ZANACORP

Financial Markets Update

June 2011

The enduring legacy of the 2008 GFC is it's impact on people's lives is felt in different countries in different ways. To date, Australia has largely been an observer of the economic woes of many developed nations. Yet even as observers, our financial markets have borne much stress and investors much pain. In the absence of evidence of a sustained recovery, we remind clients that successful investing demands patience - sometimes lots of it.

Climbing the Wall of Worry

Presently, the economic world looks like a hospital emergency ward, pleasing those who like to see a glass half empty and scaring others.

Toppling regimes in North Africa, the earthquake/tsunami and nuclear crisis in Japan, the European sovereign debt crisis, concerns of a US double dip recession, floods in Queensland and Victoria and Australia's two speed economy are just some of the issues investors currently have to worry about.

These are serious matters bringing with them formidable economic headwinds which have weighed heavily on all markets over the last six months. The only question we need to concern ourselves with is whether we are at the end of the economic recovery, governments being left with no tricks and no money, or is it just another correction, as it was a year ago?

Scouring the views of "experts" and economists provides no clarity to the direction of the delicately poised global economy. Depending on the view you wish to find, there is no shortage of doomsdayers prophesising another global meltdown just as there is no shortage of analysts calling the All Ords to be above 5,600 by Xmas.

We believe we are currently experiencing the range bound trading conditions anticipated 12 months ago. Periods of relative calm see investors prepared to buy shares which are relatively cheap and prices rise. But when the calm is threatened, sellers invade the market bringing prices down. We expect this volatility to continue, until there is evidence of a sustainable upturn.

Although disconcerting, investors should not be distracted from their longer term asset allocations. Remember that markets have already factored in much of the above reasons to worry. Which is why they are low. It is new information, good or bad, that will determine whether they rise or fall tomorrow. Our advice is to ensure portfolios carry both growth and defensive assets rather than have extreme lop sided weightings hoping to pick the winning asset class.

GROUNDHOG DAY – 2011 A RE-RUN OF 2010

Mimicking Groundhog Day, the 2010/11 financial year as in 2009/10 saw markets enjoy a strong first 9 months only to be punished in the last quarter with April, May and June experiencing major declines in all sectors. In both May 2010 and 2011, the problems in Greece have held centre stage. Firstly, came the admission that the Greek government was unable to meet its obligations and required a bail out. A year on, the debt problems have worsened, despite the introduction of austerity measures. With that news markets quaked.

There is a ground swell of thought that Greece will need to "restructure" its debt (code for default) in order to survive. As is true in most matters, talking about fearful things helps us to deal with fearful things and make them less intimidating. Markets are now becoming comfortable with the thought that all is not lost if Greece were to default. Is Greece the European Lehman Brothers? We think not. Given the relatively small size of the Greek economy, the problems there are as much political as they are economic.

The political side of the European crisis is that stressed governments must take stern fiscal action or else find themselves abandoned by the EU, IMF and ECB. With the Greeks now responding, the precedent has been set for Portugal, Ireland, Italy and Spain to follow suit.

The threat of "contagion" in the region is thus best mitigated by having each country coerced into compliance with its lenders. So far, it appears to be working and markets are reacting favourably.

Struggling nations are outlining dramatic plans to increase taxes, reduce government costs and sell assets.

Yes, there will be marching in the streets and protests etc . This happens whenever groups of people feel disenfranchised. Many will be justified in their concerns, nevertheless, change must occur in order to achieve a greater good. Like the Russia of post 1989, not all change is bad.

Resembling a failing debt-laden company, there is a certain inevitability that countries can only "kick the can" down the road for a limited time before they must face the music. For the PIIGS, that time is fast approaching as are opportunities for investors. 2012 is shaping up to an interesting year.

FLASHBACK TO VICTORIA CIRCA 1992

The commentary that follows is not a political discourse but rather a retracement of events that may have faded from the minds of many.

Just in case we view the Greek crisis as something "foreign", let's turn back the clock 19 years and take a look at our own backyard. The Victorian fallout of the "recession we had to have" was the Cain/Kirner debt of $32 billion (when a billion dollars was a lot of money) and a State budget deficit of $2.1 billion. Angry Pyramid investors were marching up Spring St, Melbourne. Things needed to change.

