



Profile Financial Services

Investment Research Newsletter

October 2008

Recent Seminar

A message to take home...



Many commentators have attempted to rationalise and explain away the wild swings in investment markets, with phrases such as 'unprecedented', 'absence of fundamentals' and 'buyers strike'. The only thing investors want to know is, when will it end?

We conducted our annual client seminar on Remembrance Day, with our guest speaker Mr Simon Doyle from Schroders Investment Management. Simon provided an overview of where we had come from and opportunities going forward. Our Research Analyst, Jai Parrab, followed

Simon's presentation up with what Profile has done to insulate client portfolios and outlined the portfolio construction process we undertake to arrive at the final investment recommendations. The seminar was held for the first time in the City and was well attended. We appreciated the feedback provided and can assure you that it is well considered in planning for future events.

For those clients who were unable to attend, we plan to have a copy of the presentations on our **new website** in the coming weeks.

We cannot control the markets and as noted earlier, they are behaving in a very irrational manner which makes it very difficult to both plan and invest. I hope that lessons can be learnt from what we are experiencing and look forward to returning to the quaint notion of spending within your means. Yes, a discipline

long forgotten by most, but one that will be making a comeback in the years to come.

'Spending within your means...'

I implore you to ignore the mayor of London who at the opening of the new Westfield, encouraged shoppers to "spend, spend, spend..." but in addition, do not become a pessimist and stop spending altogether. The message is, and always will be, to spend within your means.

I trust that you enjoy the latest version of our research report and encourage you all to provide us with any feedback on the current content as well as topics and issues you wish to see discussed in future editions.

Kind Regards,

Phillip Win
Director

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



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Feature Commentary

Government Intervention:

What measures have been taken to date and could they be the solution...?



The nine most terrifying words in the English language are: "I'm from the government and I am here to help."

Ronald Reagan

The world was privy to an unprecedented event when on the 8th of October 2008, the US Federal Reserve led a coordinated round of global official interest rate cuts in an attempt to stem the global financial crisis. Markets did not respond.

Just a week earlier, US Congress finally passed the Bernanke-Paulson bailout package which provided funding for the US Fed to start a reverse auction in order to buy distressed securities and equity off financial institutions [a fund very similar to that established during the

1980's savings and loan crisis]. While markets were expected to react positively, they seemed to gain no comfort in the deal. Instead focus remained on the greater dilemma that economic indicators were showing a slowdown across developed and emerging economies, and that the capital required to provide some stability was not flowing. The next move was global action by Central Banks designed to help free up the supply of US dollars that seemed to be drying up in the system. While this may have helped the flow of money internally within institutions, it did no part in helping to restore liquidity between banks and non-banks [businesses].

The 'short-lived' market rally finally did come when over the weekend of the 11th and 12th, European Central Banks took significant action by providing European commercial banks with an unlimited amount of dollars in a joint operation to provide them with relief. This was not supported by any positive action out of the G7 meeting except to comment that they would do all in their power to improve matters [not what we were hoping to hear from a group that carry's such weight on investor confidence].

'Providing European Banks with an unlimited amount of dollars...'

If the U.S. government moves ahead with a plan to take ownership stakes in American banks, as seems likely, it would be an exceptional step –

but not an unprecedented one. Over the past century, the U.S. government has nationalised railways, coal mines and steel mills, and it has even taken a controlling interest in banks when that was deemed to be in the national interest. For those who read last month's article on the American Twin deficit and are interested, I would have a look at the following news article: [<http://news.bbc.co.uk/2/hi/business/7660409.stm>].

So while the world seems to be taking significant action to stimulate their economy's and shore up financial institutions, what are Mr Rudd and his accomplice Treasurer Swan doing on the home front? While the government did not need to provide capital injections to prevent any bank collapses, they did provide some supporting plan of action through their recent announcement on the 12th of October and subsequent Fiscal stimulus package. On that Sunday, the Mr Rudd announced three key measures: **1** A guarantee over all bank deposits including credit unions **2** A mechanism by which the Australian government could use its AAA sovereign status to help domestic banks borrow in overseas wholesale markets and **3** A comment that the Australian Office of Financial Management [AOFM] would look to buy MBS's from mortgage originators and banks to free capital. Given our view that the Australian banking system is **not** in the same predicament as their American and International counterparts in regards to failing and over geared balance sheets, the key problem for banks going forward will be their ability to access funding given their high reliance on overseas funding markets. Since this market has essentially closed to anything rated below AAA, a government guarantee to underwrite any borrowing should help restore the capital inflows into Australian banks thereby helping to support the long run economic system. While we also believe there was no need to provide the deposit guarantee to retail investors, we believe the RBA intervened too restore confidence in the Australian banking system.



