ZANACORP

Financial Markets Update

April 2013

Since June 2012, the investment world has found itself in the midst of an uneasy solace. Many markets have risen to multi year highs. Investors' animal instincts have returned in a frenzied rotation out of cash into shares and sending prices up by over 20% in the first 10 months of 2012/13. But tempering excitement is the fact price gains have occurred in spite of tepid global growth, debt-laden turmoil confronting most of the developed world and potential for mishap behind every corner.

Yield, Yield, Yield… I Want Yield!

Flashback to December 2011

Remember what an investor's life was like back in December 2011? Here is a reminder. We were 4 years into the GFC. Cash in the bank earned 4.5% while term deposits paid a handsome 6%. At these rates, who would bother with shares? The grand predictions of most investment gurus proved to be fool's gold.

Equities had failed to deliver any sustained or meaningful gains for over 3 years and were vulnerable to external shocks every morning we opened our eyes. The Australian All Ordinaries index hovered at just over 4,000 points for years. Europe was in the middle of a Greek dance going round and round in circles trying to avoid a meltdown. Meanwhile back at the ranch the FED was flat out printing money. **CASH WAS KING**.

Our December 2011 newsletter went under the heading **"This Time It's Different… Or Is It?"** In that update (found at www.zanacorp.com.au) we reminded clients to stay the course and add to your growth assets if you were in a position to, as this *"may prove to be the buying opportunity of the decade"*.

Client frustration was so severe, we were drawn to make the following most uncharacteristic & controversial statement:-

"We continue to expect 1 year in the next 4 will deliver a return in excess of 25%... those people trapped in cash will be… haunted by the knowledge of their missed opportunity and the fear of getting back in too early or too late".

With the All Ords now over 5,100 points, AREITs and overseas markets reaching new highs, that year we were expecting has happened. Interest rates have fallen and **THE KING IS DEAD.**

Our present view is that most markets (Australia in particular) are either at or close to their near term highs and are arguably FULLY VALUED. It is a time to be CAUTIOUS not careless.

All Zanacorp clients have enjoyed great gains and will be contacted soon to take profits and "lock in" a portion of those gains, if we have not already done so. It has been extremely satisfying to see investors finally rewarded for their patience.

A Key To Making Money Is Not To Lose It

Zanacorp advisers have invested in financial markets since the early 1980's, witnessing first hand, the October 1987 stock market crash and its aftermath. We commenced advising clients under our ASIC licence in 1989, during the "recession we had to have". They were tough times. We make no apologies for being conservative. Having seen the adverse outcomes of people obtaining bad or no advice, we aim never to repeat them. We adhere to tried and proven investment principles.

Investment processes we apply to all client portfolios, include continually adapting and learning from other successful investors and strategies including Tactical Asset Allocation (TAA).

One of Warren Buffet's rules of investing is ***"Rule No 1: Never Lose Money. Rule No 2: Never Forget Rule No 1".***

In a variation of that rule, we use active TAA for clients. This involves selling a portion of one's growth assets after a significant rise, then reinvesting the proceeds more conservatively. This protects profits and mitigates unexpected losses knowing no asset class rises forever. The strategy may not extract every last dollar of profits, but it certainly ensures that capital is best protected. TAA was invaluable to us all during the GFC.

A critical feature of this process is that portfolios always retain exposure to both growth and defensive assets. Only the proportions change. So if prices continue to rise we continue to capture profits, but should they fall we have proceeds available to repurchase quality assets at cheaper prices than we sold them. It is a win/win even if our timing is less than perfect.

Liquidity, Banks & Baby Boomers

Australian shares and AREITs are currently the most vulnerable asset classes as they appear to have run too hard and too fast on the back the latest investment theme – **the hunt for yield.**

Like trapeze artists performing dangerous manoeuvres, without a safety net, central banks across the world have flooded markets with liquidity whilst running near 0% interest rate settings. These measures aim to stimulate domestic growth, employment and consumption. But they are uncharted waters.

Regrettably, rather than create production, employment and economic growth, the global glut of money has been used to seek passive investment gains. The manifestation of this trend is that investors, no longer rewarded for holding "risk free" cash are instead chasing returns from riskier investments such as high yield corporate debt and high dividend paying equities.

This behaviour resembles that of the 2005-2007 period where investors hopelessly failed to correctly price the risk of high yield instruments. They paid far too high a price for the assets underpinning the income. The resulting GFC is now carved into history.

