

Investment Market + Portfolio

8 August 2011

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Where are we now?

Table 1: Market movements over the 2011/2012 financial year to date

MARKET INDICATOR	LEVEL AT 30 JUNE 2011	LEVEL AT 31 JULY 2011	LEVEL AT 5 AUGUST 2011	MOVEMENT IN LOCAL CURRENCY OVER THE COURSE OF THE FINANCIAL YEAR	MOVEMENT IN AUD TERMS OVER THE COURSE OF THE FINANCIAL YEAR
S&P ASX 200	4607	4425	4104	-10.9%	-10.9%
S&P ASX RESOURCES	5584	5464	5002	-10.4%	-10.4%
S&P ASX AREIT	843	791	749	-11.1%	-11.1%
USA: S&P 500	1307	129	1201	-8.1%	-6.0%
UK: FTSE 100	5855	5815	5393	-7.9%	-4.5%
GERMANY: DAX	7294	7158	6414	-12.0%	-12.4%
JAPAN: NIKKEI 225	9816	9833	9300	-5.3%	-0.5%
CHINA: HANG SENG	22398	22440	20871	-6.8%	-4.7%
USD/AUD	1.0718	1.0935	1.0476		+2.3%
YEN/AUD	86.32	84.90	82.23		+5.0%
EUR/AUD	0.7390	0.7677	0.7420		-0.4%
GBP/AUD	0.6677	0.6610	0.6437		+3.7%
AUS: 90 DAY BANK BILL % P.A.	4.96	5.01	4.89	-0.07	
AUS: 10 YEAR GOVT BOND % P.A.	5.21	4.80	4.53	-0.68	
US: FED FUNDS RATE % P.A.	0.09	0.11	0.12	+0.03	
US: 10 YEAR GOVT BOND % P.A.	3.09	2.80	2.38	-0.71	
GOLD USD/OUNCE	1501	1627	1657	+10.4%	+12.9%
OIL USD/BARREL (WTI)	95	96	86	-9.5%	-7.4%
COPPER US CENTS PER LB	467	445	409	-12.4%	-10.4%

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1	23	23.97	22.74	23.37		
1	239	391.70	377.43	391.66	+12.51	3.30%
1	314	95.67	93.96	95.61	+0.74	0.78%
1	34	25.32	24.74	25.22	+0.42	1.69%
1	342	24.99	24.95	24.99		

Where are we now?

Continued from page 1

- Share markets have weakened significantly over the course of the financial year to date, as we foreshadowed may occur, due to various risks and negative momentum factors. The rate of decline has accelerated in the last week following the near default of the United States Treasury and the ongoing problems of European government debt positions which are now threatening to spread from smaller peripheral economies to the major economies of Spain and Italy. We discuss the issue of sovereign debt in more detail below.
- Short term interest rates have remained at or near record lows in much of the developed world and the Reserve Bank of Australia decided last week to keep its key cash rate at 4.75% p.a. instead of raising it (as many economists expected) to combat the risk of rising inflation.
- Long term bond yields have moved significantly lower as investors worldwide bid up the prices of long term government bonds as they shifted assets from shares to perceived safer alternatives (notwithstanding the risk of a US bond default). This illustrates clearly the strength of fear as a driving emotion, with investors clearly choosing the lesser of two risks.
- The events of the last two weeks have shown the fragility of consumer confidence in the USA, Australia and elsewhere. They have also impacted on fragile investment market confidence, turning a slow growth scenario into a fear of impending return to recession.
- The downgrade of the US Treasury bonds from AAA to AA+ has received a lot of publicity. This is less important than the negative impact on sentiment of the nature of the deal done to allow the US Congress to vote in favour of the increase in the US Treasury debt ceiling in order to avoid a default. This included no tax increases, a partial reduction in spending and a deferment of the more difficult aspects to consideration by a committee of Congress which will report back in November. The fragmented nature of the US government has now precluded it from being able to prevent a slide into recession by means of another fiscal stimulus package, similar to that used in 2008 and 2009.
- The likelihood of a return to recession has increased markedly and the share markets are adjusting prices to reflect that. They may well overshoot and trade at below long term fair value but the momentum may be negative for some months to come. Patience will be needed to take best advantage of renewed buying opportunities.
- There are a wide range of factors influencing returns on assets including market valuation and momentum factors. We have commented on the momentum factors, so we should now look at the valuation factors.
- We make long term (ten year) assessments of the relative valuation of the major world share markets in terms of their current prices versus long term Fair Value. Fair Value is the price that a share market should trade at in order to achieve the long term Fair Value Return. The assessed Fair Value Return is the current long term government bond yield plus a margin or Risk Premium which is sufficient to justify the additional risk of investing in the market. We have used the Australian 10 year bond yield as the basis for assessing Fair Value together with long term estimates of growth in earnings per share which are linked to projected growth in nominal GDP for each country. This in turn is the sum of the rate of inflation and real GDP growth.
- The lower the ratio of Current Market Price to Fair Value, the more attractive the particular share market appears. The higher ratio of Current Market Price to Fair Value, the less attractive or expensive the share market appears. In addition to our Base case assumptions, we repeat the analysis for the Upside and Downside scenarios as well, to provide an indication of the sensitivity of the results to the assumptions made. The various scenarios of what may happen in financial markets are set out in more detail later in this report, but they key assumptions are noted in Table 2 below.

