Financial Markets Update

June 2012

ZANACORP

We are now living in the fourth year of post GFC life. These years have delivered a barrage of poor investment outcomes, social unrest, economic & political uncertainty and natural disasters. To make matters worse, from where we currently stand, the future looks no better than the past. Investors, particularly retirees are being truly tested. But make no mistake, in the years ahead we will look back at this time with either satisfaction or regret. Investment choices made today will impact on your life for years to come. Choose wisely.

Problems Here, Problems There, Problems Everywhere

Since our last publication in December 2011, financial markets have yet again teased long suffering investors with glimpses of a better world. In the March quarter of 2012, global markets appreciated in excess of 10% which was the best 1st quarter outcome in 14 years.

This promising start to the new year was quickly snuffed out by the re-emergence of the European sovereign debt crisis and the unfortunate choice of Greek voters in their mid-April election. That election spooked global bond holders and frustrated EU leaders. Since then, the economic news of the world has simply deteriorated into its now familiar parlous state.

Three years ago we explained that it would take many years to mend the colossal global imbalances that led the world headlong into the GFC. Two years ago we graphically illustrated the 4 stages of a typical secular bear market including the duration of the cycles. Last year we spoke of the reluctance of Western peoples, particularly Europeans, to accept their new and more humble future reality.

Today, we find ourselves precisely where we would expect to be. No better, but no worse. Readers may feel differently because the path here has been exhausting. But investing, like life, is a marathon not a sprint. Along the path, the end seems so far away that one struggles with the here and now. Especially when it is tough.

In June 2010 when we charted the course of a bear market, we chose to end the graphic at the point of range bound trading. But since that chart was historical, we have some guidance as to how future will look. The near term direction of markets is unclear as nations are adopting policy on a trial & error basis. However over the medium to longer term, we are confident that human adaptation to changed economic circumstances will lead to changed economic outcomes. ***Today is not forever, it never has been and never will be.***

Presently the world appears so overwhelmed by problems that investors' patience & confidence is spent. We feel it is important to convey our current views on global conditions to provide clients with some context as to how these conditions may impact financial markets and investment performances.

EUROPE

For 2 years now, Europe and particularly the Southern European PIGS have been the primary source of economic attention and global concern.

With so much having been reported on Greece, Spain and Italy in recent times, most clients will be familiar with the plight of those nations and their citizens. Many of you will have cast your opinion on the outcome, informed or otherwise.

Whilst the story is still unfinished, we expect a further round or two of debt restructuring and gut wrenching "argee bargee" with the Germans. Sovereigns are negotiating for their right to govern. With the stakes so high, this negotiation will be brutal and the consequences huge. The final leg of this saga may evoke the type of climactic financial panic that signals the end of a bear market. Conditions are just right for capitulation. Should prices fall precipitously, take a deep breath to see the opportunity at hand.

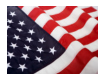
All EU nations and most intelligent investors know what the European problem is. The countries share a common currency, but no common government and no common tax base. As a result, when the EU was formed, credit was extended to people and countries who would not otherwise have received it and now have no ability to pay it back or devalue their currency to restore internal balance. The inevitably painful solution to this dilemma is to spread the losses across all stakeholders by:

i.An infusion of sufficient bail-out funds (ECB, German funded)
ii.Partial debt forgiveness (bond holder/bank system funded)
iii.Structural tax/labour/welfare reforms in the crisis countries (citizen funded)

Unfortunately at the moment, no stakeholder wants to lose anything. If the Eurozone is to stay together, and we believe that is their collective desire, the first steps will look something like those described in (i)-(iii). At that point, with markets and bond holders pacified sensible policies can be developed to get people back to work. EU unemployment at 11% is a significant problem especially amongst the youth whose skills are needed.

The ultimate resolution to the debt crisis will rely on years of Eurozone economic growth and inflation rates exceeding interest rates. Along with the printing of money to debase the currency, it is extremely likely that recovery will be real and visible.