In 1992, the State of Victoria was Australia's economic basket case. The collapse of organisations including Tricontinental, Pyramid Building Society, the National Safety Council, and the Victorian Economic Development Corporation, culminating with the CBA swallowing our state's crown jewel, the State Bank of Victoria, led to the downgrading of Victoria's credit rating.

State Bank Victoria

The 1992 Victorian election saw a brash young Jeff Kennett sweep into power with the most daunting economic challenge facing any Premier, either before or since. Confronted with nothing but bad news and demanding voters, the government embarked on Project Victoria. It raised state taxes to the highest in the country. And in a manner devoid of any subtlety, the government then proceeded to dismantle, liquidate and privatise nearly every asset the State owned.

The State Electricity Commission of Victoria, Loy Yang Power Station, the public transport system, public roads, schools, hospitals and airports were all sold. Services in education, healthcare and local government were simultaneously slashed. Desperate times called for desperate measures.

The net result of this ferocious cut back in government was the collection of $30 billion in asset sales, the recovery of the State's AAA credit rating and a fiscal surplus of $2 billion by 1999/2000. Victoria was now back in business. With our finances in order, government was able to again afford to re-invest capital in services as well as offer tax incentives to promote employment and grow revenue.

We concede that great damage and suffering was created by the slash and burn approach of the Kennett government, but it was needed at that time to resurrect the State. The tough measures in large part explain why we prosper today even without the natural resources available to WA and Queensland.

WHY IS THIS IMPORTANT TO TODAY'S INVESTOR?

Many of us lived, worked and raised children through the turmoil of the late 1980's and early 1990's thinking that life as we knew it would never be the same. And it wasn't. It was tough for many years, but no less satisfying.

Many clients will relate to the early 1990's when business failures, job losses, redundancies and uncertainty were the harsh reality of daily life. During this time, the lives of many Victorians and their families changed irreversibly. Some for better, some for worse.

The European malaise which is currently the focus of the world's attention is reminiscent of Victoria circa 1992. Similarly, the UK and US are heading inexorably to a point where tough decisions will need to be made in order to secure their economic survival.

Today's problems are undeniably different to those that faced Victoria two decades ago. Inventive new solutions will be required. But there is no reason to believe that just as Communist nations reinvented themselves after 1989 to create a new future, so too can the struggling West. The only uncertainty lies in what that future will look like, knowing that it must be different from the past.

We are not expecting any miraculous short term recovery in the developed nations. However, the day of reckoning for these nations beckons and we are confident that both political leaders and their constituents have the will to take the medicine that is long overdue.

Over the next 12-18 months we expect continued economic shocks and market volatility. Bouts of fear and pessimism will be unavoidable as will be credit downgrades. But each of these mini cycles will bring economic repair to those economies that are broken. The weaker economies will be forced to take action, just as we did in Victoria. Mistakes will also be made. But this path is the only one available to restore growth and wealth to future generations.

THE HIDDEN OPPORTUNITY REVEALED – INFRASTRUCTURE ASSETS

It is common knowledge that those investors who participated in most of the public infrastructure/utilities privatisations of the 1990's have been very well rewarded. Origin Energy, GIO, Transurban, Commonwealth Bank of Australia and CSL are some examples of companies that control businesses once owned by government.

We believe the massive debts carried by the PIIGS, UK and the US will seed the next privatisation wave. We strongly expect that in order to secure the continued support of lenders, Greece, Portugal and other European countries will privatise their public assets - probably at deeply discounted prices. In the US, over $US 2 trillion of infrastructure assets remain government owned and need upgrading.

In March 2011, Greece promised to privatise €50 billion worth of public companies and other assets in order to reduce the external funding of their public debt. Portugal and Spain have also commenced the process of releasing equity in power, gas and utilities together with state owned lotteries and airport assets.

A key feature of the privatisation of government assets, particularly in basic utilities such as power, gas and water is that the assets are usually monopolies and have regulatory protection of both their services and their pricing. Lotteries enjoy similar rights.

Most utilities have the ability to raise prices annually by at least the level of CPI making them the equivalent of indexed bonds. Once privatised, the income comes with the added benefit of capital growth via productivity gains and cost management measures which usually accompany privatised utilities.