The key question will always remain, should the US Fed [and its global counterparties] have let those financial Institutions it recently supported go to the wall instead?

‘Some institutions really had become too big to fail...’

Well I think the reality has dawned on investors that Wall Street flows straight into Main Street. Rumours at the time of the AIG bailout were that if the Fed had not provided the company with the overnight bridge loan of US \$85 billion, then AIG would have gone to the wall the next morning resulting in the failure of over 2,000 regional banks across the US that day. While the US Fed did let Lehmann Brothers declare Chapter 11, some institutions really had become ‘too big to fail’. Going forward there will no doubt need to be a focus on regulation to ensure that the Fed [and by the Fed I mean US taxpayers] are no longer underwriting the corporate greed that dominates the industry again.

Jai Parrab

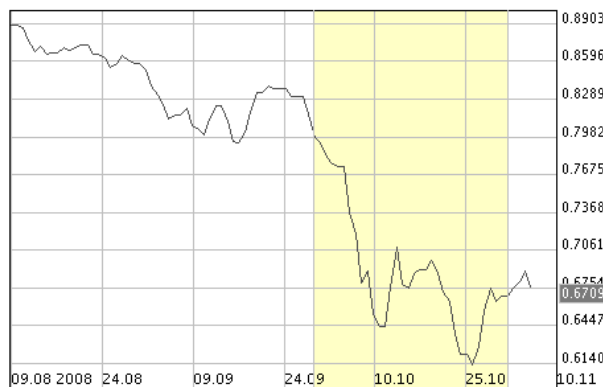
Global Markets



Key Events:

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

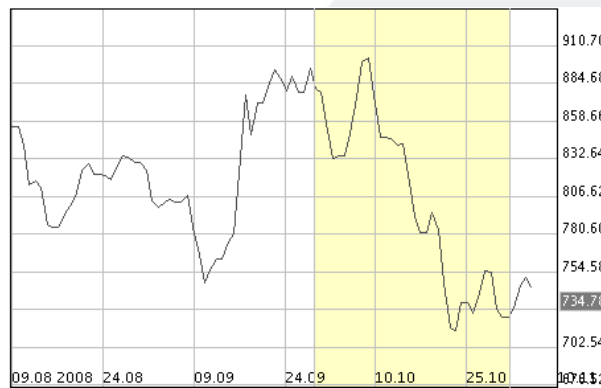
AUD/USD



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

While **currency** is as unpredictable as the weather is in a fortnight, the dual effect of falling commodity prices and a narrowing interest rate differential has led to the USD strengthening against the AUD as well as other global currencies. We now believe the AUD went from being one of the most overvalued currencies to being one of the most undervalued. The short term [twelve months] movement is going to be irrational and a function of investor confidence but fundamentals would indicate that a longer term trend for the AUD/USD is above its current trading range.

Gold [USD/oz]



Gold has been one of the most discussed subjects internally and the last two months would support our view that it is not a stable commodity given the underlying trends which support its demand. As economic fears persisted globally, there was a flight to the safety of gold which was reversed within the month sending the rare metal on a US\$170 swing.

Oil [Light]



Oil continued its downward trend as fears persisted that a global slowdown would dampen the demand for energy. Energy **derivatives** also continued to be unwound as the global liquidity crunch put further pressure on traders.

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.