Table 2: Share market valuation indicators

SCENARIO	BASE CASE		UPSIDE CASE		DOWNSIDE CASE	
CURRENT PROBABILITY ASSESSMENT FOR THIS SCENARIO	30%		15%		30%	
ASSUMPTIONS						
CURRENT BOND YIELD MULTIPLIED BY	1.15		1.20		0.80	
CURRENT EPS CHANGED BY	0.0%		5.0%		-10.0%	
EPS GROWTH RATE CHANGED BY	0.0%		0.2%		-2.0%	
COUNTRY	RATIO OF CURRENT MARKET VALUE TO LONG TERM FAIR VALUE %	REQUIRED LONG TERM RETURN FROM STOCKS IF PRICED AT FAIR VALUE % P.A.	RATIO OF CURRENT MARKET VALUE TO LONG TERM FAIR VALUE %	REQUIRED LONG TERM RETURN FROM STOCKS IF PRICED AT FAIR VALUE % P.A.	RATIO OF CURRENT MARKET VALUE TO LONG TERM FAIR VALUE %	REQUIRED LONG TERM RETURN FROM STOCKS IF PRICED AT FAIR VALUE % P.A.
USA	101%	10.2%	97%	10.5%	119%	8.6%
CANADA	112%	10.2%	107%	10.5%	132%	8.6%
JAPAN	137%	10.2%	131%	10.5%	159%	8.6%
BRITAIN	78%	10.2%	74%	10.5%	91%	8.6%
GERMANY	77%	10.2%	74%	10.5%	91%	8.6%
FRANCE	77%	10.2%	73%	10.5%	90%	8.6%
ITALY	88%	10.2%	84%	10.5%	103%	8.6%
AUSTRALIA	87%	10.2%	84%	10.5%	103%	8.6%
BRAZIL	76%	13.2%	72%	13.5%	88%	11.6%
RUSSIA	58%	13.2%	55%	13.5%	67%	11.6%
INDIA	134%	13.2%	128%	13.5%	157%	11.6%
CHINA	63%	13.2%	60%	13.5%	75%	11.6%

