

14 July 2009

Mr and Mrs

Dear Client

2008/09 was expected to be a tough year for the market and unfortunately it didn't disappoint. The financial year started with the S&P200 (the top 200 companies in Australia) at 5215 points and ended at 3955 for a **drop** of 1,260 points or **24.2%** from the open. After allowing for market dividends and franking credits the yearly market wide loss was still approximately 19.5%. Meanwhile on average across the client accounts within my service total returns on the same basis for the year were up a couple of percent – more if you contributed cash during the year or we deployed excess cash into stocks and you participated in the share purchase plans. And less if you withdrew funds during the year and avoided the share purchase plans.

From the absolute top of the market at 6850 in November 2007 the market hit 3073 in March this year – for a high to low fall of 3,777 points or 55% from the top. To put this in context the market move we have just experienced is now the equal largest correction in the history of the Australian stock market – worse than 1987 – worse than 1929 – and now equal with 1973/74. People will still be talking about the size of this correction 50 years from now.

If there is one thing we should note from the last five or six year cycle it is that our investment behavior in situations of extended market optimism needs to be different to that of periods of market pessimism - but not our thinking. We must consistently apply the same principles of business valuation across all market circumstances as best as we can if we are going to use the stock market as a means for providing acceptable investment returns. This is what helps minimise damage from overheated markets and provides the strength to buy in times of opportunity allowing for long term positive returns.

In this letter we will look into the portfolio returns for the financial year then turn our attention to what we should be concentrating on, and avoiding, to see our way clear of this economic mess – there is a road map.

As Winston Churchill said 'If you're going through hell, keep going'.

Financial Results 2008/09

Your gain for the financial year 2008/09, being 1 July 2008 to 30 June 2009, before taxes and fees, has been **\$0**.

Expressed in cash/stock movement

Closing account balance on 30 June 2009	\$	-
add net withdrawals made during the period*	\$	-
add dividends and franking credits earned during the period	\$	-
less opening account balance on 1 July 2008	\$	-
net loss for the period	\$	-
% change from the opening account balance		

* net withdrawals explained

add back Withdrawals of cash form ANZ CMT E*Trade \$0

add back Withdrawals via stock maturing & returned as cash to you \$0

less Contributions of cash into ANZ CMT E*Trade \$0

less Contributions via share purchase plans \$0

Expressed in accounting terms

Change in Unrealised gains/losses for the period	\$	-
Capital gains/losses for the period	\$	-
Dividends, franking credits and interest earned during the period	\$	-
less brokerage	\$	-
	\$	-

This brings our Total net gains since we started this service (2003) to approximately:

Total Unrealised gains/losses	\$	-
Total Capital gains/losses	\$	-
Total Dividends, franking credits and interest less brokerage	\$	-
	\$	-

Economics, Markets & Portfolios Reviewed

(Please remember that not all client portfolios are the same. They can differ on what securities are held and by what percentage. The reason for the different individual situations comes down to the time the client joined the service through to the investment balance needed from their portfolios. As a consequence not everyone may hold the security in question or have the same asset weightings, so some individual stock discussion may be less consequential for some as it may be to others. As a rule unless the stock was held by at least half the accounts it is not mentioned.)

As far as the portfolios are concerned the second half of the financial year saw strong share price performances which made up for the poor first half – but price movements come and go like the news, and like the news most of it ultimately proves unimportant and transitory. Meanwhile dividends and distributions from our securities kept rolling in and they saved the day. I kid you not when I say one of my favorite parts of the day is checking the mail for dividend cheques. And when I get one I'm just like Charlie Bucket.



