ZANACORP

Financial Markets Update

June 2014

In a continuing saga, investors are having to grapple with the choice between investing with capital security accompanied by very low returns or investing into shares and property which may generate higher returns but necessarily involve placing capital at risk. It is a global quandary. Over the past 2 years, fortune has favoured the brave. Risk based asset returns have generated 3-4 times the return of cash/term deposits. Growth investors are now richer and the fearful poorer. This is history. Our gaze now turns to what lies ahead.

Failing to Prepare, Will be Preparing for Failure

Investor Educate Thyself

At Zanacorp, we see education as empowerment. It can lead to better future outcomes. We have always seen our role as financial advisers to include educating our clients in the art of money management.

Education and education funding is topical in Australia today, with students and government seemingly at loggerheads as to who should foot the bill for higher learning, when money is in short supply to both.

Your writer is a baby boomer and (like many) is not too proud to concede to having the academic component of his university degree 100% funded by taxpayers. Thank you Gough.

But his 6 years of post graduate professional studies were self funded. Paid for by hard work and sacrifice, as they should be. (As an aside, perhaps the hardest exam to complete was the one held the day after Adriana, our first child was born, 21 short years ago. That day was an emotional roller coaster, adding a new perspective on life. Thankfully, mother/baby were well & the exam result was an honourable CREDIT).

After 37 years of active investing, there is still so much to learn. This newsletter contains an important lesson clients need to grasp to be successful investors. It is the psychological effect of ***anchoring*** and ***herding***, and how it can fundamentally impact people's sense of price and value.

BEHAVIOURAL FINANCE 102 - PRICE & VALUE

Often people confuse the difference between asset prices and asset values, but knowing the difference is critical. The oft-quoted Warren Buffet coined the phrase ***"Price is what you pay. Value is what you get"***. This is a truism intrinsic to nearly every purchase we make from the supermarket to the stock market.

How often do we really stop to assess how much we pay for something and what we get? For centuries, marketing people have been able to get buyers to buy goods they don't need, or at the very least, get them to pay more than they should for what they do need.

An example is the "price/quality illusion" which goes something along the lines of convincing people the more they pay, the better product they get. As with all things in life, very often this is true. Since it is often true, it blurs the line between reality and belief. By linking a product or idea with an expensive price, it is quite easy to lead people to believe they are getting something superior. "Brand value" is built on this concept, like Mercedes, Gucci, Chanel and Apple. The generally accepted notion that high quality must come at a high price is exploited by most industries, successfully able to part people from their money simply by using words or labels that meet a consumer's desire or hope.

"Long wearing", "deep cleansing" and "exclusive design" are very basic tags illustrating the point. Why are such simple techniques effective? Surely in the 21st century we have been educated sufficiently to see through such things? Why are people so easily led to mortgage their homes to invest in apartments promising "high returns & low risk"?

We know such things are too good to believe, yet even intelligent people fall victim to their lure. Why would anyone borrow huge sums of money to invest in property or shares, when they know they will be most likely paying too much? Why is an ounce of gold (a simple rock) worth $900 one year and $1,400 the next (or of course vice versa)?

The answer to all these complex questions lies in the basic understanding of human motivation and behaviour. The fibre of all human activity.

Numerous psychological studies have been conducted that show how we are all susceptible to making serious errors in assessing value, especially in a world that bombards us with prices and information.

Behavioural economist, Daniel Ariely, in a series of experiments was able to demonstrate how our previous experiences and choices in life affect our future decisions. The concept of "price and value" are often irrationally linked by nothing other than random events, like a birthday, credit card number, or ***more dangerously, somebody else!***

People who buy "economically" priced cars and have good experiences are likely to continue to do so whilst those who have poor experiences will change brands or price points, believing this to be their error. People who buy expensive cars, make the same choices, adding a little ego into the mix. ***Is 1 Merc or BMW worth 3 Camrys?*** You decide. The choices we make that deliver the results we expect, tend to be repeated over and over again often irrespective of price, changed conditions or newer options. This behaviour called **anchoring**, happens all the time and is especially true when we come to investing money. It often leads people to make very poor decisions.

Another powerful behavioural force that affects us all is the concept of **herding**. As the name suggests, if many people seem to have the same ideas as we do, it reinforces our confidence that our choices are sound and therefore increases the likelihood it will be repeated. It is a variant of "keeping up with the Jones'" and seeking the "safety of numbers".