Investment markets will see this well in advance. Don't miss it.



UNITED STATES

Unlike the austerity policies adopted in Europe which guaranteed their recession, the US employed expensive FED and government growth policies to deal with its crisis. These have had limited success in a consumer economy in deleveraging mode.

Since early 2008, the US government increased its debt by nearly US $5 trillion with a resulting increase in GDP of only US $1.5 trillion. Similarly, expanding the FED balance sheet via QE1 and QE2 may have saved US banks, but has done little to boost economic growth as households saw little of this money.

With sub par growth and stubbornly high unemployment, Uncle Sam's debt level of US $16 trillion has become the focus of political debate, instead of bipartisan policies to fix it. Until the November 2012 election, political gridlock will impede any significant recovery in the US economy. With the role and size of government at the heart of the debate, Republicans and Democrats see very different paths to recovery.

As in Europe, politics has set the agenda not economics. Without effective leadership and policies to get people back to work, we fail to see any immediate or sustained joy in markets.

The US economy is by far the largest in the world. Although its recovery from the GFC has been anaemic, it continues to grow, add productivity and adapt to changed conditions. It is not a bad story, merely an unexciting one. US commercialisation and development of shale gas via fracking represents a minor industrial revolution. It carries the real prospect of providing US manufacturing with a competitive advantage and transport cost efficiencies unimaginable even 10 years ago. Look out for it.

BRAZIL, RUSSIA, INDIA & CHINA (BRIC)

The emerging countries surprised all in 2009-2011 with their swift recovery to pre GFC growth levels. Regrettably, over the last 6 months this growth has stalled leading to significant falls in commodity prices and concern about future global growth.

India is the country experiencing the greatest difficulties at present with the currency tanking, growth rate falling, inflation rate rising and budget deficit blowing out to nearly 6%.

Russia remains in fairly robust fiscal and economic shape as a result of its oil and gas export revenues and internal restructuring. Nevertheless, recent falls in oil prices, if prolonged, may weaken the economy which still suffers from a weak banking system and protectionist trade policies. We note that Russia (like Asia) was in crisis in the 1990's and defaulted on its debt in 1998. 14 years later it finds itself in a relatively strong position.

Brazil's domestic economy has been sluggish and dark clouds are now emerging on their external trade as a result of waning commodity import demand from China. The silver lining amidst this gloom is that Brazil has room to implement counter cyclical measures via government stimulus and easing monetary policy. Brazil currently runs a budget surplus and has interest rates at 9%. (Brazil last defaulted on its debt in 1990, now look at it!)

China is the country the world looks to for economic hope. The centrally controlled, largely state owned system is the economic miracle of this century. Debate rages as to whether growth rates of 8% or above can be sustained and whether or not the planners can engineer a soft landing.

What is known today is that the 2011 planned slow down is working. What is unknown is whether the economy can be reignited if it slows too fast. Vital domestic consumption growth has been disappointing and property prices are falling leading to concerns that sentiment may have irreversibly changed.

Uncertainty over future Chinese growth explains why commodity prices have fallen so sharply and the share prices of Rio, BHP and Fortescue Metals along with them.

We believe a slowdown in ongoing GDP growth to 6%-7% is sensible. There are cost stresses in the Chinese system that pose risk, but they are manageable. China remains a long term growth story. What we are witnessing are the bumps on the road that were always there but unseen until now.

JAPAN

Japan is unlike any other country, both culturally and economically. Its current economic prospects are both diabolical with its ageing population, yet enviable for its productive capacity. Government debt now exceeds 200% of GDP, yet it enjoys a massive export driven trade surplus, one that it has had for decades. The government runs a fiscal deficit yet domestic growth is over 4% following the Fukushima disaster. The strong Yen reflects confidence in the economy. Interestingly, Japan's legislature is looking to double VAT from 5% today to 10% in 2015. Japan like other nations is responding to change.

