

12 January 2009

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Dear

It is a bit hard to know where to start the report for the first half of the 2008/09 financial year except to say it has been a period of the Good, the Bad and the Ugly, and not in that order.

The Ugly is the market has now experienced the second largest correction from market highs in its entire history surpassing the market falls of 1987, the 1929 depression and now only behind the 1973/74 market collapse. Since the 6851 high of November 2007, the market has retraced 53% to a low of 3217, a level first seen in early 2000 and previously last seen in late 2003. In the period with which this report relates to – 1 July 2008 through 31 December 2008 - the market bore the brunt of that correction, eventually closing above the lows but still, at 3722, a drop of almost 29% for the period (or 26.5% including gross dividends). Now that is ugly.

Australian sharemarket decline – some perspective



Source: Australian Stock Exchange as at 21 November 2008



The Bad is that we have not escaped unscathed with losses across all accounts I manage. The less bad is that our losses across accounts do not resemble the degree of general market losses, especially for accounts that have held strongest to our original plans of reserving funds for deployment when the opportunities appear.

I started this portfolio management service in 2003 and 2008/09's market correction sees the completion of the full stock market cycle from low to high and back to low again. This experience has confirmed my view that applying certain basic risk management principles and having the ability to acknowledge when the market is simply cheap or obviously too high while avoiding in between, is all you need to be a profitable investor. Unfortunately, just because something is simple to understand it does not make it simple to apply and much of the heartache market participants feel today (us included) has more to do with investment decisions taken in 2006 and 2007 than anything else. Money is made and lost in the buying not the selling.

Results for the 1st Half of 2008/2009

So what went wrong in the world?

The early 2008 credit crunch turned into a full blown credit freeze which resulted in all kinds of unpleasant consequences for commerce and consumption worldwide. The blame rests with banks, predominantly in the USA and Europe, who became insolvent as a result of very poor banking and investment banking practices. To understand the cause, implication, government actions and likely outcomes we best start with a basic review of how banks work in the first place.

What may surprise many is just how leveraged banks get and the implication that leverage has. If we look at a typical bank balance sheet you will see what I mean.

Bank Balance Sheet

| | | |
|---------------------|-----------|----------|
| Assets | \$ | 100 |
| less | | |
| Liabilities | \$ | 95 |
| leaves | | |
| Shareholder's funds | <u>\$</u> | <u>5</u> |

Here a bank has \$100 billion of assets made up of loans it has made for housing, consumer debt and business loans etc. But not all of that number is made up of loans, as banks own other financial and hard assets, such as government bonds and other financial assets it has purchased. This is especially the case for investment banks who owned over-priced Mortgage Backed Securities (MBS), Collateralised Debt Obligations (CDO) and Credit Default Swaps.

For every dollar in assets a bank has it borrows 95% from someone else. Those liabilities are to people who make bank deposits and anybody who buys interest bearing securities from the banks, i.e. their bonds.

The remaining \$5 billion (or 5% of assets) is what the shareholders own. As you can see the shareholders leveraged their capital 20 times, i.e. the \$5 billion of shareholders money supports \$100 billion of loans made and other assets purchased. So if the \$100 billion of assets deteriorate just 5%, then the whole shareholders equity disappears. And for many banks around the world this is exactly what happened when the value of loans and MBS's, CDO's and other financial assets had to be written down or off.

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| | | |
|---------------------|-----------|----------|
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| leaves | | |
| Shareholder's funds | <u>\$</u> | <u>-</u> |

Once it becomes known that bank assets are deteriorating and shareholder equity is vanishing, the depositors decide they all want their money back and so a run starts on the bank. Because the bank's assets are usually long term loans and other financial assets which may be hard to sell quickly, the bank can't pay back the deposits and becomes insolvent without central bank or government intervention. (The reality is that a bank can't repay all its depositors on demand at any time even when it has full shareholder equity available - but then again people aren't asking for their money back when everything appears ok).

The implication of many banks simultaneously losing their equity is far reaching. Besides depositors wanting their money back, the banks themselves want the loan money back from borrowers by failing to extend credit and ceasing to lend to one another for fear of default. They also slow down or stop new lending to companies and consumers because of their limited access to funds, i.e. depositors are withdrawing and no-one is buying bank bonds. The domino effect causes businesses who were reliant on bank support to close; businesses to contract because they either can't fund their inventory or contract in anticipation of slower demand; businesses to delay expansion for the same funding and slower demand reasons. No jobs are created, old jobs are lost and people still employed fear for their jobs, so consumption stalls. All of a sudden the economy freezes. When the economy freezes, governments can't collect taxes, so governments act.