Goldman Sachs JB Were Market Outlook

'Where to from here?' summed up our own views in that global uncertainty abounds. With credit markets evidently fragile and confidence in global financial markets low, they looked at economic fundamentals which are clearly weakening across the board: Consumer confidence and spending are weak; Employment is declining; House prices have declined in several developed markets and trade flows and emerging markets are being affected. Looking at portfolios, and with current asset allocation favouring Cash, they highlighted the benefits and penalties of timing the cycle and the opportunity cost of being 'conservative'. While investors at the moment are being driven by short term earnings outlooks, **valuations need to be viewed on a long term context**. While attractive opportunities are appearing across the board, the debate remains on timing and they used several indicators to display the lead gaps these indicators have in line with markets actually turning. An example of this was that on average the S&P 500 equity index bottoms three months prior to a confidence trough and turns before the data is released. Goldman's had further specific outlooks on the following two sectors: **Australian Equities** – Despite the Australian economy being more resilient, the market has moved in sympathy with global financial markets. On the flip side however, the Australian economy is essentially at full employment and therefore would be coming off a strong base. Furthermore, there is significant room for an easing in monetary policy and a stimulating fiscal policy. The controllable components of inflation are no longer problematic and with fear and volatility at elevated levels, the market is appearing cheap on conventional metrics. In line with a deteriorating outlook for global growth and a short term pause in emerging market growth, leading to decreasing business and consumer confidence and falling commodity prices remaining a concern, they have recommended overweight positions to materials, health care and telecommunications [although more expensive on valuation metrics] while maintain underweight to property trusts, financials and industrials; **Infrastructure** – Earnings have performed in line with expectations and outlook statements remain surprise free but volatility has increased. While asset prices appear to be resilient, the cost of debt has increased and markets had overreacted to concerns on interest rates, gearing and re-financing risk, ratings downgrades and slowing economic activity which has been reflected in subsequent outperformance following initial reaction. While the sector continues to offer diversification benefits, what remains in limbo is the timing around the return to 'normal' credit markets and the timing around the closing of the valuation gap. Focus must be maintained on **long term valuation** [albeit the market], **macro conditions and capital requirements**.

Schroders

Market Outlook

'A world of uncertainty or a world of opportunity?' outlined the events that led to the current credit crisis: Relaxed US monetary policy for a prolonged period of time, leading to increased global leverage, spreading into the sub-prime, resulting in over financial engineering and finally the bubble bursting. With several financial market participant failures, we are certainly seeing a new world develop. With growth assets having copped the brunt with equity markets down c40% and listed property being hit the hardest and now down c60%, there has been renewed interest in the formerly unloved asset class known as government bonds which, in the past twelve months generated returns in excess of 10% amidst the global financial meltdown. With the US recession now inevitable and also likely in Europe and Japan, inflation has taken a back seat as the focus of governments shifts to stimulating demand and rebuilding the banking system. The Australian terms of trading are now reversing and Australia is flirting with recession. However in all the doom and gloom, opportunity is certainly emerging with global equities now starting to look attractive with domestic valuations also improving. Another key niche opportunity now appearing through the overreaction by markets is the **yield** from hybrids with current option adjusted yields now in excess of 10%, a significant premium above the ever decreasing cash rate and hence increasing their risk-return attribute. While corporate defaults still remain a risk, the premium now being offered is starting to justify taking on that risk.

While Schroders and Goldman Sachs are gradually increasing their risk appetite, we believe that although there is certainly opportunity emerging in niche sectors, **risks still remains inherent** in the broader market. We are currently intensely evaluating both unique investment opportunities as well as effective strategies to re-enter the more core 'beta' markets. The volatility is a clear indication of the uncertainty currently present in global markets and **trading cautiously will remain the key.**



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.

Platinum **[Recommended]** International Fund

The fund generated a return of -7.7% for the twelve months ending 31 October 2008 versus the MSCI of -20.7%. With 32% of the fund net invested in Industrials and Information Technology, Kerr emphasised that they are continuing to seek very good companies with valuations at historically low levels. An interesting point Kerr also raised was a reduced short exposure to financials with shorts now rotated to the health and consumer staples sectors given their current expensive trading ranges. In times of slowing growth, markets tend to pay a premium for defensive stocks and hence they trade at a premium. Kerr believes this trend will tend to reverse amongst individual stocks. In light of the turbulent times, we believe the fund will continue to play an important role within the portfolio, through its **ability to take positions on both the long and short side as well as across all geographical regions and industry sectors.**

