global outlook set to be governed by growth outlooks [particularly China], the stabilisation of financial markets, inflation momentum and currency movements, our focus has been proactively based on building portfolios to accommodate for these factors in line with our economic outlooks. While valuations look better on the global front, Australia also has one of the strongest banking systems in the world. Going forward is really a time to be pro-actively searching out the best opportunities in what will be **a stock and investment pickers market**.

Perpetual

Australian Equities Update

Perpetuals core Australian manager presented a 2008 market view depicted by the following characteristics: more reasonable valuations; easing in earnings growth; interest and inflation on the up; a shy away from corporate leverage; increase in corporate activity but an absence of private equity; and finally that sentiment will be nervy.

In our view earnings will most certainly come under pressure as the consumer slows. Profits will also be impacted through margin contraction as further pressures emerge on the cost line. While valuations have certainly improved, they are not necessarily cheap, especially when compared on a global spectrum. The key will be to be conscious of the 'value trap' and hence this really will be a stock picker's market with a focus on **earnings sustainability, conservative debt and sound management**.

Macquarie Group

Company Update

Richard Sheppard, Managing Director of Macquarie Group, held a conference to discuss the bank's current position given the turbulence in global financial institutions. An important clarification was the fact that Macquarie Group is **under APRA regulation** as an Australian bank. This regulation has been significantly more stringent than the regulation [or lack of regulation] formerly imposed on its US counterparties. Macquarie Group's main business model focuses on making returns by providing a diversified range of

services to clients [50% through Macquarie Capital] rather than through leveraged trading mechanisms, which has played a large part in the global financial collapse. The Bank has also been known for its long-standing approach to risk management on which Richard commented has helped the Bank navigate the current events resulting in **no significant exposures to problem credit and a well funded balance sheet.**

Host: Brilliant [yes, with an 'e']
Portfolio Construction Conference

This year's portfolio construction conference brought through a range of themes; performance outlooks; asset allocation theory's; and drilled right down to the investment selection process. With a diverse selection of speakers and investment presentations, here are some of the key ideas we extracted.

A shift from return on capital, to return of capital: The objective of portfolio construction going forward should be focussed around preserving capital rather than generating excess returns. While portfolios will still seek to generate 'real returns', more emphasis will need to be placed on minimising volatility as we enter a very challenging market ahead. Profile has long been an advocate of this philosophy in an attempt not to chase 'hot money' but rather look for unique sustainable opportunities. In doing so, portfolios had been pro-actively positioned in this manner over the past cycle with further insulation put in place eighteen months ago.

Is current asset allocation in line with performance outlooks? A questionnaire was conducted to gauge the audience's performance outlooks. Although the performance outlook results differed significantly from the same questionnaire last year, a majority of the audience did not plan on changing their current asset allocation [quite scary]. As mentioned, Profile has been further pro-actively working on the current portfolio construction in order to take into account the 'non normal' significant events that have taken place aiming to seek the optimal blend of allocations [refer to note on [Contents](#) page].

The interpretation of information: An economist from the US made a very valid point [not normal for an economist]. In simple terms he said, 'there is too much information out there'. I could not agree more. Everyday we see the market react to news flows whether it is a move in oil, gold, currency or commodities, or a monthly piece of economic data that says more cars were produced this month than last. What he went on to explain was that we should focus on key themes and filter and interpret the information we hear rather than process it all. Given the recent nightly news flows that have been sending the market on to a rollercoaster ride [both up and down], I think his point stands up quite well.

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.

Perpetual **[Recommended]** Share PLUS Fund

The fund is used as a satellite fund to our 'core' Australian equity exposure and adds value through its [long-short](#) investment approach. The fund has **continued to outperform the broader equity market index** and fulfil its roll within the portfolio. The 'short component' of the fund operates using a system based on processes and fundamentals rather than [quantitative analysis](#). While equity markets continue to remain in **turbulent times**, we believe that the fund is **well positioned to add value** in the Australian equity space through its ability to make high conviction bets on both sides of the field.

Will ASIC's ban on short selling change the holdings of the fund?

The existing short positions within the fund are not affected by the ban, as they are all covered positions, and hence do not have to be closed out. The fund has never engaged in naked short selling. The typical holding period for short positions in the fund is between 6-12 months, highlighting that it has not been the fund's intention to make a quick return on the current financial crisis or cause unwanted disruption to financial markets.

Profile will continue to monitor updates from ASIC as they become available to the market with the intention of ensuring the fund's sustained ability to add value to the portfolio construction process.

Magellan **[Recommended]** Global Fund

The fund is used as a satellite fund to our 'core' International equity exposure and adds value through its [deep value](#) investment approach. Like the Share PLUS fund, this fund has **continued to outperform the broader equity market index** and fulfil its roll within the portfolio. With recent sell-offs in the global equity space, it is no mystery that 'the baby has been thrown out with the bath water' and hence distinct opportunities are merging in the oversold and therefore fundamentally cheap value arena. The fund has made recent acquisitions in the global financials sector in late June-July. Three of these companies being Bank of America, American Express and Lloyds TSB [which we recently saw go on the acquisition path and

make a bid for HBOS demonstrating its **strong balance sheet position**]. The fund also maintains exposures to **strong brand name companies** such as Nestle, P&G, Kraft and Yum brands [which is benefiting from the growth in China through the roll-out of its directly owned chain of KFC stores. Apparently the Chinese consumer loves their chicken]. Going forward the fund is focussed on acquiring companies with strong '**network economics**' and a '**fast moving consumer**' and therefore we believe is well positioned to navigate the forward looking market.

