Winter 2011

First Samuel LIMITED ®

Live well. Sleep well.

First HAND

First Samuel is a boutique wealth management company that provides individual, indispensible and enduring relationships that create, manage and protect wealth.

Jargon Buster!

GFC

Global Financial Crisis. A term used to describe the conclusion of the transfer of wealth from individuals to banks, stock brokers and financial planners.

Tech Wreck

An historical term used to describe the coincident failure of information technology companies to meet their promised investment returns.

See also South Sea Bubble.

Warren Buffet

An old man, given to making pithy comments about investing.

Prior to Mr Buffet's investment ascendancy, his hometown of Omaha, Nebraska was famous only for the location of the US Strategic Air Command.

P/E ratio

The value of a stock or the market overall. The price it costs to buy $1 of expected profits (usually expressed as "x times earnings, e.g. "ANZ is trading on ten times earnings").

The lower the P/E, the cheaper the buy. And hence the better.

IMPORTANT NOTICE

Any advice contained in this newsletter is of a general nature only and has been prepared without taking into account your personal objectives, financial situation or needs. Because of that, before acting on any advice in this newsletter, you should consider whether it is appropriate for you having regard to your objectives, financial situation and needs. Further, we recommend you seek personal financial advice before acting on any advice in this newsletter.

Lessons of share market history: the long-term takes care of itself

by Anthony Starkins, Founder & Director

The volatility of investment returns simply depends upon the time period you use. In the long term, shares are no more volatile than, say, property.

Since the GFC many investors have become scared of the long-term.

And certainly, many were so badly scarred by poor investment decisions, either they made or that were made on their behalf, that they have fled the most productive and efficacious of asset sectors.

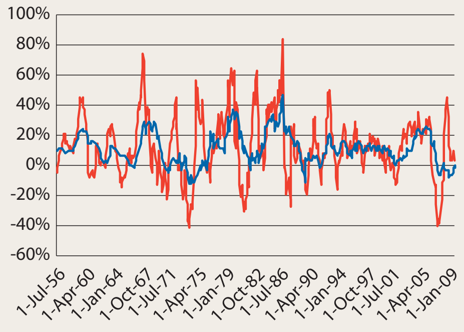
The result is a return to naïve investing: thinking short term and being pushed around by emotion: perhaps that any downturn will signal the next GFC.

But if you are a long term investor, then you should be thinking seven years or more. Ten, 20 years or more.

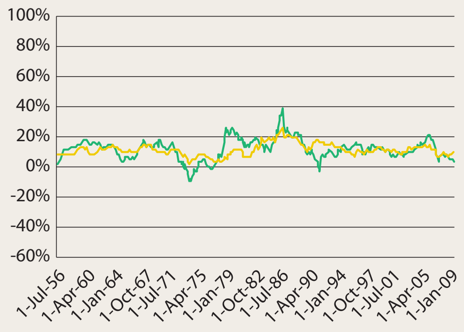
Volatility is a question of time period

Each of the following three charts represents the same data: the performance of the Australian share market (plus dividends) for periods ending July 1956 through to April 2011.

With the same underlying returns, measuring performance over 3 years (blue) shows less volatility than over 1 year (red)



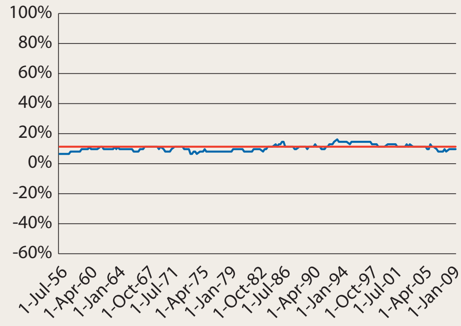
Same data – 10 year (yellow) measurement less volatile than 5 year (green)



The trap is, of course, that investors are not patient. As Warren Buffet said:

"the share market is designed to transfer wealth from the active to the patient."

Same data – 20 year returns (blue) are almost as flat as 104-year average (red)



The third also extends that time period back 104 years.

The clear point is that the volatility is simply determined by the period that you look at.

This is important when comparing share market returns to other asset sectors.

For example, you do not measure the investment return that your home has achieved every day or every year.

There may be an occasional bank revaluation, but essentially you value your home twice: the day you buy it and the day you sell it.

It's probably the same for an investment in other real property.

But you can measure the performance of the sharemarket every day, or every minute for that matter.

Measurement – because you can

Many people measure stock market performance every day or month, not because they need to, but because they can.

The reality is that such measurement means short term stock or market moves that are driven by emotions might trigger an emotional reaction to buy or sell.

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Superannuation Still Not So Simple

By Nikki Hill, Head of Client Strategy

In spite of promises of simplification, the government continues to make superannuation more complex.

The budget was no exception. But superannuation is still worth the effort – it's still the cheapest way to save and invest.