Those characteristics make them irresistible to investors who seek a stable and growing income. Especially pension funds and retirees.

Zanacorp clients who invested in our 2009 series capital protected products have already enjoyed returns in excess of 30% over the past 2 years from holding infrastructure investments.

Over the past 12 months, we have progressively introduced infrastructure assets to clients in our preferred platforms, One Path (formerly ING) and Colonial First State.

As with any investment, we caution that short term returns from infrastructure assets may be volatile and cannot be guaranteed. However, we believe that over a 5-7 year time horizon, these assets will produce superior returns at lower risk than most other asset classes.

If your chosen investment platform and/or super fund does not offer a dedicated infrastructure option, you are probably in a fund that believes lower costs equal higher returns. With respect, we categorise such funds as "you get what you pay for". Infrastructure investments by their very nature are complex and tend to require greater analysis in order to determine their long term investment value. This usually means the specialist managers who offer these investments charge marginally higher ongoing fees.

Should you wish to find out more about the suitability of infrastructure investments to your particular circumstances, please contact us.

GLOBAL IMBALANCES & INFLATION

Imbalance is a Problem - But Not Forever

At the core of the world's problems lies the continuing great divide between debtor and creditor nations. Most developed countries have been unable to close their trade gap. They continue to struggle to create jobs, production and income and become increasingly indebted to their lenders.

The GFC was basically caused by a liquidity problem emanating from the post Lehman Brothers seizure of major financial institutions, who simply stopped lending. This has now been remedied.

On the other hand, ongoing trade imbalances and excess debt represent a very different problem. A problem of insolvency. In order to correct this, deficit nations will be required to make structural changes to their economies as we have indicated.

It may take 5-10 years to turn countries around, but it will not take 5-10 years for markets to re-price their prospects. As the inevitable changes to debtor countries begin to unfold, ***be prepared for markets to swiftly pounce on opportunities***. Waiting until it happens before moving will almost certainly ensure you will miss the boat.

In an uncertain world, people have flocked to the certainty of cash based investments. But certainty has two sides. Whilst offering the certainty and safety of a 6%+ return, cash/term deposits provide no growth. So the other certainty of cash is that it's value and buying power reduces over time. Rapidly, in times of rising prices. (We intend to expand on this theme in future updates, but for now our purpose is to remind clients to stay the course and remain diversified).

The Ugly Face of Inflation in China

For the first time in over a decade, inflation has returned as a real threat to global economic recovery. The issue however is not so much about the rate of inflation, but where it is being found.

We have long promoted the continuing growth stories in the emerging BRIC countries - Brazil, Russia, India and China. The strong dynamics of these centres have allowed them to largely sail through the Western based GFC. But as we have previously warned, these countries are not renowned for spreading prosperity around. Workers are now demanding a greater share of the pie, and like the Baby Boomers of the 1970's, they are demanding higher wages in return for their labour. Higher wages, together with higher input costs such as raw materials and oil have become a toxic combination fuelling the worst type of inflation - COST PUSH INFLATION.

We set out below a table of the current inflation and interest rates of a selection of countries:

	Interest Rate	Inflation Rate
Australia	4.75%	3.30%
Brazil	12.25%	6.55%
China	6.31%	5.40%
India	7.50%	9.41%
Germany	1.25% (ECB)	2.31%
Japan	0.10%	0.30%
Russia	8.25%	9.60%
United States	0.25%	3.56%
Great Britain	0.50%	4.42%

Source: www.global-rates.com (annualised May 2011 rates)

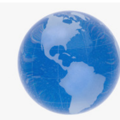
From the table we can see the BRIC countries carry nearly twice the inflation of developed nations and have used higher interest rate policies to keep it in check. So far the policies have failed because interest rates are a poor means to control supply side cost increases. They usually work to dampen demand. Pushing rates up too far also risks killing off growth and hurting over geared borrowers. What to do?

Our December 2010 update eluded to the currency "fudging" being undertaken, particularly by China, and its potential to create inflation. This is now a reality that will need to be dealt with.