AUSTRALIA

Australia has a multi speed economy. Mining is booming. Tourism, education and retail are in serious decline. The booming sector employs less than 2% of our population, but generates massive revenues for our governments to spend. Meanwhile the declining sectors (employing over 18% of our labour force) rely on easing monetary policy to keep them afloat. This is an uncomfortable dichotomy for policy makers.

Relative to most other Western economies, we are indeed a "lucky country". But how lucky you are depends largely on which industry you work in.

We don't see any catastrophe hitting Australian households any time soon. The Reserve Bank has room to drop interest rates if necessary. At a State and Federal government level however, the picture is less clear. Finances of most eastern states are stretched with lower stamp duty and GST revenues. At the Federal level, CGT collections have plummeted & mining taxes are shrinking. And carbon tax fiscal neutrality is yet to be proved.

Favourable "Terms of Trade" (TOT) explains why Australia has been so well insulated from the world's dilemmas. Recent years have delivered the biggest TOT boom in Australia's 200 year

history, but since March 2012 the trend has reversed sharply. Disturbingly, like the Europeans, the spoils of the income boom have been squandered contributing to poor productivity performance and a hollowing out of the economy outside mining.

The terms of trade is what quantity of imports can be purchased with a fixed quantity of exports. In other words, with high commodity prices, ***we have been able to exchange our dirt for imported digital devices*** (and all else) ***almost painlessly and without working for it.*** Australia is vulnerable to weaker Chinese and global growth, falling TOT and a weaker $A.

Whilst we are in no way as poorly placed as other nations, Australia may get a short taste of overseas style austerity dished out by our now deficit ridden governments, both State and Federal.

"A cow for her milk, a hen for her eggs. And a stock by heck for her dividends" J.B. Williams - Theory of Investment Value, 1938

What Does This All Mean?

Our short global tour explains why markets are where they are. Nothing you have read is a secret. Yes, there are bingles everywhere and the road is icy. However, as this is known, prices of listed equities are already discounted to reflect future risks and slower growth.

Many fantastic Australian and overseas companies are no longer being priced for their particular quality or value, but rather by global economic conditions and concerns.

As cautious and patient value investors, this is a perversely fabulous time in history to invest. We can gradually acquire stakes in good businesses for clients at attractive prices and collect their generous dividends. In time, as prices reflect underlying value, we will pick up 2% - 3% capital growth for free.

There are short term risks of further turbulence, to be sure, which could discount prices further. However, we believe that most people who could not stand the heat, have left the kitchen. They are in cash and will get ever decreasing returns.

All clients who are sensibly invested or are still investing in growth assets may need to withstand downside risk of up to 10% (ie an All Ords of say 3,600), but need do nothing to benefit from the inevitable 20% - 30% recovery in prices to fair value.

The future is not yet written so we each have a chance to make the most of it.

Behavioural Finance

It is time to change pace a bit. After all, even simplified economics can be dry and somewhat unsettling. Let's talk money!

In our October 2009 update, we introduced clients to behavioural finance with a simple diagram showing the emotional roller coaster that leads people from euphoria to despondency.

It is precisely this tool that capably assists us in understanding the psychology of all booms and busts, including this one.

There are many good reasons why people seek the safety of defensive assets like cash and term deposits. It is rational to do so. But if one is seeking good returns isn't it rational to buy quality growth assets when they are cheap, as they are now? Of course both views are correct, which gives rise to the truism "don't put all your eggs in one basket".

So we have had turbulent equity markets falling some 30% over the last 4 years and property prices are sinking. We get scared to read the paper or listen to the news just in case there has been another financial disaster in some foreign country.

Ring, ring**.** You get a phone call and hear that dear old Aunt Betty left you $100,000 in her will. Beauty, won't the income from that windfall make life a little more enjoyable?