By way of update:

Don't exceed concessional contribution limit

As I have noted on numerous occasions, concessional superannuation contributions are one of the most tax effective strategies to accumulate wealth in what is usually the most tax efficient investment structure.

However, you need to be mindful of the annual limit that applies for contributions made by you and on your behalf from all sources.

Unless you qualify for the proposed 'one-off refund' (refer below), penalty tax applies to contributions made above the limit.

Minor budget super changes

While the budget was quite the non-event, it did contain a couple of minor positive but slightly complex superannuation measures regarding concessional contributions:

First-time-over-the-limit offenders

From 1-Jul-11 first time over-the-limit-offenders can make a one-off withdrawal of excessive contributions up to $10,000 to be assessed at their marginal rate.

The first-time-offender concession can only be used once. It will really only be of benefit if you are subject to a marginal tax rate below 46.5% (i.e. below the penalty tax which applies to excessive contributions) or if you have also reached your non-concessional limit (as penalty tax can be 93% in this instance).

This measure is, in my opinion, a lame excuse at apparently tackling the issue of ridiculously high penalty tax applicable to excessive contributions. Excess contributions are most often made in error, not deliberately.

Higher limits for some people aged over 50

From 1–Jul-12 the previously announced higher concessional limit of $50,000 for those age 50 (plus) with accumulated superannuation balances less than $500,000 was confirmed.

The over 50's higher limit will be calculated as $25,000 above the indexed universal limit which is currently $25,000.

Three problems

While the over 50's higher limit appears to somewhat support the notion of self funded retirees, it will come with a number of problems.

Firstly, the limit is only partly indexed because the $25,000 incremental amount will stay fixed, while the universal limit (currently $25,000), will increase with inflation and over time the value of the concession will reduce.

Secondly, it sends the wrong message of how much accumulated superannuation is sufficient to fund even a modest lifestyle in retirement. Thankfully the $500,000 threshold is lower than the value of assets an individual can own (excluding their home) and still be entitled to at least part of the age pension. So those not eligible to make the higher contributions can still look forward to putting food on the table with the help of the government age pension (phew!).[1]

Thirdly and perhaps most importantly, are questions about practical application of the concession. The how, when and what questions to determine eligibility and implementation need to be answered. Consultation is being currently undertaken between Treasury and industry to this affect.

Benefit splitting

In the meantime, we note that the consultation document released by Treasury earlier this year appears to exclude contributions which have been split to a partner for the purpose of calculating a person's accumulated benefits (in the instance that withdrawn benefits are counted in determining a person's accumulated benefits).

Those of you with total superannuation benefits less than $500,000 may wish to investigate the merits of splitting concessional contributions to your spouse in order to increase your potential eligibility to qualify for the higher limit, along with other potential benefits, like for example, more equally weighting your benefits between you (and your partner). Having more equal values may be beneficial in future, should the government make changes to tax free superannuation withdrawals for those age 60 (plus).

As always, the rules continue to present navigational difficulties, which is why we are here to help.

Please call Duro, Simon or me to discuss how we can better optimise superannuation strategies for you at anytime.

[1] Eligibility for the age pension is based on a number of factors including being of age pension age and is means tested (on income and assets). Assets counted include all investment assets and some personal assets in addition to superannuation benefits.

Lessons of share market history: the long-term takes care of itself

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What returns can you accept?

The Australian sharemarket has a long-term average return of just under 12% p.a. If you could get that year-in, year-out, I guess you'd be happy.

The question is, how much volatility can you take? If your investment horizon is just one year (saving for a vacation, perhaps), then you would be daft to invest in the share market.

But if you are investing for longer periods, then you should be able to manage the short term volatility, comfortable in the knowledge that the long term will take care of itself.

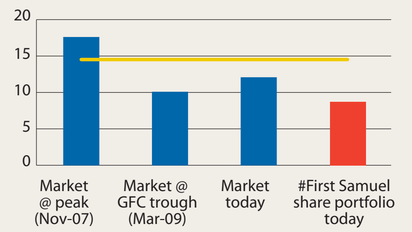
Just by being patient.

The trap is, of course, that investors are not patient. As Warren Buffet said: "the share market is designed to transfer wealth from the active to the patient."

Aside from taking a long view, what else can make me comfortable?

Of course, if you can find a wealth manager who can boost returns after fees and franking credits above the share market, then your success outlook is enhanced.

Enhancing the long-term: buy when the market is much cheaper* than average



* As measured by P/E. A low P/E is good, – see text. "Today" is 31-Mar-11
Note: yellow line is the long term average P/E.

Adding 2% p.a. after fees and franking credits will, over, say, 10 years, add over $220,000 to a $1m portfolio.[1] That is good value.

The other factor is to invest after a downturn has occurred – or more particularly, when the market or shares are cheap.