Our table also illustrates the severity of the UK and US conundrum where real interest rates are over –3% pa. That is, money in the bank is diminishing in purchasing power at 3% pa. Imagine the plight of a US retiree with bank interest rates of 0.25%pa!

So the genie is out of the bottle. We believe much will be written about inflation in the near future. Watch this space!

Market Commentary



International Shares

In the midst of all the negative issues markets must contend with, readers may be surprised by the 30th June 2011 investment returns of world share markets.

Australian All Ords	7.7%	UK FTSE 100	20.9%
US Dow Jones	27.0%	Hong Kong Hang Seng	11.3%
Japanese Nikkei	4.6%	Chinese Shanghai A	15.0%
German Dax	23.7%		

Clients may recall that this time last year, the best results were similarly skewed to the US, UK and Germany, each with returns in excess of 15%. Regrettably, the 26% rise in our dollar in 2 years against the $US has heavily diluted investor returns. If and when our $ declines, Aussie investors will enjoy major gains from their overseas assets.

Australian shares have performed poorly relative to those of other countries because our market is very heavily weighted to domestic financial stocks and retailers. To outsiders, our banks are seen to be to heavily exposed to an overpriced residential property market and retailers to tapped out consumers. Whilst our miners have performed well, much of their super profits have been stolen by a strong dollar and ongoing concerns over global growth and China.

Overseas stock indices on the other hand are filled with dynamic technology and software companies, together with large manufacturers and pharmaceuticals that have all prospered by falling local currencies. International Dow stocks Alcoa (↑59%), Caterpillar (↑81%), IBM (↑41%), Du Pont (↑61%) and Pfizer (↑50%) are examples of why the Dow Jones 30 index continues to rise strongly.

Australian Shares

The Australian sharemarket had a mixed year with many blue chip stocks underperforming whilst lesser lights added considerable value. Although lacklustre, many clients may be surprised to know that Australian shares again performed better than cash with the All Ords Index rising by 7.7% for the year.

We find that people who constantly track their portfolios have a tendency to lose sense of starting and finishing values, particularly when there are many transactions in between. Having too much information, they struggle to absorb it correctly. Referred to as the "recency effect" people recall the most recent events most vividly and earlier information becomes blurred. With the last 3 months fall of 9%, the first 9 month gains of 16% seem to be forgotten, so many believe it was a poor year. Clearly this is an incorrect conclusion.

Another effect (anchoring) occurs when people compare the current level of the All Ords (4,660) against the November 2007 high of 6,853 points. Whilst it is absolutely true that our sharemarket remains 32% below its peak, it is not true that it has performed worse than cash in the last 2 years. In fact, ignoring the fluctuations (if you can), the return from Australian shares in the last 2 years has been 18%.

Assuming a term deposit rate of 6% pa, cash based investors are already one year behind their "buy and hold" share investing neighbours and without the franking (tax) credits.

Market stars this year included Rio (↑24%), BHP (↑16%), Brambles (↑ 32%), airport operator MAp (↑24%), Flight Centre (↑30%), cinema/video distributor Village (↑86%), engineer Worley Parsons (↑27%) and mineral sands producer Iluka up a staggering 261%. The banks, Woolworths and Wesfarmers all returned less than 10%. 2011 was a year investors needed to be diversified to make money.

Amongst the laggards this year were builder Leightons (↓28%), retailer Harvey Norman (↓25%), uranium producer Paladin (↓30%), baker Goodman Fielder (↓22%) and steel producers Bluescope (↓42%) and OneSteel (↓ 38%). Most losers were down only 8% - 12%.

In a year of few big losers and these being more than accounted for by gains in widely held large cap mining companies, investors were left with a quite reasonable, if unspectacular year.

Looking ahead, we see the Australian market trading in a range of 4,100-5,200 points, which is +/- 12% from current levels. We do not buy into the doomsday predictions, but are wary of downside risk. On the other hand, should markets overcome their US/UK concerns, it is quite conceivable that our market could be above 5,000 points by this time next year. Adding dividends of 3.5% - 4%, we favour shares over cash for most non-retired investors who have time and income on their side.