The combined effects of anchoring and herding explain, at least in part, how investment booms are created and why they always end in tears.

What may start off as a very **good investment** by early investors in an investment cycle ends up being a very **poor investment** for those who buy late in the investment cycle. This is true even though they invest in the same asset. **The only difference is the price paid** for that asset.

Presently both bank shares and property prices are sky high, so why do people continue to buy at these prices? It is essentially the same reason as others buy gold at $1,400 per oz. They see potential gains as greater than potential losses, probably based only on recent data.

The "dot com" boom was 14 years ago. The pre GFC property & shares frenzy was 7 years ago. Are we there again today? Having emptied our economic arsenal, what do we have left to deal with the next crisis?

Zanacorp Tactical Asset Allocation - We are taking profits

Over the course of the last 3 months, Zanacorp has reviewed the portfolios of all clients and in the overwhelming majority of cases, recommended and implemented defensive changes to asset allocations.

As telepathed in our **November 2013** newsletter, we are extremely pleased with the 20%, 30% and often 40%+ returns to our clients over the last couple of years. However, it was our stated intention to take part profits during 2014 and reduce growth (risk) if asset prices continued to rise. TAA sheltered our clients from losses during the GFC. It will again.

So as to be clear with our current investment/economic point of view, we believe that the meteoric rise in the price of shares, property and bonds is approaching its peak. As prices continue to rise, potential downside risks increasingly exceed residual upside gains.

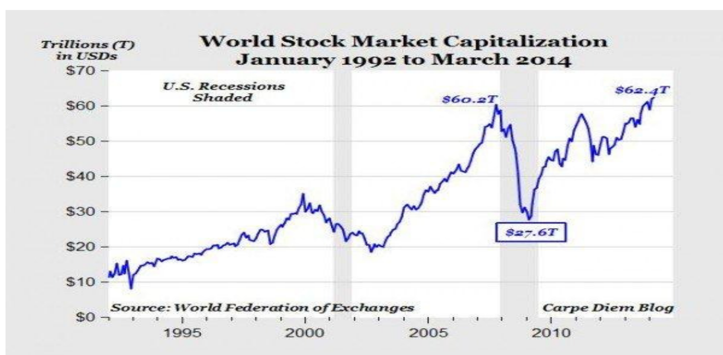
2014 eerily resembles 2006/07 where high expectations and investor complacency to increasing risk were trademarks. Known as ***the fear index***, the **VIX** (CBOE Volatility Index) is at its lowest point since before the GFC. Although this index is far from being an accurate bellwether, it points to risks being under-priced across all markets.

That said we are presently unable to scope any catalyst for a sudden change to the status quo, so ***it is quite possible that markets and debt will rise further over the next 6-12 months***. Fundamental economic metrics do not support any further rise in asset prices, but momentum and investor appetite to assume greater risk, certainly does.

Beyond the next 12 months however, unless markets do correct to price in risk, we are concerned that a serious downturn, particularly for Australia, would be imminent.

In June 2012, after 3-4 years of poor investment returns with investors still licking their wounds, our newsletter advised all clients to be buyers not sellers. Our cry was ***"Don't be blinded to the opportunity in front of us...There is no trick to successful investing. You just buy quality investments at fair prices...And take profits when prices are high."***

We believe that advice to be just as relevant today as then, however, in 2012 we recommended buying, today we recommend profit taking.



Markets are now capitalised at an all time high. Are things that good? Our aim is to have cash to buy the next dip, like 1994, 2003, 2008 & 201?

Avoid Extreme Positions

The next section of this newsletter may present certain facts that may be disturbing to some clients and result in them heading for the exit doors. We strongly recommend no one take this course, as the dynamics of global economics and geopolitics are exceptionally difficult to distil into a basic buy/sell/hold decision. There are too many contradictory forces in play.

Diversification remains the best way to negotiate uncertain times. Whilst we have taken part profits for clients, we continue to retain an appropriate level of exposure to growth assets so as to ensure that all clients continue to participate in the currently strong investment markets. We remain open to make money but not obsessed with that end.

Our recent TAA switches were designed to ensure portfolio asset allocations to growth assets were reduced by 5%-10% to bring that exposure closer to each client's risk profile target allocation. In every case, our profit taking locked in gains that were simply non existent 12 months ago.