So, without being cute, when is the share market cheap?

A rough rule is to look at the "value" of the market. The simplest measure is the ratio of the price of the market to the expected earnings (or profits). This is called a P/E ratio (bizarrely, as it not a ratio).

The market is currently cheap. That is not to say that it will not get cheaper – prices may fall or expected profits may rise.

But from a long term point of view, cheap is good. And for a decade or more of investing, it is a sound way to start.

So, provided you have a manager who can add value to the share market and you have patience, you can invest at almost any time and your objectives should be met.

[1] First Samuel has added more than 2% p.a. to the sharemarket after fees and franking credits for over 10 years. See back page for details.

Buyer beware... Bank shares ≠ low risk investments

by Dennison Hambling, Chief Investment Officer

Prospectivity, looking backwards

People view investments with a prospectivity based on their experiences, hearsay or emotions, from the past:

"I have never seen anyone lose money investing in property, so I'll invest in property"

(People rarely tell you when they lose money)

"Dave made a killing on those IT shares, so I'll invest in them."

(So Dave is an expert; the shares will keep rising; who is going to tell you when to sell? etc).

What's missing?

What is commonly missed, however, is a full assessment of the risks (particularly of a significant or total capital loss) that could occur if the investment thesis is incorrect.

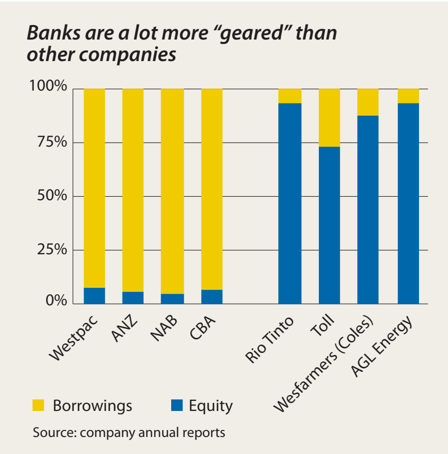
In Australia, because of a near 20-year run of significant levels and growth of profits and dividends, a generation of investors has grown up with the aura of banks being blue-chip and wise investments.

It is an aura that the financial community is happy to cultivate. It is money for jam; an easy sell.

Unfortunately, this seemingly well supported feeling of wisdom does not stand up to the pure economics of how a bank works, nor of their outlook.

Banks 101: High Leverage = High Risk

Banks are, almost without exception, the most highly indebted businesses in an economy.



They borrow most of the money they lend, against a very small equity (i.e. shareholders' funds) base: usually around 5-8% of assets; currently around 6.75% for the big 4 Australian banks).

This is akin to you borrowing 93% of the value of your house.

What this means is that if the assets the bank has lent decline in value by 7%, the equity of its investors is wiped out (the bank may survive in some form or another but will be owned by its debt holders, not its equity holders).

Whilst people will invest hours in the arguments about the potential (or not) for this to happen, the fact is that in the early 1990s two of the big 4 Australian banks came close to collapsing and two state banks did fold.

I'm not suggesting that any Australian bank is going to collapse, just that their very capital structure makes them vulnerable.

Australian Banks 101: Unique vulnerabilities

There are two important and unique vulnerabilities about the Australian banking system that overlays the high leverage.

Firstly, over the past ten years Australian banks have become heavily reliant on offshore funding. That is, a significant portion of their debt is borrowed from offshore lenders. As at June 2010, overseas wholesale funding was an uncomfortable 28% of total funding.

Therefore, the desire and/ or ability of offshore lenders to continue to invest in our banks is essential to our banking system.

Secondly, the Australian consumer, the main recipient of the bank's lending (be it through housing, personal loans, or credit cards) is amongst the most heavily indebted consumer in the world, with a household debt to disposable income ratio of 156%. This profligacy has helped the banks' profitability.

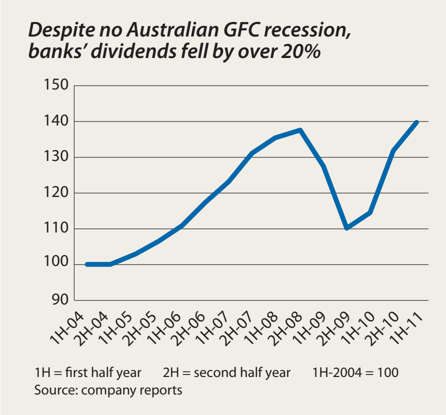
But a slowdown in borrowing (especially for housing) and/ or increased bad debts will mean slowing profit growth.

No GFC recession but bank dividends slashed

During the Global Financial Crisis, Australia stood virtually alone in the western world, withstanding the pressures.

Australia did not have a recession (two quarters of economic contraction). To outsiders looking in, nothing happened here, we were not impacted.

Despite this fact, every significant bank in Australia had to raise large amounts of capital to protect their businesses and their balance sheets.