- Turning our attention to the Base Case results first, longer term valuation indicators (over a ten year horizon) for the Japanese and Indian share markets indicate that it would be wise to hold investment in these at well below benchmark levels or zero.
- Given recent falls in share markets, the indicators for the USA and Canada are less negative and closer to long term Fair Value.
- The analysis suggests that among the G7 major economies, the share markets of Britain, Germany, France and Italy are now trading below long term fair value. On valuation grounds alone they are attractive.
- In emerging markets, among the rest of the so called BRIC countries China, Brazil and Russia are trading well below long term fair value.
- Finally the Australian share market is also cheap relative to long term Fair Value.
- The analysis in the Upside case does not essentially change the picture or the relative rankings of the share markets.
- The Downside case, which we now believe is as likely as the Base case, clearly indicates that the USA and Canada are more risky, while Australia is less compelling and is trading just above Fair Value under this scenario.
- Momentum or sentiment is also very important to consider. There may well be additional significant falls of 10% to 15% over the three to six months as the accumulating bad news keeps on coming. From a longer term valuation perspective this would offer a longer term accumulation opportunity, to go above benchmark weight in Australian and International equities.
- Fixed interest is still in the shadow of the recovery from the GFC. The course of long term interest rates is driven mainly by inflation expectations here and internationally and the expected worldwide trend is towards an increase rather than a decrease in inflation. Yields on long term sovereign debt issued by some governments such as the USA, Germany, Canada, Britain and Australia have actually declined in recent months as a result of a flight to safer issuers. Not all of them have the low debt to GDP ratio of Australia and are not as safe in terms of default risk. We expect the yields on some issues such as US Treasuries to rise as the perception of default risk increases. Paradoxically, any such increases are likely to drag Australian bond yields up with them, notwithstanding our better government debt position. This is due more to the correlated dynamics of global bond markets than any rational form of behaviour by bond investors. In general bank term deposits offer better value for money than government or corporate bonds.
- Short term interest rates on cash are driven mostly by the official RBA cash rate. As this is the main policy instrument that the RBA has to control inflation, we should expect it to rise rather than fall in the next two years, but the extent of any rise will be tempered by the anti-inflationary effects of the higher Australian dollar exchange rate and concerns about the risk of a global recession.

Some thoughts on sovereignty in today's world

- There has lately been much said and written about the sovereign debt crisis. Yet sovereignty is seldom defined. Sovereignty includes the ability to collect revenue. In the good old days, sovereigns were able to collect revenue by virtue of their monopoly on violence or the threat of it. Sometimes the exercise of this power eventually led to countervailing violence from the collectees towards the collectors, such as in 1789 in France, following a long period of abuses caused by tax farming.
- In most developed countries, the legal force behind tax collection is now more developed and its exercise more nuanced, with little prospect of violence by either the collectors or the collectees. Greece may prove to be an exception, as indeed may others in due course.
- Essentially, it is the exercise of monopolistic power of some sort that provides the ability to collect revenue and hence deliver the financial basis of sovereignty.
- It is useful to survey the extent to which sovereignty is being exercised or compromised by major governments around the world. It is also useful to compare this with the effective exercise of sovereignty by private sector entities: the major listed companies.
- Within the resources sector the iron ore and coal miners have their earnings growth underpinned by demand in the Peoples' Republic of China (PRC) and other industrialising and urbanising countries. This is expected to continue for some years, offsetting any adverse effects from carbon taxes or emissions trading schemes, other minerals related taxes or supply increases over the next five years.
- Coal exports, especially coking or metallurgical coal used in steel production, are unlikely to experience a supply increase similar to iron ore and the price rise is likely to be greater as a result. This will further underpin the miners' revenues and profits.
- In any event, the major diversified miners clearly demonstrated in 2010, their ability to resist an increase in taxes to a substantial degree. There was at least a partial transfer of sovereignty from the Commonwealth of Australia to BHP, Rio and Xstrata.
- Energy companies will benefit from support for the oil price that comes more from the declining productivity of major oil fields, due in part to poor maintenance and investment by state owned oil companies in places like Iran and Venezuela. Periodic spikes due to supply choke threats in some of the world's most dangerous places will be icing on the cake for energy producers. It is no accident that many of the world's most valuable listed companies are the major oil and gas producers. Natural gas producers in Australia such as Woodside and Origin, which have long term supply contracts in place will benefit from these trends regardless of whatever else is happening in the Australian domestic economy.