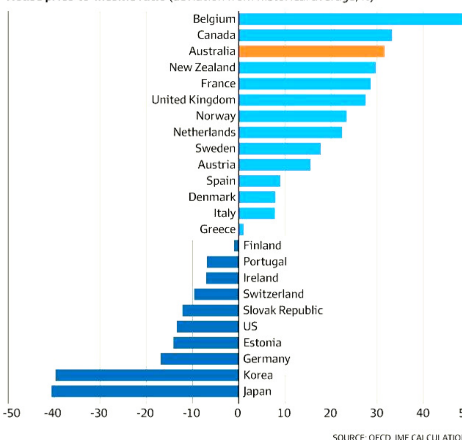
Following any period of either market over or underperformance, asset allocations become disproportionately over or underweight their target asset allocation levels and therefore require fine tuning.

Since the direction and timing of market movements is impossible to anticipate with precision, ***no client at any time should hold more than 80% defensive assets or 80% growth assets.*** Holding asset allocations outside of these extreme parameters risks either being too aggressive to prevent capital destruction, or too defensive to enjoy capital appreciation.

Although our current view is decidedly bearish, it remains possible for asset prices to continue to defy gravity and **rise even further** over the remainder of 2014. If that should be the case, we would again consider locking in even more gains for clients, until the inevitable tipping point in prices arrives.

The market correction we foresee is unlikely to match the severity of the GFC. Typically, a retracement of 50% of cyclical gains would be expected, thereby capping possible downside in Australia to 20%-25%, this being at the extreme end of our expectations. We expect the $A to also fall.

WHAT WE WORRY ABOUT



We are not value based contrarian advisers simply for the sake of it. Our task is to assist clients to create and build wealth so that they are able to have choices later in life. Choices in respect of retirement age, aged care, standard of living, etc.

The option to have choices in the future is most often determined by the financial choices made 10-15 years earlier. ***We reap what we sow.***

Over the decades, adhering to views not supported by the majority has been, at times, a very lonely place. It also invariably means we miss out on being fully invested at the very top of any market. By the same measure, we do not endure the severity of investment losses as others. We accept that trade-off is a necessary companion of capital protection.

" To profit from any market you need to be prepared to sell at a price just low enough to entice another person to buy. If there is no upside there will be no buyers. If there is fear, there will be too many sellers, and that is the time to be a buyer" - Anon.

Amidst the calmness of June 2014, we will now outline the key causes of our current concern over the medium term (2– 3 years).

THE "NEW NORMAL" IS ANYTHING BUT NORMAL

The post GFC stimulatory environment has been with us for 6 years. During that time the US, Europe, Asia and particularly China have been supported by almost continuous fiscal stimulus, near zero interest rates and an avalanche of money printing. ***In the case of China, private sector credit has increased by over 50% since 2008*** now representing 190% of GDP and for the first time, exceeds US Corporate Debt levels.

Notwithstanding these extraordinary measures, US, European and Asian growth remains well below long term averages and China's rate of growth is declining. There are no more rabbits left to pull from the magic hat.

The enormity of the money printing around the world has created asset price distortions that will inevitably lead to some form of calamity. Politicians have little incentive to deal with this problem as the medicine is political arsenic. Welcome to your new job Joe Hockey.

Despite the generally correct view that the world is recovering, it is impossible to apply normal economic investment rules to a global marketplace underpinned by the most abnormal measures ever seen. The ECB's recent decision to implement **negative interest rates** is yet another layer of 21st century economic magic pudding, yet to be tasted.

MARKETS APPEAR TO BE MISPRICING RISK

One of the serious consequences of cheap and plentiful money is that it inevitably leads to investment, speculation, arbitrage and asset price anomalies. The longer it lasts, the deeper it seeps into an economy until it establishes its own style of asset price anchoring and herding.

Most markets in the world are priced at all time highs despite modest profit growth, most of which has been generated by cost extraction not pricing power. Over the last 3½ years price growth has exceeded profit growth by between 30% - 55% depending on which market is being viewed. Mean reversion would dictate that in coming years, either profits need to expand (greatly) or prices need to fall (painfully). All investors are, of course, entitled to their own view and determine their own financial fate. We prefer to err on the conservative side.

One of the wonders of the internet is that there are now billions of amateur economists in the world. Information has indeed been liberating for the self directed individual. Unfortunately, understanding and knowledge remain somewhat more elusive. Be wary of herding.