They made significantly dilutionary equity raisings that, with diminished profits, had a marked impact on dividends.

The dividends of Australia's big 4 banks fell by 20% in 2009.

Australia didn't have a recession and yet the banks' dividends were cut by a fifth.

It's worth considering what could have happened to bank dividends if we actually had a real recession.

Bank downgrades

The downgrading of the credit rating of Australian bank debt by both Moody's and Standard and Poor's is a problem.

A downgrade will mean that lenders to banks will want a higher return on their investments; this will increase the cost of borrowing for our banks (decreasing profit or pushing up the price of debt [interest rates] for consumers).

We believe that the agencies new-found post GFC appreciation for risk will lead to further downgrades this year.

Banks essential for an economy but not for investors

Banks are an essential part of any economic system, without them our modern paper money society could not function as it does.

As a result, no matter what the risks of banks may be, the government will never allow them to cease to exist (as we have seen).

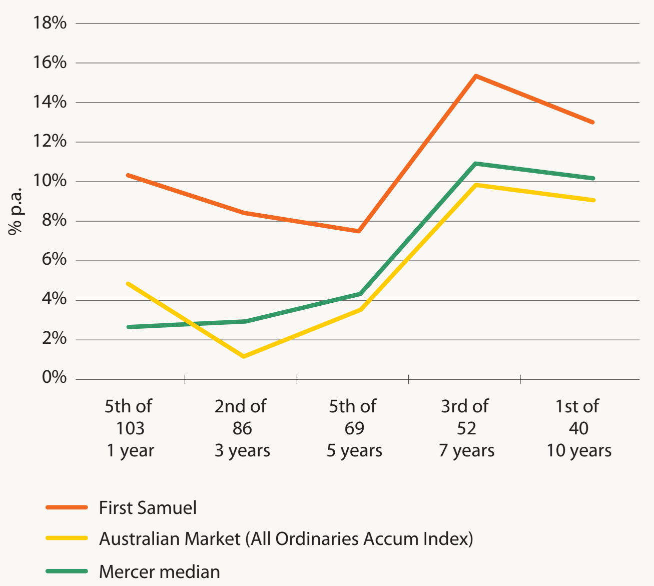
Investors, however, should be very careful not to confuse this reality as meaning that investing in the shares of banks is wise.

1 It depends a little on what you count as equity. Banks typically talk about Tier 1 capital, which for Australian banks is 9.2% on average for the big 4. There are a number of ways to look at this but regardless, all tell the same story: low equity, high debt.

2 Source: Australian Bureau of Statistics

First Samuel in top 5 Australian share managers

First Samuel has continued to outperform the market in the major asset classes. Of special note is our Australian share performance, where we are #1 in Australian share investments over 10 years and in the top 5 over all other time periods, if we were to participate in the Mercer Survey of Australian long-only share managers.



Source: Mercer Investment, April 2011. Performance is % p.a., before fees and tax, for the period to 31 March 2011.

First Samuel is not officially part of this survey. First Samuel data ("First Samuel") has been inserted and is calculated on the same basis and represents broadly the same equity style ("long only") as the managers in the survey. "First Samuel" is the asset weighted average of the performance of all clients' Australian shares. No portfolios have been excluded. "Median" is the median of managers in this survey. "All Ordinaries Accum Index" is the benchmark for the Australian sharemarket. There are fewer managers in the survey for longer time periods because of "survivor bias." That is, investment managers will close funds that have either poor investment performance or fail to attract sufficient assets. Past performance is not a guarantee of similar future performance.

Calendar

Reporting

In addition to a suite of six reports available every day via our secure on-line website service, each client also receives a comprehensive suite of Annual Reports.

The Annual reports are also accessible via our website. Our reporting schedule for the FY-11 year is as follows:

1. Flash After-Tax Performance Report	2nd week of July
2. June Quarter Report	4th week of July
3. Annual Investment Report	First week of August
4. Accountants Pack & Taxation Report	Final week of September
5. Independent Audit Certificate	Final week of September

Upcoming Client Events

Annual Client Forum

Our guest speaker will be Saul Eslake, former Chief Economist at the ANZ and now Director at the Grattan Institute. Invitations will be sent in June.

Tuesday	2nd August	RACV Club

CIO Conversations

This is an opportunity for our clients to join in a roundtable conversation with Dennison Hambling, our Chief Investment Officer and others of our investment team. All over a dinner of fine food and wine. Invitations will be sent in July.

Tuesday	6th September	Undertaker, Hawthorn
Wednesday	7th September	Vivace, Brighton
Wednesday	12th October	Undertaker, Hawthorn
Tuesday	15th November	Quaff, Toorak
Wednesday	16th November	Morning Star Estate, Mt Eliza

All the First Samuel team is available to meet your wealth management needs

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