AUSTRALIA

- Australian governments over most of the last 30 years have generally cut personal tax rates while forgoing the ability to borrow to any great extent in order to finance major programs including transport and social infrastructure, to the extent that much of the voting public has lost faith in the power of governments to provide adequate services or infrastructure. Sovereignty (the ability to collect revenue now or later- in order to repay debt) has been surrendered in the face of the economic orthodoxy ushered in the period after 1975, courtesy of Milton Friedman and promotion of his ideas by leaders such as Reagan and Thatcher. Australian politicians of both major parties have competed to become miniature Reagan's or Thatcher's in the eyes of the financial markets.
- Meanwhile listed companies in a number of key sectors have built their capacity to collect revenue. They have achieved a degree of sovereignty in a manner reminiscent of the Dutch East India Company of the 17th and 18th centuries.
- The four major banks have oligopoly pricing and distribution power although their overall business volume is largely tied to the rate of credit growth in housing mortgages and credit card balances. This means in practice that their profit growth will be influenced by credit growth in Australia but it will vary between about 4% p.a. in the bad years and over 12% p.a. in the best years. Overall their earnings per share growth and hence their share price growth should be less volatile than that of the mining and energy companies but will be significantly better than that of most of their corporate customers (the industrial share market and unlisted companies). In part this will be due to their capacity to be highly leveraged with an implicit government guarantee of liquidity (they are really deemed too big to fail by the politicians).
- Given the high combined weight of the mining, energy and banking sectors in the overall stock market index, investment via broadly based or passive funds should benefit from the strong degree of sovereignty that they exercise over their revenue streams.

THE UNITED STATES OF AMERICA

- The United States of America has for over two hundred years operated with a deliberately fragmented governmental structure which makes most legislative change protracted and difficult. The recent impasse between various parts of the Congress and the President over the Federal Budget and the limit on Federal borrowing is a prime example.
- The impasse was resolved just prior to the 2nd August 2011 deadline. This was done at the cost of ruling out the possibility of tax increases, be they through rate increases or closing off loop-holes on deductions.
- The weakness of the sovereignty of the Federal government was amply demonstrated in the debt ceiling deal that the Obama administration had to conclude with the Congress. The result is that the tax base of the US Federal Government is far more constrained than that of many of its foreign counterparts.
- In good economic times this would not cause acute difficulty. The difference now is that the US economy remains in a slow motion recovery, which is typical of the aftermath of financial crises. Real GDP growth is below that required to reduce unemployment and recent revisions to forecasts indicate that this will continue for the next year or two. Unemployment is coming down slowly and the housing market has fallen for much of the last six months, although the most recent monthly report on the Case Shiller House Price index across twenty major cities has shown a slight upturn.
- The Federal Reserve is unlikely to increase interest rates in any of its next several monthly meetings. While the second round of quantitative easing ended on schedule in June of this year, they have not ruled out a third round should one become necessary. Indeed they have more recently hinted that QE3 is entirely possible.
- While the US economy has difficult times ahead, it is important to recognise that it is not equivalent to the US stock market. Many of the major companies listed on the US stock market operate worldwide and derive much of their revenue and profits from faster growing economies in Asia and elsewhere. They are posting very good profit results due not only to foreign sourced revenue but also cost cutting and access to very cheap finance in the current easy monetary conditions. In effect they have a stronger degree of control or sovereignty over their revenue streams than does the US Government.

THE EUROPEAN UNION & BRITAIN

- Europe has been the epicentre of the sovereign debt crisis in recent months (although the USA looks set to take over that role soon). The two key decision makers, the French President and the German Chancellor, reached a compromise that allowed a renewed bailout package to be offered to Greece, provided it voted in favour of a sufficiently stringent austerity package to reduce its deficit. The Germans agreed not to insist on private sector banks which had major loans to the Greek government (such as the major French banks) taking compulsory write downs on these loans. In return (some two weeks later) the French government "persuaded" French banks to take significant "voluntary" write downs. For its part, the bankrupt Greek Government passed the necessary legislation, albeit at the last minute among swirls of tear gas in the streets outside the Parliament.
- The scare driven sell-offs in financial markets as Europe stumbles through the sovereign debt crisis will continue. They have already shifted the valuations of major European companies, such as Siemens and Unilever, from somewhat over priced, to under priced. The time for increased allocation to European equities is approaching but it should not be rushed.
- A similar story applies in Britain, which is already further along the path to fiscal austerity, causing a fall in living standards and a backlash in public sector industrial action. Britain's particular problem is its high reliance on the financial services sector as a result of London being a prime financial centre. This leaves Britain exposed to a loss by emigration of financial services businesses and their more highly paid staff, if taxes (or regulations affecting profit) are increased beyond what is acceptable to these participants in the economy. They can move to lower taxed and lesser regulated jurisdictions in ways that manufacturers and miners cannot.
- In a similar way to the USA, the British and European economies, which are experiencing very slow growth, are not the same as their major stock markets. The major British and European multinationals have global revenues and profits, they have also cut costs during the GFC and they also have access to very cheap finance in a time of low interest rates. Their capacity to protect their revenues and profits is arguably better than that of their host governments.

