NEWELL PALMER
SECURITIES PTY LTD

WEALTH – LIFESTYLE – SECURITY

November 2005

# 2005, the year in review

Welcome to our November 2005 client newsletter. This edition includes our regular economic overview and investment outlook, an informative article on asset allocation, a home/investment loan update and the benefits of including direct shares in portfolios.

2005 has seen equity markets resilient to the unprecedented natural disasters of the tsunami, US hurricanes and Pakistan earthquake. They also reacted maturely to acts of terrorism, notably in London and again, Bali. We take time out to reflect on these events at this time of year. Again, markets have coped with rising oil prices, inflationary pressures, the prospect of rising interest rates and the unknown consequences of bird flu in a different light to similar recent events such as 9/11 and SARS.

Legislative change domestically has seen us embrace the abolition of the superannuation surcharge and vendor tax, the introduction of super choice, co-contributions and we await the long overdue prospect of super splitting. These and other issues have no doubt been discussed in depth on an individual level at client reviews.

Newell Palmer Securities continues to pride itself on the talent and depth of it's advisory team, so it is not surprising we have been featured regularly in the financial press throughout 2005.

Our core business continues to concentrate on what it has been doing best for over 20 years – strategic advice, complemented by a strong research ethic, pipeline of unique investment opportunities and the support of a network of professional associates in the fields of tax & accounting, law & estate planning.

This is an appropriate time to commend our adviser support team, the "engine room" of the office, headed by Practice Manager Patricia, our Project Manager Georgia and a group of dedicated and committed support personnel – Ian, Petrina, Roger, Charlotte and Vicky who juggle the phone calls, faxes, emails and paperwork as the integral link between adviser, client and fund manager/broker/insurer.

Having recognised an increased demand for our financial planning services, September 2005 saw the launch of our new Financial Planning Division.

Whilst Newell Palmer Securities advisers will continue to concentrate on high level strategic advice, the new Financial Planning Division headed by Financial Planner Brenton Pittman is designed to provide core financial planning services including quality advice on investment, superannuation, risk and debt management/budgeting, estate and retirement planning.

We trust you will enjoy this edition, and please don't hesitate to contact your adviser should you require further information on any article.

With best wishes for the festive season and a prosperous 2006.

# Investment Synthesis

### Economic Overview

The current focus on financial markets is the risks from rising inflation.

China revalued the Yuan upwards by 2.1% and is expected to continue this measured and controlled appreciation. Despite this, the Chinese trade surplus will widen to US$100 billion this year and is expected to increase again next year.

US Producers Price Index data released in October showed a large annual rise of 6.7% with the major concern being the significant upward trend even when food and energy were excluded. In addition, cost of imported goods also rose in September and the headline inflation rate of 4.7% in September was the highest since 1991. On the bright side, US exports are actually rising and inventories are low, providing a positive outlook for US manufacturing.

The Euro Zone is expected to see GDP growth rise from about 1.5% this year to 2.5% next year. Despite less inflationary pressures, long term rates are expected to rise from 3.5% towards 4.5%. UK employment continued its slow rise in September and there is anecdotal evidence of higher wage growth on the continent. The Governor of the Bank of England claimed that the days of strong growth and low inflation with little volatility are over.

Japan however is a bright spot where after over a decade of deflation, bank lending and money in circulation is rising. The focus of the increased lending has been housing and small business and implies that credit constraints on a potentially fast growing part of the economy are lifting. The rise in the Government's leading indicators and the re-election of Prime Minister Koizumi on a platform to privatise the massive postal system are just more reasons to be bullish.

For the first time in almost 25 years, the real 10-year US interest rate is negative and the 30-year is almost 0%. Prudent investors should now be factoring in higher inflation and interest rates in the US. This has historically flowed on to Australia and we too can expect higher bond rates ahead.

### Looking ahead …

**A$** – We expect the A$ to move down to trade in the wide US$0.68 to US$0.73 band.

**Inflation** – The CPI for the 2005 calendar year is expected to come in around 2.8% and rise above 3% in 2006.

**Cash** – A strong labour market is underpinning consumption and giving rise to concerns about inflationary pressure from wages. Combined with high oil prices and rising inflationary expectations, we expect the Reserve Bank to raise the cash rate by 0.25% in the next six months.

**Fixed Interest** – The Australian yield curve remains inverted despite rising over October. In recent fixed interest commercial securities issued, we noted investors demanding over 2% margins to the cash rate on variable rate loans.

**Equities** – The Australian market suffered a sell-off in October as concerns about inflation and rising interest rates took its toll globally. Analysts have upgraded earnings expectation for the resource sector by 40% and downgraded earnings growth forecast for industrials from 9% to 7%. While the market does not look expensive on historical measures, it has become less attractive when compared to many overseas countries. International equities continue to look more attractive on valuation parameters.

**Property** – The listed property sector has started to come off its highs in response to rising bond yields and as rates are expected to go higher, further falls can be expected, though yield support will limit downside. We expect an earlier end to the slowdown in residential property sales and a leveling off in prices.

### Sector View

| | | |
|---|---|---|
| Cash | – | Positive |
| A$ Bonds | – | Negative |
| A$ Hybrid Securities | – | Neutral |
| International Bonds | – | Negative |
| Australian Equities | – | Neutral |
| International Equities | – | Positive |
| Listed property | – | Neutral |
| Residential Property | – | Neutral |

## Should I have Direct Equities in my portfolio?

Investors face a number of issues in considering whether it is prudent to include direct equities in a portfolio or if investment in a managed fund is more appropriate. Key considerations in making this decision include:

### Asset Allocation

Asset classes including Australian equities, Australian fixed income and property securities provide scope for direct equity investment. Consideration however should be given to the benefits of direct investment versus the benefits of managed funds. The size of the international equities market could make it impractical to invest in direct stocks and would see managed funds as a more viable option.

