PGW Financial Services Pty Ltd
AFSL 384713

O'Kane Investment Services Pty Ltd
Portfolio Management
ABN 66 101 935 737

23 January 2014

Dear Client

Welcome to the interim 2013/14 client financial report. Included within this letter are the financial year to date portfolio returns and transactional reports.

The positive general market returns for the last six months were heavily influenced by the ongoing support for the big four banks, as the chase for yield continued, and a rebound in the two big mining stocks, as fears for commodity prices subsided.

The last time we actively bought bank stocks across portfolios was after the GFC when perceived risk was high and actual risk was low. That is the correct circumstance to buy a bank share and I struggle to appreciate what today's new buyer of bank shares expects. Meanwhile the future economics of mining stocks continue to be notoriously difficult to predict. A cornerstone of our investment philosophy is to maintain a margin of safety in our stock holdings via avoiding highly indecipherable situations and seeking more certain situations, despite the allure of speculative returns.

With the market looking fully priced over the last six months we have been switching from over-weight equity allocations to more neutral allocations. As the general cheapness of the market has dissipated and perceived market risk has diminished it has become important to position portfolios for the next opportunity. Should a 'market opportunity' take an extended period to eventuate I continue to remain satisfied with our core portfolio of stocks holdings. I expect these businesses to generate sustainable earnings growth that translates into a stream of growing dividends.

While we are not in the business of predicting the future I have set out below a broad framework that can be used to help with market expectations. They are broad rules of thumb and as handy as these insights may prove, in no way, do they replace the primary need to understand the economics of the businesses we are interested in owning.

Regards

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PGW Financial Service P/L AFSL 384713 (Contact PO Box 622, Marden SA 5070, Australia Phone: 0421 908 266)

Closing E*Trade account balance on 31 Dec 2013	**$ -**	
less		
Opening E*Trade account balance on 1 July 2013	$ -	
Change in the account balance	$ -	
Adjust account balances for contributions and withdrawls		
less		
cash contributions from dividends debited into E*Trade ANZ CMT	$ -	
add		
cash transfered out of E*Trade ANZ CMT	$ -	
Change in account balance due to market price changes*	$ -	
add		
dividends earned during the period	$ -	
franking credits earned during the period	$ -	
Portfolio Return for the period	**$ -**	
Portfolio Percentage Return for the period	**0.0%**	
* note: interest received and brokerage paid are included in E*Trade account balances		

What to Expect When You Are Expecting

A common question this time of year is what the market will do. An insightful market forecast might seem a rational ambition however, like New Year resolutions, well intended forecasts are usually soon abandoned. That doesn't mean we shouldn't be 'market aware' as we do have some helpful techniques to assist us in shaping our expectations of what is possible in the coming market. Through benchmarking typical market yields and typical market movement against the current market circumstances we can assess the risk and opportunity that the year presents.

Market Dividends and Market Yields

Becoming 'market aware' starts with market dividends and market yields. We all know the saying that *cash is king*, well it isn't, *cash flow is* actually *king*. Investor willingness to pay for cash flow drives market prices, just look at what happens after every stock market crash; investors return looking for the growing cash flows companies can spit out.

Advantageously for us a noticeable pattern as to what the market will and won't pay for dividend flows (or yield to be precise) can be detected. The figure 1 graph displays the estimated market dividends while the second graph converts those dividends into market yields (dividend/price). For easy use I have noted the dividend/yield next to the market price.

What is determinable from the yield graph is the market has struggled when the yield has hit 4% or less, while the market rarely stays below levels where the yield is 5% or greater. Put another way the market could be considered vulnerable to a correction should a 'future event' occur when it yields 4% (and less), while there is an opportunity to buy regardless of news as it approaches a 5% or better yield.