Listed Property Trusts (AREITs)

Following a solid 12% return in 2010, AREITs were unable to sustain their recovery in 2011 posting a 2.6% index return. Mounting concerns over internet sales stealing market share from traditional retailers and flagging first home buyers saw the major players Westfield, GPT and Stockland drift sidewards in price. With yields running slightly over 6% per annum we continue to believe investors should buy the sector and wait for the imminent recovery in sentiment.

While the high AU$ currently attracts consumers to go online, we believe it will take many years for shopping habits to fundamentally alter. In the meantime, both Westfield and larger retailers are developing online models to compete against offshore e-tailers and keep the retail dollars in Australia. The sector should produce 6% - 8% pa.

Residential Property

Australia's love affair with residential property will not disappear. But it may have a temporary "period of separation". After a strong 2010, the current year has brought out more sellers than buyers, and prices have been relatively soft since Christmas.

With interest rates steady and employment strong, we do not see any immediate threat of large price declines. Assuming China manages to avert a hard landing, we would expect house prices to remain flat for the foreseeable future. For investors, a net rental yield of 3% pa and cost of funds of 7.5% pa means the next 2-3 years are likely to produce modest losses. However, given the significant gains both before and after the GFC, the market was ripe for a pause.

New entrants into the market will be offered more choice in property than previously, but few bargains. We continue to hold the view that the residential property market is significantly overvalued, held up by sentiment rather than fundamentals. Clients expecting to negative gear their way to early retirement may be disappointed, particularly if the China train is derailed over the next 3-5 years.

Interest Rates & the Australian Dollar

Irrespective of the RBA's recent hawkish comments on interest rates, we expect little change in the next 6-12 months. We continue to be aligned with China and whilst Chinese growth remains robust, rates should be on hold.

Likewise, our currency, like commodity prices is heavily dependant on the Chinese/Asian story. We expect the AU$ has already peaked at US 110¢ but looks unlikely to rise further or fall unless China's economic situation deteriorates.

ZANACORP WEBSITE

As most clients now have access to the internet, we invite you to take a tour of the Zanacorp website at www.zanacorp.com.au. We hope you will find the content and links of interest.

"Success usually comes to those who are too busy to be looking for it" Henry D Thoreau

LAST CHANCE FOR SUPER

We remind all clients over 50 years of age that 2011/12 is the final year of pre-tax super contributions of $50,000. From 2012/13, all taxpayers will be limited to contributing pre-tax contributions of $25,000 with the exception of people over 50 with less than $500,000 in super.

EPILOGUE

In writing this piece, your author took the liberty of reviewing the Zanca Partners economic newsletters penned during the 1990's.

A recurring theme for the four years between 1991 and 1995 was the sense of frustration that investment markets failed to perform. But then, as now, we encouraged clients to continue to invest each year despite their disappointment. Needless to say that the 1996 to 2000 period saw markets rise on average by over 60% (with US/Asian markets more than doubling in four years). The lesson offered by this anecdote is ***you simply have to be there when it happens***.

We caution retired Baby Boomers who have time on their hands, to resist the urge to micro-manage their portfolios based on short term events and emotions. The more you worry about your finances and make spontaneous changes, the more prone you are to make errors. Don't be distracted by the constant invasion of news and views and remember the old adage "today's newspaper wraps tomorrow's fish & chips". Success comes to those too busy to be looking for it.

If your broad asset allocation is set and your income needs established, we suggest you sensibly manage/enjoy your retirement years.

MARKET FACTS	June 2011	June 2010	June 2009	June 2008	5 Yrs Ago 2006	7 Yrs Ago 2004	10 Yrs Ago 2001	15 Yrs Ago 1996
Australian All Ordinaries	4,660	4,325	3,948	5,333	5,034	3,530	3,425	2,242
Dow Jones (US)	12,414	9,774	8,447	11,350	11,150	10,435	10,502	5,717
FTSE 100 (UK)	5,945	4,917	4,249	5,626	5,833	4,464	5,642	3,701
Nikkei (Japan)	9,816	9,382	9,958	13,481	15,505	11,859	12,969	22,531
Hang Seng (Hong Kong)	22,398	20,129	18,378	22,102	16,627	12,285	13,043	10,959
Dax (Germany)	7,376	5,965	4,809	6,418	5,683	4,052	6,058	2,566

DISCLAIMER

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