PEOPLES REPUBLIC OF CHINA

- The government of the Peoples Republic of China has arguably the strongest position among sovereign states by virtue of the 80 million strong membership of its Communist Party backed up by the arms of the 3 million strong Peoples Liberation Army, both of which have pervasive business interests throughout the economy. Apart from enforcing tax collection and controlling bank interest rates and reserves more tightly than its developed country counterparts, it has demonstrated a more draconian approach to corruption than most.
- When its Premier Wen Jai Bao says that they plan to control inflation and maintain real GDP growth at 7 % p.a. over a 5 year period, this has more credibility than a similar statement from any of the G7 leaders would carry.
- China is not without its challenges but its ability to deal with them at least in the short to medium term out to 10 years from now, is quite good. Consumer price inflation is a growing issue of concern to the Chinese political elite in a world where authoritarian regimes are being increasingly challenged but it appears to be under control at fewer than 6% p.a. in spite of rapidly increasing food prices (mainly pork). There is no doubt that there is growing unrest in some cities due to rising food prices and shortage of accommodation, but also due to government appropriation of land for the construction of new housing to be rented out at up to 40% below private sector rents (in order to address the housing shortage in the cities).
- The rate at which housing and infrastructure is being built is very high, but also needs to persist for years to come. The consequent demand for steel and concrete is both high and continuing. These in turn require large imports of iron ore and coal.
- The positive impact of China on the Australian economy looks set to continue for the next 10 to 15 years. As we have said before, falls in mining share prices due to periodic bearishness on China look like opportunities to buy or accumulate the shares of major iron ore and coal miners.
- While the Chinese stock markets (Shanghai and Hong Kong) are likely to be both volatile and at times over priced, investment in companies listed elsewhere, which export to China, such as Siemens, Nestle and BHP, makes a lot of sense from a medium to longer term point of view.

SUMMING UP

- Summing up, in today's world, sovereignty is more dispersed than it was during much of the 20th Century. Some corporate credits are better quality than many so called sovereign debt issuers. Many listed equities offer better prospects of return with lower risk than any fixed interest through their capacity to maintain growth in dividends.
- We live in world where most major governments are weak or timid or both. They are often weak due to the fact that they are minority parliamentary governments. They are often timid due to the low calibre of people attracted to a long term career in politics, who have not worked at any other task within the economy that they purport to manage.
- Among the G7 countries, Canada has the strongest government, having just been re-elected and it also has the strongest resource base relative to its population. Among the major emerging economies, Brazil is in a similar position but has problems that Canada does not.
- The rest of the G7 include governments that are weak due to reliance on coalitions of parties or factions (Japan, Britain and Germany), due to imminent elections and compromised leaders of major parties (Italy and France) or constitutionally unworkable governance arrangements (the USA).
- Among the rest of the major emerging markets, Russia is facing uncertainty in its upcoming election (not about which party will win, but who will lead it), India is plagued by corruption scandals and a dearth of foreign investment as a result, together with rising inflation, and South Africa is becoming politically less stable.
- Weakness in government matters less when financial conditions are easy. It can be crucial in a time when the margin for fiscal or monetary policy error is as diminished as we now see.
- Longer term over a 20 year period, the demographics of the USA indicate that it is more likely to resume faster growth than Britain, the Eurozone or Japan. Australia is in a similar fortunate demographic position. The transition for the USA may however be quite arduous, requiring consistent fiscal reform over ten year period. Given its fragmented governance structure this will not be without drama (with or without Obama) for the financial markets.
- There will be sentiment spillovers from the credit and foreign exchange markets to the equities markets. Given the global nature of many companies and their ability to maintain their revenues and profits somewhat independent of the nation states in which they operate, any major falls in their prices should offer long term accumulation opportunities for investing in these new sovereigns.