It is no coincidence that asset bubbles were created as a direct result of the post September 11, 2001 period when the US Federal Reserve lowered interest rates to 1% in order to avert a recession. Why is the same outcome so unlikely after 5 years of 0.25% rates?

We acknowledge that market PE's of 14-16 do not indicate extreme valuation (relative to the last 30 years) but we also hold the view that the next 30 years will be very different to the last. Boomers have already passed their peak earning years so their positive influence on growth has expired. It is yet unclear as to whether this group will drain global reserves heavily or lightly in the future, but one thing is certain, they will be drawing from the capital pool, not adding to it. Health and welfare bills around the planet will rise at the same time as taxes fall. This is hardly new information to anyone. With a future quite different from the recent past, we draw little comfort from such comparisons.

At the risk of stating the obvious, asset prices have risen to current levels because ***investors with money receive inadequate returns from cash***, and have pursued the higher, but riskier returns available from shares and property. Simultaneously, ***speculators with little or no money have found it easy to obtain and service low rate loans*** and have pursued those very same high returns from shares and property.

Ironically, in a world attempting to deleverage, savers are punished and borrowers subsidised. This toxic combination which presents itself in Australia and all over the world has the makings of a perfect storm.

For some time now, the long held view of investors, borrowers and lenders has been that interest rates will remain low for a very long time. This has created a widely accepted anchor in asset pricing, and a confidence in borrowing that will not shift without the element of fear.

Do not confuse signs of economic recovery with continued asset price inflation. Be very fearful of it. High asset prices rely on weak economies and subsidised debt. Any change to this accepted view will be extremely destabilising on asset pricing and ignite fear of capital loss.

Economic recovery, especially in the US will lead to less stimulus, rising interest rates, a rising US dollar and the rapid repatriation of capital. This is not likely to occur within the next 12 months, but beyond that, we are confident the US recovery has gained significant traction. Statistically, ***every US worker that lost their job during the GFC has been re-employed***. That's 8.7 million US workers added in the last 4 years.

THE ELEPHANT IN THE ROOM - CHINA

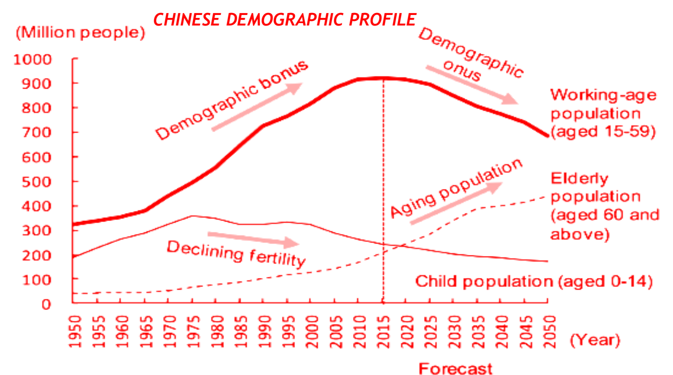
Although the rest of the world may be US focused, Australia cannot afford to be. Over the last 6 years our exports have been increasingly dependant on China's insatiable appetite for our resources (and more recently Japan's infrastructure rebuild). China's share of exports has grown from 18% in 2008 to 38% in 2014, so what is good for them is good for us and what is bad for them …. Well, you know how it goes.

Back in 2008/09 Australia's strong banking system, huge resource investment boom and rising Chinese exports, essentially insulated us from the massive dysfunction around the world flowing from the GFC. We were most fortunate then, to side step disaster. Today, those tail winds may have become headwinds as evidence of Chinese economic inefficiency and domestic credit problems are beginning to emerge.

We would do well to never underestimate the resilience of an oppressed people and a Communist political regime to "do whatever it takes". What follows is written with respect and caution to that resilience. China's strong international reserves will make managing their economy easier. But not easy. ***China may get old before it gets rich***.

China's Demographics Won't Help

By 2016, China's working age population will decrease for the first time as a result of the so called "***1 child policy***". The cheap and plentiful labour that made China the factory of the world will slowly decline and the problems of an aging society slowly increase. Their situation is no better than ours, fewer workers to support more demanding mouths.