Morgan Stanley **[Recommended]** Global Franchise Fund

At the end of September, the fund had generated a return of -7.8% after fees versus the [MSCI World Index](#) of -16.7%. While the fund was up until recently only modestly outperforming the index, we believed that their underlying investment strategy of investing in strong brand name franchises would separate them from the rest as markets took flight to safety. This has been clearly evidenced in the current performance to date. The manager further conveyed that although these certainly were difficult markets, they were still seeing solid franchises at attractive valuations and that opportunity remained. In the current environment they were continuing to select companies with a strong brand name and as importantly strong free cash flow. Stocks that did not fit this class, such as Kimberly-Clark, were removed from the portfolio following fundamental erosions to their franchise. The fund was also able to enter select stocks that had been marked down, such as Danone, and were trading on a [FCF](#) of c6%. Starbucks was another interesting stock selection whereby they believe management has refocused on increasing [EPS](#) and is now lowering [CAPEX](#) and increasing efficiency to improve FCF. Similar to Platinum, we continue to believe that in this current market, this fund plays an important role within the portfolio as an **exposure to the growth sector with defensive qualities.**

Credit Suisse [Recommended]

Global Income Fund

Key takeouts: **1** We are witnessing significant corporate activity [Government assistances, institutional failures, M&A's], capital raisings to sure up balance sheets and reduce debt, coordinated government and central bank action, all of which are dramatic and drastic reactions to an unprecedented environment **2** Global credit markets are continuing to suffer from ever widening credit spreads without significant default activity. Spread levels are significantly wider than we have seen over recent recessionary periods. **3** Historically credit has outperformed strongly after a peak in yields during poor economic conditions **but** sound portfolio construction is the key to credit investment. The Australian hybrid arena is too small in size and concentration to achieve adequate diversification. **Outcome:** Profile is satisfied Credit Suisse demonstrates very strong risk management principles and processes within what appears to be an increasingly attractive investment opportunity as risk aversion has become irrational and the asset class is ridiculously cheap, short of a total global financial meltdown. However, even then credit appears to be already priced for such an event.

Deutsche [Hold]

RREEF Global Real Estate Securities Fund

Globally, listed property recorded heavy losses in the month of October and the RREEF Fund was not spared. While the fund is 'underweight' the US relative to global property indices, the fund is still significantly [>50%] invested in US REIT's which were trading in line with underlying NAV while Australian and Asian REIT's are trading at steep discounts to NAV. As expected, the housing market recession and tighter credit conditions have slowed the US economy and the transition in both the economy and capital markets has resulted in increased required IRR's of 75bps to 150bps in private real estate underwriting across the Americas. Realised earnings growth for US REIT's is expected to moderate to 4-6% in 2008 from 8-10% in 2007 driven by negative forces such as cost pressures, job losses and declining consumer spending. Going forward, property stocks are continuing to look for a bottom off the back of deteriorating fundamentals, poor sentiment and a few hints of M&A bids. Discounts in various regions are prompting speculation that private equity views the stocks as cheap but investors remain focussed on asset quality, tenant health, availability of capital and the strength of management. The sector will continue to remain under pressure until investor sentiment returns and fundamentals start to hold.

Goldman Sachs JB Were [Suspended]

Multi Strategy Fund

In this current environment dominated by uncertainty and restricted liquidity, the fund is facing harder times along with the general Hedge Fund of Funds sector. The underlying investment strategies that were once profitable in the long-short sector are now becoming inefficient as short selling regulations are maintained and good stocks are being sold off in a market governed by deleveraging. Liquidity and now prime broker risk continues to be monitored and evaluated by the Manager. The fund has not changed its strategy allocations and has a line of credit available to manage liquidity and prevent forced investment sales. This is appearing to be another case of strong funds management being overwhelmed by the broader market conditions. The 'new' market environment no longer appears to be conducive to the performance of the underlying strategies and at the most recent R&D day [Friday the 14th] a decision had been made to redeem the fund. However, over the weekend we received notification that the fund has officially closed to redemptions and we will need to continue to monitor any developments.