The first step was to resurrect the banks balance sheets and restore equity (the difference between the assets and liabilities). With equity replenished the credit process can start again.

First the USA government agreed to buy distressed financial assets which would swap illiquid balance sheet assets for cash. Then the UK and European governments decided to directly replenish shareholders equity by injecting cash and becoming shareholders of banks themselves. Many governments around the world guaranteed bank deposits, hence stopping the need for depositors to withdraw funds. In Australia, our government guaranteed the bonds our banks issued overseas. It has been a swift and effective reaction by governments and world banks – we don't want to think about what it would have been like if they hadn't acted but it does make one think how fickle the financial system is.

What are the implications for the economy and the stock market?

While the banking system has survived and is slowly thawing out, the world economies are still suffering the fallout caused by the credit shock. Despite governments trying to stimulate economic activity, there is rising unemployment, deteriorating company profits and GDP around the world reflecting recession or risk of it.

It appears all is forlorn and we are without hope! Well not exactly.

Consider this from Buffett: "There are always people who say that the rules have changed. But it only looks that way if the time horizon is too short."

Fortunately our economies have a self correcting mechanism that almost ensures future economic activity to be higher through time – it is 'capitalism' or 'profitability' as a means of allocating resources. GDP growth will eventually resume and this is why.

GDP or Gross Domestic Product is an economic measure of what an economy produces (in its truest sense it is measured per person per hour). GDP grows when an economy produces more output than the previous year on a per person basis, i.e. increases productivity. The three forces that stimulate growth are 1. The amount of capital each person uses (the more equipment you use the more productive you become), 2. Increasing skill levels (doing things smarter), and 3. The discovery of new technologies (doing things better).

Unfortunately in 2006 and 2007 a major misallocation of resources occurred; for example far too many houses were built in the USA and financed through Wall Street peddling falsely priced MBS's and CDO's. When credit was easy, capital allocation decisions were made that didn't stand the test of profitability and, as the credit freeze occurred, it has exposed the shortcomings of some of those decisions.

The desire to make future profits will see the reallocation of resources and skills to more productive means. This is a painful experience the economy must work its way through, but the end result will be GDP gains as capital, human know-how and new technologies result in future capacity where needed. For example, consider the enormous brain power previously wasted on Wall Street that with retraining will effectively be used in other fields.

While world economies do come out of economic crisis stronger on the other side, today we have a lot of uncertainty and adversity associated with the reallocation process. Consumer and business sentiment are at lows as a consequence. The further effect is consumption and manufacturing decisions are deferred as people wait out the uncertainty.

What is the evidence of value in the market?

I have spoken before that stock prices, first and foremost, follow earnings and earnings expectations. Markets fail to average out earnings in a meaningful way and do the opposite by overshooting stock prices on both the upside and downside, which is simply greed and fear playing out. But if we know the economy must recover and with it profitability this brings us to the next issue - that in every problem an opportunity is presented. How can we tell if what we own or are buying is cheap besides the price falling (having said that, falling share prices of even 50% doesn't make stocks automatically cheap).

With profitability a questionable guide at the moment, (remember Buffet also said some of his best purchases were made when the numbers told him not to), we can turn to a more reliable yardstick of analysing stock value via the book (equity) value premium. This is the ratio of total market capitalisation (or share price) of a stock versus the amount of shareholder equity (or equity per share). Higher ratios of market price to book/equity values are associated with companies that can earn high returns on their shareholder funds, i.e. quality costs more. Each company usually trades within its own range of price to book ratios and at the moment, many excellent companies are at their all time bottom of those ranges.

Before getting into a detailed examination of one particular company and its price to book ratio, it may be worthwhile having a look at how future profits may play out. After all, if stock prices follow earnings and we expect GDP to resume growth, a closer inspection of what causes profit swings will help understand these market cycles.