Source: Compiled by Nomura Institute of Capital Markets Research based on United Nations, *World Population prospects: The 2010 Revision.*

Chinese Property Market

From a Western perspective it is difficult to comprehend the vagaries of China's property market and it's Hukou (huji) system. In 2014, Prof Li Gan of Texas A & M University conducted an extensive research survey into China's housing market. His study identified that at this moment there are **49 million empty houses** and the country's vacancy rate is a staggering 22.4%. Inexplicably, until recent months, property prices have risen year after year, even though there is a property glut.

We have all seen the pictures of Chinese ghost cities, so these statistics should not come as a surprise. However, the world has never witnessed an over-building boom of this scale and we can reasonably anticipate how it will end. We just don't know when.

It is estimated that property construction represents 15% of China's GDP. If construction were to contract sharply, GDP and confidence would be hit hard as would the demand for iron ore, copper, zinc, coal, nickel and gas that Australia, Canada, Africa and Brazil supply them.

To be fair, this bubble is unlikely to burst overnight since there is not a disproportionate amount of debt carried against the vacant stock. You see in China, only affluent people can afford to buy a home and they don't need the rent. If you go to Wheelers Hill in South East Melbourne, you can get a 1st hand look at what a "**land bank**" looks like.

Shadow Banking System

Like all things emanating from China, no one quite knows what's going on in debt markets and whether there is a problem or not. That said, mimicking the US derivatives market, a system of Chinese finance has developed over the last 10 years which has provided both unregulated investment and credit facilities to finance China's infrastructure spend.

This system is known as the Shadow Banking System (SBS). It is estimated that the SBS now provides 30% of China's credit most of which has occurred since 2008 and is part of China's 190% Credit to GDP.

Standard Chartered Plc have extracted **China's total debt** (including State Owned Enterprises) at **245% of GDP** as at 31st March 2014 (US $22.7 trillion), up 7% in only the first 3 months of 2014. Alarmingly, since the GFC, Chinese credit has grown at twice the rate of Chinese

GDP (even when GDP grew at 10% pa). It was the domestic response required to replace the post GFC European/global demand void.

As with the property market, we do not suggest a US style financial crisis, since the capital is internally sourced. However, it is another major vulnerability of the economy to either internal or external shock. Inefficient and subsidised investing in low return infrastructure, property and manufacturing projects it seems does come at a price after all.

Chinese policy makers will be asked to orchestrate a controlled debt deleveraging without seriously impacting GDP growth. A so called soft landing. In its growth phase, China has been adept at producing GDP "goldilocks" results. Can that continue if growth declines?

WHAT ABOUT AUSTRALIA?

In the short term (6-12 months) we believe Australia will travel along roughly as we have been for the last 12 months. Sluggishly.

Despite falling commodity prices, we cannot foresee any catalyst that will unexpectedly alter our low interest rates, sub par growth rate or relatively solid employment conditions. Furthermore, we cannot see any particular event or circumstances that will shatter consumer confidence or skittle investment markets addicted to property and shares.

We can concur with the current consensus view that suggests relatively benign economic conditions in the short term.

For all the reasons outlined in this paper, we see 2015 (or possibly 2016) as delivering a severe adverse economic and investment shock, particularly to Australia. It is for this event that we prepare.

In respect of timing of the downturn, we claim the right to one caveat. ***It is not necessary for an actual economic shock or incident to occur to trigger an investment correction. It is merely necessary that global markets believe it can occur***, for the reaction to be initiated.

For Australia, employment remains both our key defence and our key risk to avoid serious hurt. We remain concerned that Australia's employment position continues to deteriorate masked by a headline unemployment rate (currently 5.8%). The transition of the labour force from full time work to part time work continues unabated as does the fall in the participation rate (those seeking employment). The recent uptick in employment whilst welcome, has defied economic predictions of rising unemployment. The **Ford, Holden, Toyota** and other major manufacturing sector job losses are yet to be counted in the National Accounts but represent a major overhang to the jobs market in the near future.

Equally important to Australia will be the decision as to what extent the Reserve Bank is prepared to go to underwrite our **banking sector** and its over exposure to an inflated and overseas/SMSF influenced housing market. We believe this **will become Australia's moral hazard**.

