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Dear Client

Welcome to the 2014/15 Financial Year client. Included within this letter are the full financial year portfolio returns, transactional and position reports and the market/portfolio commentary.

Over the last 12 months the S&P ASX200 gained 1.2%, dividends added 4.8%, franking credits 1.2% while term deposit interest rates averaged 2.85%. I am pleased to say that investment portfolios (operational for 12 months and longer and reflecting recommendations) have had superior gains over relevant investor category benchmarks. Please review your performance report to see your returns.

## Review

Between October 2011 and April 2015 (start and end of the recent bull market) the ASX S&P200 gained 53%. The key index in the USA, the S&P500 over the same time frame rallied 100% making it feel like the Australian market has materially underperformed (even more so on a currency basis).

What may surprise a few investors is that parts of our stock market have experienced an equally impressive bull market as the USA, albeit obscured by industry category. For example the 'Financials' competent of the ASX S&P 200 over the October 2011- April 2015 period rallied 104%, bettered by the 'Health Care' sector experiencing a 170% gain. Parts of our market experienced moves greater to those of the GFC era. In effect we have had a hidden bull market that culminated over the February-April 2015 period.

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Every equity investment decision should be based on trying to generate total investor returns; a combination between today's dividend yield plus future business growth that eventually ends up as share price growth. When the expected return combination for a stock is priced sufficiently in our favour we buy and when it isn't we wait, or even consider selling. This year we did some selling.

In this 'hidden' bull market the gap between earnings growth and share price growth became too large for many stocks.

For example; if we look at CBA between June 2011 and June 2015 (consensus estimates) CBA's cash earnings per share (eps) will have increased from $4.42 per share to $5.59 per share. That equates to a 26% increase over four years or a 6% increase annually. Meanwhile the share price from October 2011 to the March 2015 high went from $49.27 to $96.69, a 96% gain or a 21% annual compound gain over 3.5 years.

Another example; if we look at Invocare between December 2010 and December 2014 (its financial year) IVC's eps (excluding the funeral fund) increased from 34.5 cents per share to 42.2 cents per share. That equates to a 22% increase over four years or a 5% increase annually. Meanwhile the share price from October 2011 to the March 2015 high went from $6.95 to $14.01, a 101% gain or a 22% annual compound gain over 3.5 years.

These examples highlight that share price gain has significantly outpaced earnings growth. While businesses have performed to operational expectation share price gains have far exceeded the value created. Only a Greek Finance Minister could believe this relationship can continue unchecked.

The other important explanation for the market rally is the lowering of interest rates. From October 2011 to March 2015 the 10 year Treasury bond rate fell from approximately 4.5% to 2.3% (currently approx. 3%). Whenever lower rates are used to discount future earnings or dividends the value of the shares goes up (as do all asset types). Once share prices reflect the new lower interest rate todays buyer gets the lower yield and only yesterday's buyer gets the capital gain from the rate change.

Forecasting interest rate movements to predict share price movements might be easy if you are a TV pundit or write a daily stock broker newsletter but for the rest of us predicting

uncertainty is a mugs game. At this year's Berkshire Hathaway AGM Warren Buffett noted that he had no idea a few years ago rates would drop this low so why ask him where rates were going next. He went on to say that if rates stayed well below their historical average then the stock market is probably cheap but if they reverted at all then stocks would look very expensive.

Lower interest rates spell a dilemma for investors buying stocks seeking steady income and danger to those not considering the risk to their capital. Much of today's market valuation is dependent on rates staying low. Stock prices already gyrate because of growth expectations but now interest rate sensitivities are acutely center stage in the valuation equation. Investors who have bought stocks at higher levels for yield will certainly get their chance to sell for capital preservation. I believe it has never been more important to be in a position to buy well. Buying at good prices protects capital.

Naturally Greece's default and now the Chinese stock market 'crash' are registered as the cause of the current correction but find me an overstretched and vulnerable stock market and I'll find you an economic crisis waiting to be blamed.

Incidentally there is another issue facing the current market values. Worth considering is 2015 will be the fourth year in a row where company dividend pay-outs outstrip earnings growth. Are current dividends sustainable? Like the frog in the slowly boiling pot most investors aren't aware of their precarious position.

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The cash generated from our February-April equities sales would normally have found its way to income securities by now but being a little slow hasn't hurt us. We have successfully avoided any recent hybrid/preference share issues by recommending that they be placed in the 'oval' filing cabinet. All of the new issues are now underwater. What has worked with the hybrids has been sticking to shorter dated, investment grade and mandatory/issuer self-interest conversion issues. We might have received a lower interest rate with these types of securities compared to the recent issues but our capital has been preserved; remember with investing it is the net of the two returns that count.

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As previously mentioned we now have the difficult but important decision of how to react to this pull back to re-weight our portfolios to normal equity holdings.

Here, we are guided by four key investment principles aimed at avoiding long term loss and providing a platform for return.

1. Only buy businesses we are sure can grow their long term earnings because prices eventually follow earnings up.
2. Be patient and don't over pay for these companies because a decent yield + decent growth = decent investment returns.
3. When the business's economics changes putting long term earnings growth at risk, sell.
4. Take capital off the top when i) share prices get so high they imply unreasonable future growth or ii) cyclical business earnings revert.

In 2015/16 we are presented with mounting investment challenges. The very low interest rate environment presents investors with a double vulnerability. Low interest rates are resulting in low yields and a stock market capitalisation dependent on those low yields. If we see no further changes in interest rates future investment returns will be subdued while any reversal in the interest rate trend will see the market capitalisation come under threat. Of course the low yield/capital loss threat exists in all long term asset classes, especially property.

Our best play to achieve satisfactory investment returns remains buying and holding businesses who can achieve future profitable growth by effectively out competing for customer loyalty, combined with, a portfolio designed around intelligent asset allocation. We have a plan.

Yours Sincerely

Justin O'Kane, CFA          William Allen