Before you head off thinking that's all easy enough to understand i.e. sell on a 4% yield and buy on a 5% yield, there are a couple of important factors to be aware of. First, the market dividend stream is a moving target, with long term average annual earnings growth of between 5% and 6%. Selling out of the market just because it hits a 4% yield (or a lower yield) risks missing a higher market as dividends grow through time and the yield remains constant (see the second chart between Feb-April 2011 and Oct-Nov 2013). Also needing consideration is how dependable the current underlying market dividends are. For example the 2006/07 pre-GFC era market dividends where stimulated by excess consumption that the easy credit of the period provided. In an environment where dividends have been artificially boosted we can't rely on a market yield as an indicator of value to support the market should any market worrying news emerge. The final consideration is that any meaningful change in interest rate expectations will impact the yield the market trades between. Rampant inflation makes all bets off as runaway interest rates will stall any market.

A smarter way to interpret the 4% threshold is as *possible* short term market vulnerability i.e. maybe a place to trim overweight positions or at least not a place to add to existing positions. Meanwhile as the market drops to a 5% yield, before buying consider how 'real' the underlying dividends are rather than how loud the news driving the market is. The worse situation is a combination of an unreliable market dividend and a low market yield. We know the 2006 through 2007 market dividends ultimately proved unreliable but if you were also thinking the 2007 market yield was historically low pat yourself on the back – it got to approximately 3.3%. The best case scenario is when you have a growing dividend stream and a falling market as developed in 2011. Call me when you see a similar situation unfold!

To take advantage of this noticeable yield pattern we need to appreciate where the current yield is and asses how stable the current market dividends are. Currently the market yields 4.25% (S&P200 5320) with what appears a dependable market dividend of 226 points. Consequently, in theory at least, off a 4% yield the market (S&P200) would be considered vulnerable at 5,650 points; reasonable buying at 4.5% or 5,020 points; and good buying at a 5% yield or 4,520 and lower. Given the market dividend is a moving target we also need to bear in mind what the 12 months dividend will likely be. Assuming normal dividend growth for this year, the 2015 starting dividend would approximate 237 points. Off the same yields the market levels would be 5,925 points (4% and vulnerable), 5,265 points (4.5% and reasonable buying) and 4,740 points (5% and good buying).