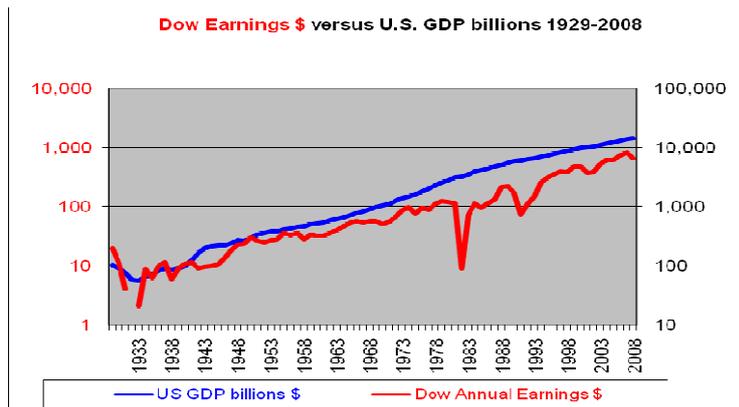
In terms of individual stocks most businesses we own have seen their earnings decrease with the exception of ARB Corporation (4WD accessories) and Cochlear whose earnings keep marching north - their dividends really are golden tickets. The earnings fluctuations of the other businesses we own will make very little difference to their valuations in the long term and their depressed prices are just better buying opportunities than previously. No company we own who survives based on selling cheaper or broader goods/services than their competitors has lost market share, or who competes based on their product/service being more desirable than their competitors has lost that desirability. If anything all our businesses are better placed than 12-24 months ago in terms of their competitive positions i.e. their competitors have gone backwards faster than they have. So customers may have backed off from buying from our and other companies but when they are buying it is more often from one of our companies. When customers return to buy more in the future you will see how this increased competitive position is very important to our long term returns.

For a more detailed analysis of the companies we own refer to last year's report which goes into detail about some of the businesses, visit a store or a website, read an annual report or call me.

Because the economic situation is creating so much uncertainty it is worth spending some time understanding basic economics to reassure ourselves (as I do myself) that through the passage of time the economy will eventually recover – if you are going to make a bet knowing the result before the bet is placed is a good thing. Having a firm grip on what drives an economy long-term (and subsequently markets) will provide us with a foundation to hold our nerve and buy good businesses while others are stabbing in the dark about the 'when' it will happen or worse 'will' it ever happen.

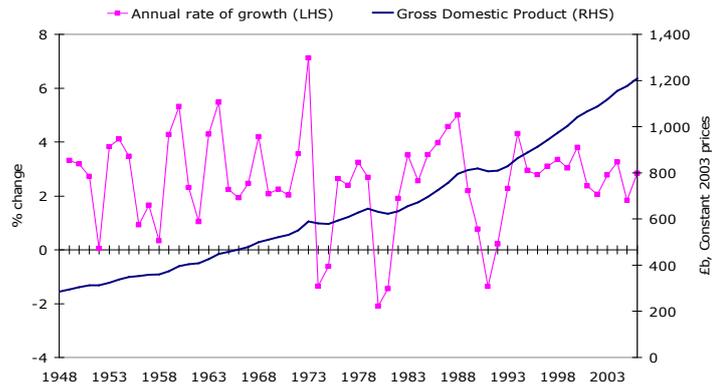
The Economy Understood

All economies, regardless of whether a democracy or communism, have an underlying long-term growth rate (as measured by Gross Domestic Product - GDP) that sees total domestic dollar production trend up – it is virtually impossible to stop it. That is because society (or the economy) constantly adopts innovation and technology, increases workforce education, increases workforce participation and increases capital applied to opportunities so more and more goods and services are produced with available resources. Economic growth via increased efficiency over a medium term period is a 'given' as long as society keeps inventing, learning, working and replacing man power with capital – everything else is a side issue in the long term. The chart below tracks America's GDP growth over the last 80 years (the top line for those reading this in print) and it can be seen that the trend is pretty constant. The 1930's credit inspired depression stalled growth the most but didn't ultimately stop growth – in fact it set up a period of rapid expansion making up for lost time. Otherwise wars, oil spikes, government changes, low or high interest rates, low or high unemployment, no or too much illiquidity etc etc have all made no difference to the long term trend. They may have influenced the rate of growth but not the direction. Long-term economic growth should be added to taxes and death as the only things sure in life.



The other line on this chart is Dow Jones Earnings – the earnings of the top 30 USA companies added together year by year. Not surprisingly it trends higher along with economic growth but worth noting is that the line is a lot more volatile than the economic growth line and this is where things become interesting – but more on that later.