But now you have a new problem. Where do you put the money? You are debt free and the kids have left home. Do you invest in shares, property or a term deposit?

If you are 60 or over, I bet this was such a simple question that you just handled it yourself and put it all in a 2 year term deposit at 5% and you don't have a worry in the world. Right?

But what would you have done in 2005? Interest rates were still 5% but the world was growing strongly. The neighbours next door went on an overseas trip using just one year's profits from their $100,000 portfolio having averaged over 15% returns for 3 years running. Would you still have put all of Betty's money in the bank for 5% less 16.5% tax, making it only a 4.1% return?

No. We think you would have sought some sound financial advice and invested some money in shares, some in property, some in bonds and some in cash. A diversified mix of quality assets generating after tax returns of around 8%. Sounds more sensible doesn't it? Spreading your eggs instead of having them all in one basket, like a term deposit.

So why did something so sensible 7 years ago become so terrifying today? The behavioural finance response would be fear of short term loss has altered confidence in long term outcomes.

This widespread behavioural response to uncertainty, coupled with more people being closer to, or in retirement, largely explains the current global "dash for cash" phenomenon. Peculiarly, this is so even though shares now generate higher income returns than cash.

Income From Shares

Owning shares is owning part of a business. Returns are comprised of both a portion of the annual profits (dividends) and a portion of the increased value of the business over time (capital growth). Once owned, these benefits are enjoyed in perpetuity.

Although both elements are important, we contend the real value in owning shares is enjoying ever increasing dividends. It always has been. We now aim to show you how this happens.

To eliminate the possibility of choosing the wrong bank, the wrong miner or the wrong retailer, we mostly recommend clients invest in professionally managed funds which will own a broad basket of quality shares, collect dividends, make all buy/sell decisions and handle all the tax and compliance matters.

Now, using an actual example of one of our preferred investments, let's look at what happened to $100,000 between 1998 and 2011, GFC and all and compare it to a Term Deposit.

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We want you to study the chart for a moment. Don't be overwhelmed by the numbers. Quite simply, we have $100,000 to invest in either an Australian Share fund or a Term Deposit.

For simplicity all interest/income distributions are paid out in cash (not reinvested).

Remember this is a real fund that many long term Zanacorp clients will have held, or one similar to it with comparable net returns.

Shares Investment *Versus* **Term Deposit**

Date	Yield from Initial Investment (% pa)	Income Distri-butions ($)	Capital Value ($)	Date	Term Deposit Rate (% pa)*	Interest Earned ($)	Amount Invested ($)
30-Jun-98			$100,000	30-Jun-98			$100,000
30-Jun-99	5.67%	$5,670	$136,370	30-Jun-99	6.00%	$6,000	$100,000
30-Jun-00	5.96%	$5,955	$136,410	30-Jun-00	5.75%	$5,750	$100,000
30-Jun-01	4.45%	$4,447	$160,160	30-Jun-01	7.00%	$7,000	$100,000
30-Jun-02	4.18%	$4,180	$169,010	30-Jun-02	6.00%	$6,000	$100,000
30-Jun-03	4.02%	$4,021	$169,140	30-Jun-03	5.75%	$5,750	$100,000
30-Jun-04	7.64%	$7,641	$195,510	30-Jun-04	5.75%	$5,750	$100,000
30-Jun-05	13.58%	$13,578	$220,910	30-Jun-05	6.25%	$6,250	$100,000
30-Jun-06	19.03%	$19,030	$234,550	30-Jun-06	6.50%	$6,500	$100,000
30-Jun-07	19.55%	$19,550	$277,360	30-Jun-07	6.75%	$6,750	$100,000
30-Jun-08	12.09%	$12,094	$213,320	30-Jun-08	7.25%	$7,250	$100,000
30-Jun-09	10.40%	$10,404	$179,840	30-Jun-09	8.25%	$8,250	$100,000
30-Jun-10	8.02%	$8,018	$199,980	30-Jun-10	4.00%	$4,000	$100,000
30-Jun-11	10.76%	$10,760	$214,260	30-Jun-11	5.50%	$5,500	$100,000
	Total Income	$125,347			Total Income	$80,750	

** 12 month term deposit rate is determined using the RBA cash rate (at 30 June each year) plus 1%*
Source: IML, RMC Dexia, Factsheet

What Do The Numbers Tell Us?