Centro [Suspended]

Direct Property Fund

The Centro story is now appearing more and more across the market as being a case of a company with short duration debt in a bad debt cycle. In Centro's case, the financing is provided by three groups being US banks, note holders [US insurers] and an Australian Syndicate [Australian and European banks]. Since January, the company received a consensus extension maturing in mid December 2008. Centro is currently working with the aforementioned financing groups to provide a long term restructuring/extension solution. Glenn Rufrano [CEO of Centro] indicated that should no extension be reached, the company will enter administration at this date. In the meantime, a focus will remain on keeping the centres well leased and tenanted. Debt repayment will be a function of asset sales. The company has learned that in the current environment, putting the entire portfolio for sale at once is not optimal. The strategy has now shifted to single asset sales through the underlying funds but management has affirmed that they do not want to sell at significant discounts. As assets are sold, the underlying syndicates will either use the proceeds to pay down debt within that syndicate or funnel through the excess to Centro Properties group which may be used to pay a distribution to investors. The Fund is expecting to make an extra-ordinary distribution this month. **The significant factor is that the debt issue is at the head stock level** and there is no 'direct' debt on the Direct Property Funds balance sheet although there is look through debt in the underlying syndicates. Downward valuations in properties are expected to continue with further potential unit price declines to come. At the end of the day, they are still invested in bricks and mortars with ongoing leases providing on ongoing income to the properties but at the present time no action can be taken and management has re-iterated that the Fund can stay closed as long is deemed necessary by Management.

Select Asset Management [On the Radar]

Listed Investments Fund

The Listed Investment Fund targets listed investment vehicles on the ASX that are inefficiently priced and represent repricing opportunities, with a benchmark target of cash +10% over 5+ years albeit high volatility due to low liquidity in the sector. Most listed investment funds trade at substantial discounts to their NTA and the average investor in this arena are retail investors and are generally not very sophisticated. There are a range of corporate actions that the listed investment vehicles management undertake from time to time to address the share market price discount gap, which Select not only identifies but is proactive in instigating when and if appropriate. Profile has been aware of the pricing inefficiencies in the listed investment company space but conscious that it is very difficult to extract value from those inefficiencies with the volatility and illiquidity. Select's fund is unique in this space and is the best option we have encountered to date to extract value from this sector. The management team have a deep understanding of this market and are able to add real value through not only identifying deep discounts and being instrumental in triggering corporate actions to return value to investors, as well as sophisticated hedged and trading strategies. This fund offers high risk adjusted return which although volatile, is not highly correlated to traditional equity markets as returns do not rely solely on underlying asset returns. Outcome: In a normal environment this fund would have been likely approved for Profile's investment menu, however we are prudently deferring any decision until markets have regained some rationality and tangibility.

Glossary

Financial Terms:

In real terms...

CAPEX

Capital Expenditure: Money spent to purchase new or upgrade existing physical assets such as equipment or property.

Chapter 11

A chapter in the United States Bankruptcy Code that contains the provisions for a court-supervised reorganisation of debtor companies

Credit Spreads

The spread on credit is the additional yield [refer below] received by investors over and above that of government bonds for a holding a bond with a particular credit rating.

Derivatives

A contract that changes in value in relation to the price movements of a related or underlying security, future or other physical instrument.

EPS

Earnings per Share: A company's net profit figure divided by the total number of shares outstanding

FCF

Free Cash Flow: Money a company could pay shareholders out of profits derived from operating activities and investment activities.

IRR

Internal Rate of Return: The percentage rate earned on each dollar that remains in an investment each year. The IRR of an investment is the discount rate at which the sum of the present value of future cash flows equals the initial capital investment.

NAV

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

M&A

Mergers and Acquisitions: A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another with no new company being formed

MBS

Mortgage Backed Security: A bond or other financial obligation secured by a pool of mortgage loans

MSCI

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

REIT

Real Estate Investment Trust: A company that manages a portfolio of real estate investments for shareholders.

RBA

Reserve Bank of Australia: Australian Central Bank

Risk Aversion

The preference of investors for the less risky of investments

Yield

The dividends or interest received on a security, usually expressed as an annual percentage of either the current market value or the cost of the investment

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