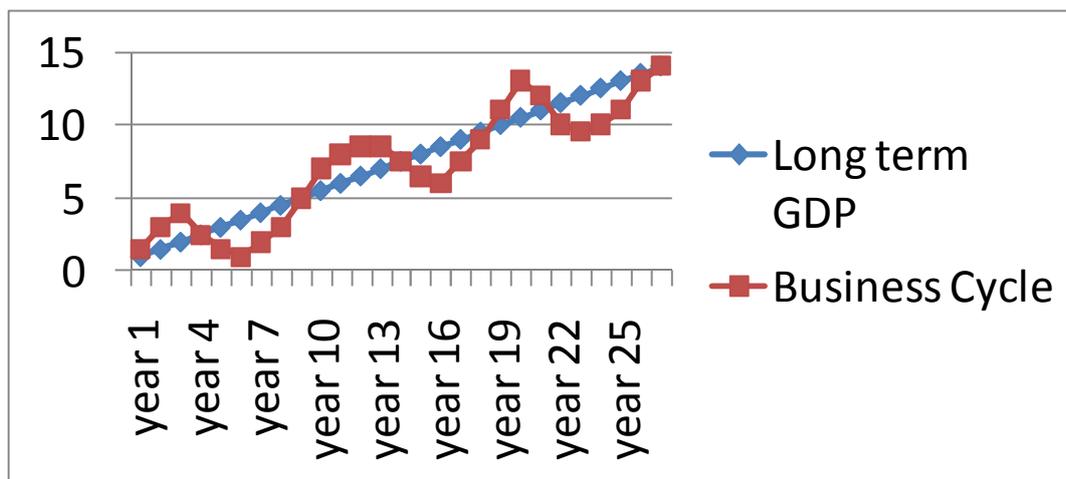
So while we know economic growth will eventually go higher – and that alone should be enough for us to invest long-term with confidence - we also know growth can appear quite cyclical and jerky, just as we are experiencing now. A study of the next chart shows the UK GDP growth over the last 60 years trending nicely higher. The other line, where the dots represent a yearly growth rate, shows the trend movements of GDP going both up and down. Year to year swings in economic growth can appear volatile within the range because interplaying are two factors – the business cycle and the inventory cycle. To make sure we are not put off or avoid our investments by these cyclical jerks we need to roughly understand them.



The Business Cycle

You may not be surprised to hear that consumer consumption is the largest component of GDP (around 60% in Australia) but you may be surprised to learn that consumer spending is fairly constant. Like the GDP trend line it marches up steadily over time and this is best explained via Milton Friedman's permanent income hypothesis. In recessions individuals will save less and decrease their consumption by only a small amount and in expansions individuals consume more but less than their income increases. Businesses do not behave the same way and the blame for cyclical swings mainly rests with the business sector. If someone loses their job their family still has to eat, house and live but if a business loses the revenue of a large customer spending stops quickly and heads roll.

Straight from the economic text books we can learn that a business cycle is made up of five classic stages; initial recovery, early expansion, late expansion, slowdown and recession. Therefore overlaying the long term trend in growth are the swings of these stages. By understanding the characteristics of each stage we can roughly know where we are within the business cycle. The business cycle is usually a 9-12 year cycle but overtime this varies and has been interrupted by wars. The chart below gives a rough idea of the concept I am talking about.



If we track back to the 2006 and 2007 years we can safely say they were boom or 'Late Expansion Years' to use the business cycle term. We can confirm this by checking off a list of classic characteristics of what defines this period.

- ✓ Confidence and employment are high
- ✓ Inflation increases
- ✓ Central Bank limits the growth of the money supply
- ✓ Rising short term interest rates
- ✓ Rising bond yields
- ✓ Rising stock prices, but risk increases with investor nervousness

I think we can clearly tick all of those boxes and say they were typical of 2006 and 2007.

Next follows the 'Slowdown' which typifies what occurred in 2008. A Slowdown is defined as:

- ✓ Duration of a few months to a year or longer
- ✓ Declining confidence
- ✓ Inflation is still rising (hence confusing everyone)
- ✓ Falling inventory levels
- ✓ Short-term interest rates have peaked
- ✓ Bond yields have peaked and may be falling
- ✓ Falling stock prices

Again, tick, tick, tick as this all happened.