What may happen next? Possible scenarios

Given the extreme level of volatility in both the equity and fixed interest markets we need to consider a number of scenarios of what may happen over the next one to three years.

It is important to recognise that we need to use scenarios because even our best assessments are so uncertain and there is a significant likelihood that our recommended portfolio strategies will turn out to be wrong if left unchanged in the face of market developments.

BASE CASE (30% PROBABILITY - PREVIOUSLY 35%)

- The USA avoids a return to recession but has slower than normal economic growth (sub 4% p.a.) during the recovery over the next five years. This means that unemployment will reduce slowly and stay higher than in most previous recoveries.
- Japan achieves low real growth but with deflation continuing well into 2012.
- Europe achieves low growth with very low inflation. Inflation in developed countries picks up only slightly into the 3% p.a. to 4% p.a. range from 2011 onwards and does not get out of control. This has the beneficial effect of slightly reducing real interest rates and the real burden of debt.
- Australian cash and short term interest rates increase modestly with the RBA cash rate rising to above 5% p.a. by the end of the first quarter of 2012.
- Bond yields have a capacity to rise by between +0.5% p.a. and +1.0% p.a. by the end of FY 2011/2012.
- Commercial property values remain fairly static in 2011/2012.
- Earnings per share for the ASX 200 grow moderately over the next 5 years with the exception of the major resource companies which achieve more rapid growth in the next two years and beyond.
- The Australian share market is prone to falls of between 10% and 15% during the course of the next two financial years but has a reasonable prospect of being some 10% to 15% above its current level by 30 June 2012.
- International share markets, led by the US, show some moderate weakness over the next six months (10% to 15%) before resuming their recovering, underpinned by some earnings growth.
- The Australian dollar continues to swing in a wider than normal range of between USD 0.90 and USD 1.20, adding more short term volatility to returns on international assets.

UPSIDE CASE (15% PROBABILITY)

- Worldwide growth stronger than expected due to consumers and businesses recovering in confidence. US unemployment drops below 8% by mid 2012, Europe grows real GDP by 2% p.a. or more, Japan recovers more quickly and Chinese growth slows only minimally.
- Inflation in developed countries picks up into the 3% p.a. to 5% p.a. range from 2012 onwards but does not get out

of control, even though it is at the higher end of the range most of the time.

- Australian cash and short term interest rates increase more significantly over the course of 2011 -2012 to combat re-emerging inflation risk.
- Bond yields up by between +1.0% p.a. and +2.5% p.a. by the end of FY 2011/2012.
- Commercial property values start to recover more quickly starting in 2012.
- The Australian share market is prone to falls of between 5% and 10% during the course of the next two financial years but has a reasonable prospect of being some 15% to 20% above its current level by 30 June 2012.
- International share markets, led by the US, show some moderate weakness over the next six months (10% to 15%) before resuming their recovery, underpinned by some earnings growth.
- The Australian dollar continues to swing in a wider than normal range, adding more short term volatility to returns on international assets.

DOWNSIDE CASE (30% PROBABILITY)

- Due to one or more of the following: A US debt default or severely compromised budget policy; an oil price shock; or increased conservatism in Japan and Asia, recession re-emerges in the USA, Japan and Europe in late 2011 to early 2012 and proves to be a worldwide double dip event and lasts till 2013 or later, threatening a recession in Australia.
- Inflation is contained by recession and slips into deflation worldwide for up to 5 years, ranging between -2% p.a. and +1% p.a.
- Australian cash and short term interest rates down by 1.0% p.a. from current levels by the end of calendar 2011 and by further 1.0% p.a. in 2012 as the world moves into recession and the RBA cuts rates to stimulate the economy.
- Bond yields down by 0.5% p.a. by the end of calendar 2011 and a further 1.0% p.a. in 2012.
- Commercial property values do not recover their 2007 level until 2016 or later.
- With the exception of major resource companies, earnings per share growth for the ASX 200 companies are negative in 2010-2011 and slower by 1% p.a. for the next 5 years.
- Australian, European and US stock markets bottom some time in 2011-12 between 20% and 30% below current levels and recover their current levels in 2013-2014.
- The Australian dollar continues to swing in a wider than normal range, adding more short term volatility to returns on international assets.
- The other 25% of possibilities we simply do not know about. They include a range of unknown unknowns. The world has become a more uncertain place in the last few weeks.