Company sales revenue generally comes from the consumption of goods and services by either consumers or commercial operations. Some consumption must occur as it is simply replacement consumption; e.g. replacing washing machines, cars or computers when they breakdown. Other consumption can be deferred for a period, while some consumption only occurs when people are confident about their prospects. With consumer and business confidence down, only replacement consumption is occurring. For companies with declining revenues and less declining costs, their profits will fall in greater proportion than sales. This will send some businesses broke and weaken others. This scenario is most likely playing out currently. But the deferment of certain consumption is only that and it must return, i.e. it gets cheaper for a company running a fleet of cars to buy a new car than service old ones. When this level of consumption returns in 2010, sales will be tracking higher once again and the gap between a company's sales and costs will widen and profits will increase. With a better outlook we might even see a return of consumption by those who buy when they feel secure, further increasing profitability. Once again stock prices will eventually follow earnings and earnings outlooks.

Unfortunately not all businesses operating today will come out the other end of this shake-up. It will become a test of survival of the fittest, i.e. those who can sell the cheapest to their customers or those with the most desirable product/service features. And the prize for winning this contest will be a greater percentage of market share and with it greater profitability. This has always been the case.

Next we move back to the reliable value indicator of price to book premiums. While all of our stocks meet the criteria of value when price is compared to book value allowing for their various returns on equity, we will look at ANZ Bank to highlight the situation as it is the most recent purchase for clients with funds available.

A study of ANZ's history of price to book premium will highlight today's value.

| | | | | | | | | |
|----------------------------|------------|------------|------------|------------|------------|------------|------------|------------|
| year | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
| share price of ANZ | \$ 3.70 | \$ 5.61 | \$ 7.27 | \$ 11.34 | \$ 9.02 | \$ 10.25 | \$ 13.28 | \$ 15.98 |
| equity per share of ANZ | \$ 3.70 | \$ 4.01 | \$ 4.28 | \$ 4.73 | \$ 5.31 | \$ 5.04 | \$ 5.34 | \$ 5.79 |
| price to book ratio | 1.0 | 1.4 | 1.7 | 2.4 | 1.7 | 2.0 | 2.5 | 2.7 |
| year | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | Today |
| share price of ANZ | \$ 17.65 | \$ 17.95 | \$ 19.02 | \$ 24.00 | \$ 26.87 | \$ 29.71 | \$ 18.75 | \$ 13.80 |
| equity per share of ANZ | \$ 6.40 | \$ 7.26 | \$ 9.30 | \$ 9.64 | \$ 10.34 | \$ 11.34 | \$ 12.55 | \$ 12.55 |
| price to book ratio | 2.8 | 2.5 | 2.0 | 2.5 | 2.6 | 2.6 | 1.5 | 1.1 |

ANZ has had a share price range of 1.0 to 2.8 times the equity per share over the last 15 years while Australian banks in general have traded around two times book historically. This ratio is justified by the long term returns of equity in the high teens while paying out large dividends. 2009's ratio is back to 1994 levels and the last time the share price reached these levels in 2000 a shareholder only had \$5.34 worth of book value, today that is \$12.55. Why is that important? ANZ is now 2.3 times bigger than it was in 2000 and that is what sustains the 2008 dividends of \$1.36 versus 2000's dividend of 61 cents.

Mind you, a relatively cheap price to book/equity price is not enough to justify a purchase without the business in question having a future. While there is no doubt in my mind that banking is in a difficult situation, the price we pay is compensating us for today's troubles. As the economy reengineers itself, our banks will stand the test of time and most likely come out stronger as evidenced by many second and third tier players folding into the majors, i.e. Wizard Home Loans, BankWest, Rams etc. Secondly, I suspect that the Australian banks are not in as bad a position that some may think and certainly not comparable to the early 1990's. By the late 1980's, there had been four years of consecutive 25% to 30% compound lending to corporations. This time round, we only had one year of 25% credit growth to businesses, so our banks haven't had time to make as many bad loans as they did during the late 1980's.

So while the economy may get worse before it gets better, there finally is The Good and that is that the value proposition of ANZ is repeated with many stocks trading at values that are extremely attractive. 2010 is most likely to see company revenues ahead of 2009 and profit growth improving. The market will eventually correct and re-weight the prices of quality businesses. Unfortunately, no-one rings a bell at the bottom of the market and many changes within the economy occur without immediate visibility, so we need to be positioned for a recovery beforehand. That means being as fully invested as is reasonable, i.e. being greedy while others are fearful. Future volatility in share prices is guaranteed, so to participate in the upside potential that today's share prices offer means we have to accept the share price volatility. Again, others' problems are our opportunity; hence we stick to our long term game plan and let human nature take its course.

Regards

Justin O'Kane
Portfolio Manager