From Slowdown the economy moves into 'Recession'. Here I am talking about the essence of a recession not just the technical definition of two consecutive negative quarters of economic growth. In a real Recession the following occurs:

- ✓ Duration of six months to a year
- ✓ Large declines in inventory
- ✓ Declining confidence and profits
- ✓ Inflation tops out
- ✓ Falling short term interest rates
- ✓ Falling bond yields, rising bond prices
- ✓ Stock prices increase during the latter stages anticipating the end of the recession.

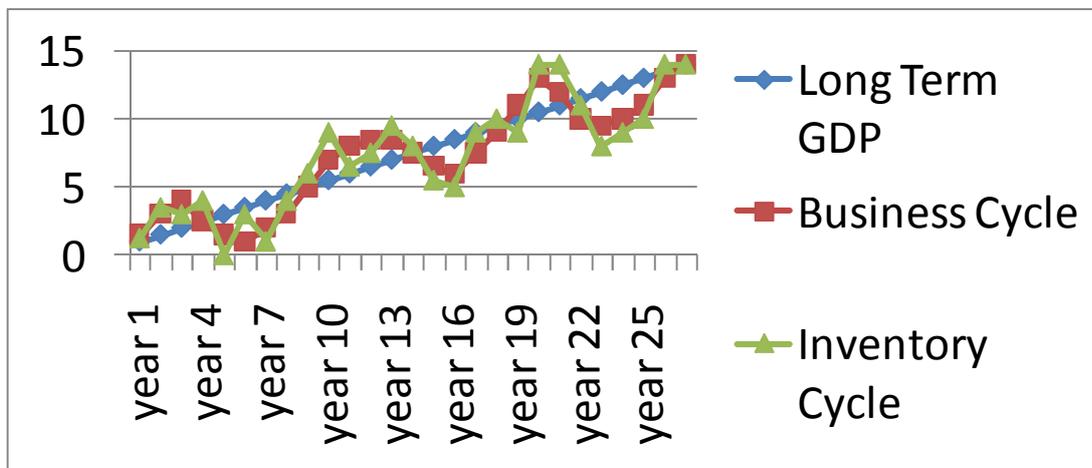
Once again all the classic signs are present in 2009 of what a recession is. But this is where it again gets interesting as look at the list of tell tale signs of an 'Initial Recovery':

- Duration of a few months
- Business confidence is rising
- Government stimulation is provided by low interest rates and/or budget deficits
- Falling inflation
- Low or falling short-term interest rates
- Bond yields have bottomed out
- Rising stock prices.

Now there are a few boxes in that category that we can tick off as well, which means we may or may not be out of a recession and starting recovery. The problem with this process is that things only look clear in hindsight. Remember we are not trying to understand this to profit from the knowledge of forecasting the swings, as the individual stock valuation process will always tell you if a stock is a buy or not, but we are learning this so that we are not too pessimistic when things are bad and get too excited when things are good. Ultimately everything reverts to the long term trend and that is the only line we can count on.

Inventory Cycle

Now just in case you think I am ignoring some pretty obvious signals and hence ignoring easy profits by not playing the cycle (which appears really quite obvious when the facts are explained) I want to introduce you to the inventory cycle. The inventory cycle sits over the business cycle (which we know sits over the long-term growth trend). The inventory cycle is the never ending effect of businesses increasing and decreasing their inventory/production in anticipation of what their customers might do. Put another way it is businesses guessing what their customers might do when their customers don't even know what they are going to do. Generally the cycle lasts two to four years and inventory/production expands when businesses gain confidence in the future of the economy in anticipation of increasing demand and vice versa. There are plenty of false starts and late starts in these cycles with each move effecting unemployment, government fiscal policy and RBA monetary policy. The effect is too murky the water in a way a shark likes it just after a storm when looking for prey. So they are waters I just don't go into.



When the inventory cycle and the business cycle are added together no one really knows what is going on as signals are everywhere hence why I spend as much time on economic analysis as I do watching news bulletins with Michael Jackson stories. Add on top of these fluctuations government fiscal and monetary policy aimed at evening out these cycles and we have no chance of short term clarity. In fact if you find yourself looking closely at these cycles I suggest you take 10 steps back from the page until everything blurs into one straight line trending higher – that is what we need to know about economics. Don't let it put you off a good investment and don't let it make you over pay for an investment.