What to do next: Implications for Investment Portfolio Strategy

PORTFOLIOS SHOULD:

- Maintain their current positions with heightened levels of cash ;
- Be ready to increase their weighting to Australian and International equities over the next three to six months during episodes of significant market weakness i.e. 10 % or more below the current levels as set out in Table 1 above;
- Continue their significant underweight in property subject to investing in exceptional opportunities which offer returns in excess of 12% p.a.;
- Bias fixed interest to bank term deposits.
- Generally avoid investment products that are not clearly transparent in terms of how they work and what they charge such as hedge funds and structured products.

RECOMMENDED PORTFOLIO WEIGHTINGS (UNCHANGED SINCE LAST REPORT)

Table 4 (right) sets out portfolio allocation guidance in terms of positioning relative to long term benchmark or strategic asset allocations.

We have expressed them in terms of percentages of the long term benchmark or strategic allocations. In summary, the recommended portfolio strategies take account of all three scenarios outlined above. They are unchanged from last month except for an increase in the allocation to Australian equities by 10% of the relevant benchmark weight. Given the level of turmoil in the market we believe that this increase should be implemented over the next three months perhaps in two or three stages at levels below 3900 on the ASX 200 index. The recommended portfolio weightings have a significant amount of cash which is both precautionary and available for the opportunity for deployment into growth assets depending on how the scenarios unfold. The situation requires fairly constant review and attention with clients. Table 3 below sets out trigger points for buying and selling various share markets for those who wish to manage portfolios on this basis.

Table 3: Share market buy and sell ranges as at 8 August 2011

SHARE MARKET (AND INDEX)	INCREASE WEIGHTING WHEN INDEX BELOW	REDUCE WHEN WEIGHTING ABOVE
AUSTRALIA (ASX 200)	3900	4800
USA (S&P 500)	1100	1440
GREAT BRITAIN (FTSE 100)	5100	6200
GERMANY (DAX 30)	6100	7600
JAPAN (NIKKEI 225)	8800	11000

Table 4: Madison Recommended Portfolios: asset allocation relative to long term benchmarks

ASSET CLASS	TARGET PORTFOLIO WEIGHTING AS A % OF LONG TERM STRATEGIC OR BENCHMARK WEIGHTING
RISKY ASSETS	
Australian equities	75% (up from 65%) for portfolios 1&2; 95% (up from 85%) for portfolio 3; 100% (up from 90%) for portfolios 4 and 5.
International equities	65% for portfolios 1 & 2; 75% for portfolio 3; 80% for portfolio 4; 85% for portfolio 5
Property	50% with a bias to unlisted assets on a very selective basis with total returns above 12% p.a.
Fixed interest -Tier 2	30% in AA rated issuers only
DEFENSIVE ASSETS	
Fixed interest -Tier 1	50% with a bias towards bank term deposits
Cash	Balance of the portfolio

INVESTMENT OF NEW CASH FLOW

We recommend that new regular cash flows in or out of the portfolio are invested in order to achieve the target allocations recommended above. Large one off cash flows should be invested over a period of six months to achieve the same result.

Gearing to invest: For some investors borrowing to invest will be worthwhile provided that (a) there is a strong prospect the return on the investments assets bought with the borrowed funds will outperform the cost of borrowing on an after tax basis over the term of the loan; (b) the investor has a very high tolerance for short term risks and fluctuations in asset prices whose effects will be magnified in any geared investment ; and (c) geared investments are not made into asset classes where the recommended allocation is less than 100% of the long term benchmark, unless the individual asset offers the prospect of significantly better returns relative to the rest of the asset class.

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