Aurora **[On the Radar]**

Dividend Income Trust

The Trust operates as a single listed investment trust on the [ASX](#). The Trust seeks to invest in Australia's largest companies that pay dividends and franking credits. Once the trust has earned the dividend from investing in the company over the dividend period, usually forty-five days, the shares are sold and the capital is returned to Cash. The Manager generally structures the portfolio with the objective of limiting the impact of a major downward movement in financial markets by selling up to around 65% of the Trust's gross capital exposure with S&P/ASX200 futures. The Fund seeks to take advantage of three scenarios being the 'ex-dividend pricing anomaly', whereby the stock prices falls by less than the 'gross franked dividend', the tax benefit of picking up a 'fully franked dividend' and finally the 'global effect' whereby stocks tend to rally following earnings announcements. We had originally analysed this Trust before but with no strategy 'track record' were not prepared to make an initial investment until one was established. With performance figures now on the scoreboard, we will be further analysing the Trust at the next Investment Committee meeting.

Deutsche **[On the Radar]**

Global Equity Gold and Precious Metals Trust

This close-ended trust will be listed on the ASX as a listed investment trust [LIT], and offer exposure to Deutsche Banks global gold and precious metals investment expertise. The benefits they promote for investing in such a specialist sub-sector exposure are: Persistent demand/supply gap [gold supply is not sufficient for demand; declining production, slower discovery rate]; Diversification in times of uncertainty [low correlation between precious metals and conventional asset classes diversifies risk in a portfolio]; DWS are specialists in this sector [150 strong specialist team managing \$5bn in this area alone, depth of understanding of mining and precious metals markets and investments, long track records in identifying the best global investment opportunities].

The trust invests in a portfolio of 40-60 global equity companies in the gold, precious metals and minerals sector [market cap unconstrained] and that operate across the entire industry value chain.

While the fund has received a recommended rating from Aegis, and Profile agrees with the theoretical fundamentals, we are less convinced that mixing equity like returns [even where the underlying product is precious metals], transcends into the true underlying commodity/alternative assets diversification benefits you may be seeking. The LIT structure is worth noting as it will be a trend for managed investment vehicles, enhanced by optional off market [NAV](#) daily liquidity facility [provided by DWS].

Deutsche [On the Radar]

Global Equity Agribusiness Fund

The Profile investment committee are well advanced into making some tactical recommendations to portfolio construction including specific exposure to global agribusiness theme. The global food supply is faced with significant issues with a rapid rise in global consumption from higher incomes in emerging markets. On the supply side, environmental pressures and urbanisation are putting further strains on our already limited resources.

The DWS Global Equity Agribusiness fund is structured to profit from this global megatrend, investing along all parts of the agribusiness food production chain. DWS are well renowned for their thematic investment skills and this fund is unique in the Australian investment space. The fund was inceptioned in March 2007 and has delivered an 8.1% pa return versus MSCI of -4.8% [to 31/7/08]. While this outperformance is not statistically meaningful over such a short term, the megatrend that the fund is trying to profit from is a long term strategic approach. **This fund is under consideration should this theme be implemented as part of our tactical portfolio allocation.**

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Glossary

Financial Terms:

In real terms...

APRA

The Australian Prudential Regulation Authority is a Federal Government agency, which regulates superannuation funds and other bodies in the financial sector, ensuring they operate within the requirements of retirement income legislation.

ASX

The Australian Stock Exchange

BRIC

BRIC is an acronym which refers to the four key emerging economies: Brazil, Russia, India and China.

EPS

Earnings per share

Futures

Contracts that require the delivery of a commodity [of a specified quality and quantity] at a specified price, on a specified future date. Commodity futures are traded on a commodity exchange and are used for both **speculation** and **hedging**

Decoupling Theory

The notion that the US is no longer the driver of world economic growth and that Europe and Asia have 'decoupled' from the American economic engine.

Deep Value

Deep value investors employ a more extreme version of value investing that is characterised by holding the stocks of companies with extremely **low valuation measures**. Often these companies are particularly out-of-favour or in industries that are out-of-favour.

Long-Short

A model that can hold both long and short positions [negative positions on the basis the stock will fall in price].

MSCI

Morgan Stanley Capital International: the MSCI provides a number of international tracking indices used for assessing International equity performances.

NAV

Net Asset Value: The valuation of a collective investment based on the market price of securities held in its portfolio

Short Squeeze

When traders, who are short a particular commodity or stock, are forced to simultaneously buy the investment back leading to a sudden jump in the price as demand overpowers supply.

Quantitative Analysis

Quantitative analysis is a form of analysis which uses **numbers and ratios** derived from a company's financials to assess its prospects.