The key points to take out of our economic analysis is that long term economic growth is assured and with it business profit growth - despite the noise of the ebbs and flows of the economic swings.

It is this analysis that explains what Buffett meant when he said.....

We will continue to ignore political and economic forecasts, which are an expensive distraction for many investors and businessmen. Thirty years ago, no one could have foreseen the huge expansion of the Vietnam War, wage and price controls, two oil shocks, the resignation of a president, the dissolution of the Soviet Union, a one-day drop in the Dow of 508 points, or treasury bill yields fluctuating between 2.8% and 17.4%. But, surprise - none of these blockbuster events made the slightest dent in Ben Graham's investment principles. Nor did they render unsound the negotiated purchases of fine businesses at sensible prices. Imagine the cost to us, then, if we had let a fear of unknowns cause us to

defer or alter the deployment of capital. Indeed, we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist. A different set of major shocks is sure to occur in the next 30 years. We will neither try to predict these nor to profit from them. If we can identify businesses similar to those we have purchased in the past, external surprises will have little effect on our long-term results.

And Buffett's reaction to economic cycles.....

We try to price, rather than time, purchases. In our view, it is folly to forego buying shares in an outstanding business whose long-term future is predictable, because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?

Beyond Economics and Kicking an Own Goal

Nice words from Warren Buffett but more easily said than done! Even with a foundation of knowledge built on looking through economic turmoil to the ultimate long term trend it is still easy for us to be influenced by the market racket when profits are swinging on the back of business and inventory cycles. Once we overlay our own expectations and emotions over the already existing economic swings it is more easily understood how a market reaches 6850 and then declines to 3073 in quick time - and as investors how we score some 'own' goals along the way.



The following (next page) is a generic measuring stick of market value that is worth looking at. The Gordon Growth Model (GGM), which is a simple discounted cash flow model, can price the overall big picture level of the market. It simply takes the dividends coming from the market and assumes they will roughly increase at the long term growth rate of GDP – a simple but fair assumption when you think back to that USA GDP/DOW earnings chart. To perform this calculation we need to estimate what is a fair return from investing in stocks over the long term and we need to identify what is a reliable market dividend based on today's market level. For the sake of simplicity I will assume the market wide return most investors will accept is between 7.5% p.a. and 10% p.a. return on their money (between dividends and capital growth) and that the current market dividend is between 5.5% and 6.0%. Rightly or wrongly as people become more nervous they want a higher return so pay a lower market price and when more confident or less fussy they are willing to accept a lower return and pay more for stocks (there is an inverse relationship). To the nervous and pessimistic the market is only worth 3200 points while to some the market is worth over 5500. You can easily see why the market index swings so much when our behavior comes into play on an already complicated situation.

		<i>Underlying sustainable Market dividend rate</i>	
		5.5%	6.0%
<i>Long term return investors want</i>	<i>10.0%</i>	3197	3488
	<i>8.75%</i>	3924	4280
	<i>7.5%</i>	5077	5539
<i>Today's Market price (S&P200 points)</i>		3800	
<i>Long term GDP</i>		3.25%	

Not only do we have to distance ourselves from the influences of the economic swings but we need to be mindful of how our own thinking about investments effects our actions. Most people will be familiar with the effect fear and hope have on investment decisions but there are other subtle behavioral finance influences that cause us to make investment decisions not based on the underlying facts i.e. valuation vs. price, but on something else and thus increasing the chance of scoring an own goal.

The last couple of years have been very tough when it comes to handling the emotions of market swings so if we can understand and resist some of the following traits we are one step closer to simplifying the investment process. I know when I read through the list I certainly have put a few into the net.

Behavioral Finance - Heuristic Driven Biases and Frame Dependences

Investors who find they rely on rules of thumb, a past experience or a lesson learnt from the market run the risk of making investment decisions based on the bias of what they know - if they ignore the valuation process. Just as do investors who make decisions and take actions according to the framework within which is it received i.e. the media or take actions based on their circumstances i.e. emotional state.