Australian 12 Month Term Deposit

From the table we see $100,000 invested in 1998 is still $100,000 in 2011. The capital never fluctuated, only the income. However the buying power of $100,000 over the years has been severely eroded. You know that. Oh, and interest of $80,750 was paid, but being fully taxable left much less in your hand to spend.

IML Australian Share Fund

A glance down the capital value chart shows $100,000 in June 1998 grew to $214,260 by 2011. That's nice. But notice the volatility in the value? At June 2007, the value was $277,360, but by June 2009 it had shrunk to $179,840. Horror of horrors, that's a 35% fall (ignoring the 8% income paid in between). Yet within 2 years the value had recovered to $214,260 (up 34%) and a further $18,788 was paid as cash income And how much was that original investment again? Oh yes, $100,000.

Over the same 13 year period income paid to the investor was $125,347 (with tax credits attached). That's $44,597 more than the term deposit! Well it was income you wanted wasn't it?

The Australian share investment is not special or unique. It generated a total annual compound return of just 8.19% (net of fees) which is roughly average over time. But look at the difference in capital value, and look at the difference in income. Over the period there have been a few pretty rough investment years along with some spectacular ones.

Since foundation, our message to people has been pretty simple. This illustration is a typical outcome for many of our clients who stood firm during the lean years and resisted the urge to chase the better returns during the good years. Investing success does not require much action, but rather psychological discipline. In volatile times, low risk, low return investments appear to be an investment panacea But like all investments, they work well for a while until they underperform other assets. No single asset class remains the best forever. Each has its time.

Because the last 3-4 years have delivered poor market linked returns, many people live in woe and apparent regret having forgotten where the money came from in the first place.

In our illustration, many people mentally "lock in" the highest investment value as their reference point (June 2007 $277,360) and then convince themselves they have "lost" $63,100 because it now valued at "only" $214,260. The initial growth is long forgotten, as is the income. But more recent stagnation and drop in value is vividly recounted. This type of simple investment analysis is very common but not very accurate. It leads people to make poor investment choices repeatedly.

Don't be blinded to the opportunity in front of us. We are neither bulls nor bears, simply advisers who see fair value on offer every day for a part of each clients' portfolio.

There's no trick to successful investing. You just buy quality investments at fair prices. Tactically add when prices are attractive and take profits when prices are high. Be diversified. Enjoy the good years when they come, but be prepared for the bad.

Really, how hard is it?

IMPORTANT SUPER REMINDER
From 1st July 2012, the new super contribution cap for total pre-tax and 9% SG contributions is capped at $25,000 for all taxpayers irrespective of age.

MARKET FACTS	June 2012	June 2011	June 2010	June 2009	5 Yrs Ago 2007	7 Yrs Ago 2005	10 Yrs Ago 2002	15 Yrs Ago 1997
Australian All Ordinaries	4,135	4,660	4,325	3,948	6,310	4,229	3,163	2,757
Dow Jones (US)	12,880	12,414	9,774	8,447	13,409	10,374	9,243	7,688
FTSE 100 (UK)	5,571	5,945	4,917	4,249	6,608	5,109	4,656	4,640
Nikkei (Japan)	9,008	9,816	9,382	9,958	18,138	11,584	10,621	20,604
Hang Seng (Hong Kong)	19,441	22,398	20,129	18,378	21,772	14,201	10,598	15,197
Dax (Germany)	6,416	7,376	5,965	4,809	8,007	4,583	4,382	3,795

DISCLAIMER
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