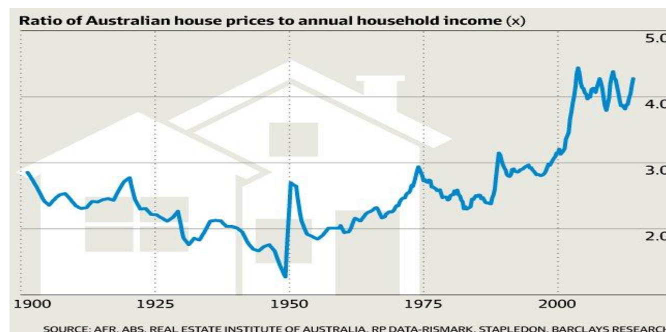
To pick on just one of our "**4 Pillars**", the CBA share price was $34 in 2001, $63 in 2007, $24 in 2009 and is now $81. ***Clearly there is a time to be in CBA, and a time to be out.*** Ignoring its present financial planning skirmish, today's price relies on very little going wrong for its millions of borrowers since its bad debt provisions are at all time lows. In equity circles this phenomenon is as known as "priced for perfection" (for balance, the other 3 pillars are in the same boat). While existing investors both direct and via managed funds/super will be chuffed with their bank returns, they should never forget **Newton's law of gravity**.

Why the concern with Australian banks?

Banks are the heart of our financial system. The GFC showed what can happen when they experience coronary arrest. The cause of the GFC and its consequential global wealth destruction, was the collapse of property prices around the world and the inability of the financial system to contain the damage. Banks lent too much to people who were too keen to borrow on the assumption prices could only go up.

In Australia, the 4 pillars now represent nearly 30% of the Australian share market's capitalisation. This is far more than any other country.

In Australia, housing is our biggest single asset and banks are our single source of finance for them. The two are inter-dependant. The chart below illustrates how since 2000 the lending and borrowing pattern has unequivocally deviated from the trend of the last 114 years.



Now let's put some context to this trend. Interest rates have been in secular decline for over 20 years (accelerated by the GFC). **Household debt has grown at 2.4 times the rate of household income** over the same 20 years. House prices have grown at 2.1 times the rate of household disposable income for the same 20 years. Australia has not had a recession for over 20 years. Our prices are now the 3rd highest in the world by most measures and we have attracted concern with the IMF.

Let's also remember what we have learned today. Anchoring sets a reference point for price which if positively reinforced, is hard to shift. Herding is the collective comfort we get from copying the behaviour of others. If for 14 years one witnessed prices go up, interest rates go down, people happy to borrow $400k, $500k or $800k and banks flush with money...what do you think would happen? Now ask the next question. Are all these factors likely to continue for the next 5 or 10 years or is there a point where rates cannot go lower, debt cannot go higher or credit cannot be looser? Changed conditions need a changed response. We caution against being anchored to the abnormal recent past.

We have little concern for offshore buyers. Our concern is that they simply bring prices to a breaking point where our bankers start losing money lending to locals who are already struggling with debt. In 2013, we had hoped for the market to cool but it simply gets hotter by the month and a supply side apartment glut is approaching. Where there is smoke, there is fire. In 2015/16, ***heavy borrowers will most likely be burned, while the rest of us are likely to be singed. Let us be prepared.***

REVISED SUPER CONTRIBUTION CAPS

From 1st July 2014, the super contribution limit for total pre-tax and SG contributions is capped at $35,000 for all taxpayers over 50 years of age and $30,000 for all other taxpayers. The non concessional contribution cap is $180,000.

MARKET FACTS	June 2014	June 2013	June 2012	June 2011	5 Yrs Ago 2009	7 Yrs Ago 2007	10 Yrs Ago 2004	15 Yrs Ago 1999
Australian All Ordinaries	5,382	4,775	4,135	4,660	3,948	6,310	3,530	2,969
Dow Jones (US)	16,826	14,909	12,880	12,414	8,447	13,409	10,435	10,971
FTSE 100 (UK)	6,743	6,215	5,571	5,945	4,249	6,608	4,464	6,319
Nikkei (Japan)	15,162	13,677	9,008	9,816	9,958	18,138	11,859	17,529
Hang Seng (Hong Kong)	23,191	20,803	19,441	22,398	18,378	21,772	12,285	13,532
Dax (Germany)	9,833	7,959	6,416	7,376	4,809	8,007	4,052	5,379

DISCLAIMER

The information, comments and projections contained herein are believed to be accurate, but represent general advice and are supplied for your interest only. You are cautioned not to proceed with any investment action until you have sought personal advice regarding its suitability to your needs from a licensed financial adviser.