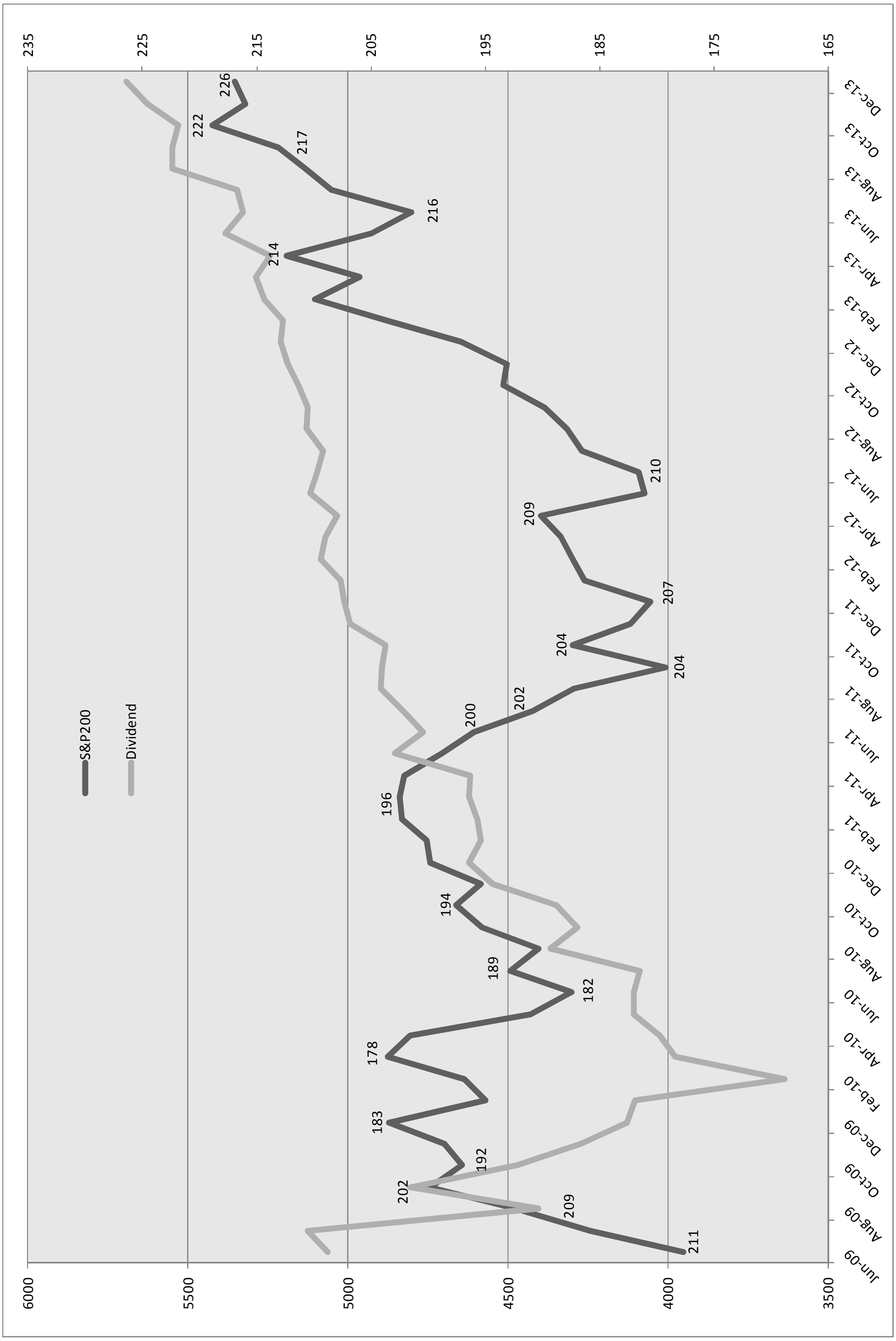
Typical market gains and losses and the inevitability of something happening

With the market sitting on a 4.25% yield, an earnings outlook neither excitingly rosy nor desperately dire and a general acceptance of few black clouds on the horizon why would there be any reason to think the market could possibly hit 4,520 or 5,920 anytime over the next 12 months?

The average annual stock market price gain in Australia is approximately six percent. This relatively pedestrian number on face value should imply market stability; compared to the cash rate the annual market return is not so big as to suggest it comes with a high degree of uncertainly, right? Yet an observation of the one standard deviation of annual market gains at 13.5% shows that this pedestrian annualised market return is in fact volatile in its make-up. In plainer English, while the average annual returns work out to be six percent there is a near 70% chance (68.2% to be exact) in any given year the annual price change will fall between a 7.5% loss and 19.5% gain, with potentially more movement in the interim.

A 13.5% potential swing either way around the average (or 27% potential range) suggests it is normal to expect meaningful annual price movement away from where we currently sit. Also consider the inverse situation implies there is a 31.8% chance in any given year that the market return is greater than a 20% gain or greater than an 8% loss in any year. We should learn to expect market movement, even average market movement is meaningful, despite what we think will happen.

While the above analysis won't tell us what the market will do, the identified ranges do offer an insight as to what the market's potential is when something inevitably happens.