### Size of the Portfolio

Size will largely dictate the practicality of investing in direct investments or managed funds. In the domestic equity market, it is argued that a minimum of 12-15 stocks is required to provide sufficient diversification. We would suggest a minimum direct equity portfolio requires $250,000 (ideally $500,000).

### Return Criteria

The ability to outperform the reference index consistently is not easy and some will argue that a low cost index fund is a better approach.

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## Should I have Direct Equities in my portfolio? CONTINUED FROM PAGE 2

### Tax Management

Maximising "imputation credits" (franking credits) is a significant reason why some investors buy direct equities. Significant support for banking stocks and other fully franked dividend yield stocks supports this view. Most managed funds on the other hand with their trading strategies are less focused on tax management and their mandate is maximising "total return".

### Attitude

The attitude of the investor is a significant issue. A direct equity portfolio can be more concentrated (ie, exposed to 12–15 stocks) than a managed fund with exposure to 40–60 stocks and can therefore exhibit more volatility in capital values in the shorter term, which may bias some investors towards managed funds.

### Cost

Managed fund investment will come at a cost. There are very legitimate reasons to incorporate managed funds into a portfolio and there are compelling reasons why the use of low cost index funds in International Equities, Fixed Interest (international & domestic) and Property Security funds can add value in a portfolio.

### Conclusion

There is no straightforward answer to the question of managed funds versus direct equity investment but a discussion with your adviser is recommended.

## Mortgage Finance

Over the past five years there has been an explosion in the availability of loan products from banks, mortgage brokers and investment banks all marketing a seemingly ever expanding array of loans and bombarding us with all forms of advertising.

Campaigns swing from happy couples buying their first home to the contented retirees walking blissfully along a beach enjoying the freedom that somehow only a loan has been able to create!

But as we all know, reality is far removed from a slick advertising campaign. So dear reader, the most important thing to do when arranging or refinancing a loan is to get good advice to make sure it is structured to suit your situation.

Therefore if you are thinking about finance make sure you speak to us first because we:

1. Understand what your finance needs are in the context of your broader financial affairs;
2. Can incorporate this into a coherent overall financial strategy as opposed to a single product solution; and
3. Can refer you to a competitive lender that can deliver first class service.

Remember a loan is simply one part of an often complex financial plan/strategy so it's imperative to speak to someone that looks beyond just arranging the finance.

We mentioned first class service and our clients certainly receive this, thanks to Mandy Haddon from Westpac's Home Loan Partnership.

Mandy is one of the friendliest, warm and importantly, highly efficient bankers you will meet, as we are sure those who have used her services would attest. If it all seems too hard because your existing affairs are linked to your current loan, don't worry, Mandy will provide a seamless transition. Most importantly, Mandy's been arranging finance for over 14 years, so she knows the business.

Finally, you may have noticed that lenders are dropping rates again. It's a super competitive market out there which may seem a little strange with inflation ticking up so it's a great time to review not only to make sure you are structured correctly, but potentially to lock in cheaper finance.

We look forward to hearing from you soon.

***Some issues worth considering in assessing your current loan:***

- Is it competitive?
- Is it flexible?
- Is it tax and cost effective?

If you require a no obligation assessment, please contact your adviser.

## Asset Allocation – what's it all about?

Asset allocation refers to how you allocate your funds across the main investment classes of shares, cash, property and fixed interest, and includes further allocations to Australian & international assets. We refer to these allocations as 'weightings' and when an allocation differs to the target weighting, it is either 'overweight' or 'underweight'.

It is often quoted that over 90 percent of a portfolio's risk & return characteristics comes from the Asset Allocation selected.

This means that it is very important that we select an Asset Allocation that is appropriate for your objectives and risk profile and that you understand the types of returns and volatility that are possible over any given period of time.

There are generally considered to be four asset classes – cash, fixed interest, shares and property. Each asset class can then have sub-classes (eg. corporate versus government debt, international and domestic shares, etc). Each asset class exhibits different risk and return characteristics. For example, shares are considered higher risk than fixed interest. Therefore, you would expect to be compensated for that higher risk with a higher return.

Risk can be defined in a number of ways, including the risk that you will lose your capital, the risk that the value of your capital will fluctuate considerably over different time periods, and the risk that you will not accumulate sufficient capital.

We use asset allocation as a tool to assist you in achieving your long term financial objectives, using the following approach:

1. Establish your risk profile and objectives. We will assume that your objectives and risk profile are not significantly conflicted, such as seeking a 15% pa return with no risk!
2. We then determine the broad allocation to debt (cash and fixed interest) and equity (shares and property).
3. Specific allocations to the different asset classes (such as Australian versus international shares) are determined, based on your objectives. For example, if you have a focus on tax effective income, we may weight the portfolio to Australian shares to generate franked dividends. This becomes our Strategic Allocation.
4. Upon review, we assess your actual asset allocation to the Strategic Allocation. Any differences can be caused by significant movements in asset values (eg. a strong run in Australian shares) and movements in capital (eg. large withdrawals or contributions to the portfolio). Where appropriate, we will seek to rebalance back to the Strategic Allocation.

This approach will allow your portfolio to deliver an expected return commensurate with your risk tolerance and objectives, but also ensure that the portfolio retains these characteristics via ongoing reviews and rebalancing.




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