The problem of pricing risk is compounded by an ever bulging group of baby boomers who control a disproportionate slice of investment assets. Boomers are progressively shifting from being accumulators and building capital to retirees living off their capital. They now seek income, not growth. This has become a crowded space, and finding value increasingly elusive.

As an aside, we are strongly wedded to the view that successful investing in the future will be very different from the past. Accurately anticipating the future needs and preferences of baby boomers will be the Holy Grail of all investors.

Australian Shares, Dividend Yields & PE Expansion

Although not appreciated by many, the hunt for yield was inevitably going to find Australia as our companies lead the world in the ratio of dividends paid out of profits made.

Our relatively strong economy, stable currency, high interest rates and high payout ratio has attracted both overseas and domestic investors alike in a scramble to buy our high yielding assets. Whilst not yet a bubble, the ingredients are all there.

As a result, the single minded pursuit of yield has meant investors appear prepared to pay a capital price premium to secure what they perceive as a predictable income stream. Having been re-rated, the PE (price/earnings) ratio of these companies has expanded by as much as 40% despite profits remaining flat. In other words they were cheap and now they are expensive. If future profits or dividends disappoint, the "P" (price) can fall a long way. We are uncomfortable that this risk is being ignored.

Defensive income and high yielding stocks (like the big 4 banks, Telstra, Wesfarmers and Woolworths) have seen dramatic price increases reflecting this income bias. Meanwhile the share prices of cyclicals and miners are falling. We feel the impulse to buy income at any price is unsustainable in the medium term and perilous for "Johnny-come-lately" investors.

We are also mindful that cashed up overseas businesses are also now increasing dividends. From a low payout ratio base, the capacity of overseas companies to increase dividends significantly is both a risk and opportunity Australian investors need to be aware of. In the US alone, JP Morgan, Wells Fargo, GE, Time Warner and Apple have all announced major capital management changes releasing vast amounts of cash to quench the thirst of shareholders. We expect that trend to continue.

We are all aware that things can change quickly. Should Australia's outlook weaken, for any reason, we could expect to see an immediate and considerable flight of capital out of our capital markets, higher yielding equities and our currency.

As China's outlook becomes increasingly uncertain over the next 12-24 months, we feel the $A may come under pressure. As such, we are comfortable holding/buying overseas companies and infrastructure assets via our preferred funds. These assets provide a natural hedge against a slowing China or any deterioration in global growth. They also profit if the $A falls.

We expect US growth and employment to stall over the next 3-9 months from the sequestered government spending cuts and increased payroll taxes. The private sector is unlikely to offset such headwinds. Nevertheless, we are mildly bullish that after a period of adjustment, the US will deliver on the structural labour, energy and manufacturing changes it has initiated. Stronger US growth over time will deflate US debt and eventually lead to a strengthening in its economy and its currency.

So What Will Be The Trigger and The Date?

In July, 2007, we cautioned investors to be wary of overheated markets only to see them continue to run until November. THEN CRASH. Our call was correct, albeit a little too soon. We find ourselves similarly placed now. Prices simply fail to reflect the fragility of the financial world. Things are far from normal, yet assets are priced for normal. Hence our concern. Our call may again be too early, but it is of no value to you if it is too late.

Momentum is a powerful driver of prices, both up & down. If markets continue to rise strongly, in the absence of adverse news, a 2nd round of profit taking may be recommended later this year. Such is our conviction. Clients will be kept informed.

We expect any correction is likely to be of the 10% - 20% variety. Thus, not nearly as damaging as the post Lehman Bros GFC.

Every correction needs a trigger. Based on what is known today, we are unable to point to that event or circumstance that will stop the momentum and the currently bullish sentiment circulating the globe. Although there is plenty to worry about.

It will need to be something significant and unexpected. Markets are focussed on interest rates so don't look there. Europe currently rests on the now famous words of Mario Draghi to do "whatever it takes". But nothing has really changed, they are still in a mess. QE in the US seems infinite, although we all know it is not. Austerity in the UK has not failed, but it has not worked. Brazil and India have fallen from favour, but are unlikely to derail capital markets. Russia is benign, Japan is pursuing inflation and Asia (ex Japan) seems to be doing OK. The only elephant left in the room is China, opaque as it is, with its shadow banking system frothing away under the radar. Could the trigger be a surprising (bad) growth number? We don't know.

Real risks can be found everywhere, yet they appear nowhere. In such times, we may be wrong, but we prefer to be prepared.

Our undertaking to all clients with investments managed by Zanacorp Elsternwick is to meet your needs by protecting and growing your capital. Invest wisely, invest safely.