S&P200
Dividend
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5500
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Oct-09
Dec-09
Feb-10
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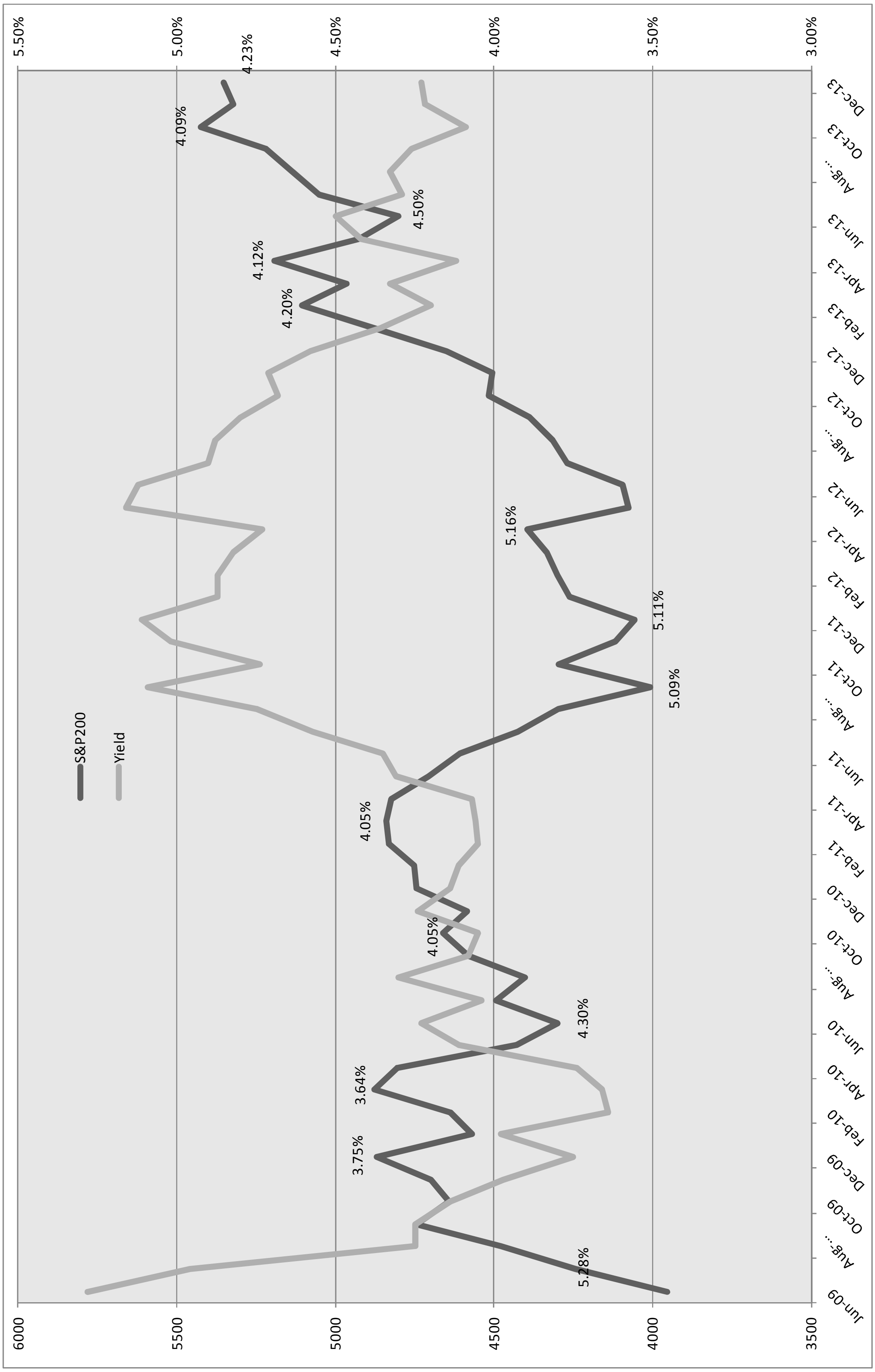
Figure 1


S&P200
Yield
5.50%
5.00%
4.50%
4.00%
3.50%
3.00%
6000
5500
5000
4500
4000
3500
4.23%
4.09%
4.50%
4.12%
4.20%
5.16%
5.11%
5.09%
4.05%
4.05%
4.30%
3.64%
3.75%
5.28%
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Jun-13
Apr-13
Feb-13
Dec-12
Oct-12
Jun-12
Apr-12
Feb-12
Dec-11
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Figure 2