- Representativeness is the term given to investors who base expectations upon past occurrences and in doing so apply stereotypes. Unless there is empirical evidence of the fact, like night follows day, such a conclusion results in just a guess. And bad guesses are as valuable as good guesses in a 50/50 situation.
- Over confidence means that people tend to place too much confidence in their own ability to predict, which can lead to surprises – usually unpleasant.
- Anchoring refers to the inability to fully incorporate and adjust to the impact on new information, instead staying too conservative and avoiding a decision.
- Aversion to ambiguity can be loosely described as the fear of the unknown - best described using probabilities associated with choices. In an up trending market, investors see the odds as greater than 50% that prices will continue moving up and therefore buy. In a down tending market they see the odds as greater than 50% that the market will continue down thus sell. Sounds reasonable until you realize that no price becomes too high to pay and no price too low to sell. Now it sounds ridiculous. An investor might not be able to base their expected odds on anything, so they might shy away or at least leave the stock picking to the experts.
- Loss aversion refers to investor's unwillingness to accept loss and hence taking too much risk to avoid loss.
- Self control is making decisions based on what suits an investor's personal circumstances rather than what the facts say to do.
- Regret is the feeling, in hindsight, associated with making a bad decision so no decision is made at all this time.

- Process versus Outcome - where investors overemphasize their recent performance and let it drive future investment decisions.
- Herding Behavior – where investors may be influenced by the masses and as a result keeps their investment decisions in line with the rest of their peer group.

Then there are other issues of Bayesian Rigidity, Price Target Revisions and the Ebullicence Cycle but enough is enough. I think the message is pretty clear and that is what counts is basing investment decisions on the valuation process i.e. value vs. price and letting what we think might happen stay in check. I certainly didn't see the market getting to 6850 and then dropping to 3073 so I am not going to let the event of that happening create a set of rules that now influence how I think investing should be done. We survive the swings by focusing our decisions on value versus price and knowing the long term trend will prevail.

When you see me making one of the above errors hurry up and get between me and the net (actually just call me) but worry less if you are making one because I'm already between you and the net.

What catching a train has to do with Investing

There is some chance 2009/10 won't be as bad a market year as 2007/08 or 2008/09 simply because the starting point of the value vs. price proposition is more attractive than it has been for a long time. But I put more faith in my valuations than I do my opinions of economic and market turns for the obvious reasons.

We have spent the great majority of this report trying to gain a better understanding of how the economy moves and how investors let their behavior be influenced by factors other than the facts. More precisely we have witnessed just how difficult it is to successfully invest when there are so many distractions around us, both external and internal.

I am far more certain we *will* have economic and market improvement at some stage than *when* it will happen – no great leap of faith I know because all I am doing is following that GDP trend line higher, but knowing it will happen is more important than knowing when it will happen. As investors though, even with our valuations at hand, we sometimes have to go backwards to stay the investment course.

Think of the analogy of finding yourself on a crowded train station trying to get on a packed train (a sure experience for anyone standing at Spencer Street trying to get to Flemington for the Melbourne Cup). The trains come and go but you just can't get on – it is just too hard. It is far better to take the long route and catch a train in the opposite direction back to the start. You may first have to go backwards to get where you ultimately want, but 1. You are guaranteed a seat for the ride when others are trying to get on and 2. More importantly you are guaranteed getting to your destination. Investing is no different – to be certain of returns we have to ride the oscillations down before we can go forward.



Just as a side issue, if we do start seeing some improvement and percentage gains start getting bantered around the press remember that if a market or stock has fallen 50%, then rallies back 50% it is still down 50% (statistics!).

In the meantime we will hunt for opportunities and hope that economic swings and resulting investor behavior continue to oscillate - for they are the origin of investment opportunities for those with an eye on the long term trend line.

Finally as always I am looking to expand my client base or encourage further investment so if you are happy with the service please do tell your friends and if not happy tell me. This letter is also available in a guest letter format as are all old reports.

Thank you for the opportunity to manage your funds and let's hope we keep getting those golden tickets.

Kind regards

Justin O'Kane
Portfolio Manager