ZANACORP

Financial Markets Update

December 2011

In Australia, the GFC and its aftermath has been with us for about 4 years. In the US, UK and Europe it has been longer and far more severe. Australia has been fortunate that it rides on the coat tails of the Chinese dragon, the economic miracle of our age. Were it not so, the GFC would be now known to us as it is to the rest of the world, "The Great Recession".

This Time It's Different……..Or Is It?

Long time readers of our newsletters will know that we get quite anxious when we hear the words "this time it's different". In good times the phrase is used to explain away rising confidence, rising debt, rising asset values and rising risk. It was a popular view leading up to 2007. You may recall terms like "synchronised global growth", "stronger for longer" and "benign inflation" as rational explanations of the 2000's boom, just prior to its cataclysmic bust.

Somewhat unsurprisingly, the phrase is now being re-introduced in conversations but in a pessimistic context. On a force fed media diet of financial gloom, presumably informed investors and retirees around the planet have concluded that the global economy is destined to collapse. They feel that financial markets have failed to recognise that "this time it's different" and so there will be no recovery. Acting on impulse, they have sold their growth assets at low prices and flocked into increasingly low yielding bonds and cash assets.

The last few years of false market rallies leading to ever deeper losses, have taken their toll on confidence. As has the emergence of systemic problems and inept management of global debt, with countries and continents lurching from one disaster to the next with no end in sight.

Confronted with bad news at every turn one can understand how talk of recovery can be easily dismissed. So without need of further proof, "this time it's different" seems to ring true. So too, are the fears of conditions getting worse. But every major financial crisis is accompanied by the uncertainty of solutions and outcomes. Every crisis brings unexpected events, and every major crisis appears worse than the last. In spite of all this, every economic crisis has also come to an end, as this one will.

We remind clients that poor investors have an uncanny habit of shifting from euphoria to despair and then positioning their capital accordingly. We dislike such polarised views because they fail the test of time. More often than not, extreme optimism and absolute pessimism are the trademarks of capital destruction and foregone opportunity. Staying invested sometimes requires courage but is always rewarded.

Having recently marked the 48th anniversary of the assassination of JFK, a man who could have truly altered the course of our history, we were reminded by his words:

> ***The Chinese use two brush strokes to write the word 'crisis'. One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger, but recognise the opportunity.***
>
> *John F Kennedy, 12th April 1959*

WEARY INVESTORS LOSING CONFIDENCE & TRUST

In keeping with today's demand for quick solutions, investors have become weary of years of ongoing volatility. Even though in economic terms the 4 year recession to date is unremarkable. Consider the 1970's stagflation years that saw markets fall over 55% & take 7 years to recover. The October 1987 stock market crash saw prices fall by nearly 50% & remain range bound for some time, finally recovering over 6 years later. These prior periods of economic mayhem were no less pervasive, persistent or fearful, they have simply been forgotten.

Markets today are struggling to deal with the uncertainty created by the gradual transfer of wealth and power from the developed world to the emerging world. This is the single biggest economic change in over 100 years and will define the 21st Century.

Few of us like change, especially if it reduces living standards. So it comes as no surprise that the US, UK and Europe should want to avoid it. However, one by one, each country is being forced by credit markets to accept the reality that debt needs to be repaid and living standards will fall.

The current European "sovereign debt crisis" is a continuation of the 2008 crisis, except the burden has now been transferred from the private sector to the public sector. Until recently, politicians have not had the will to deliver the harsh truth to their constituents. This has led to both markets and the masses losing confidence and trust in their economic leaders. The fear of a Eurozone collapse is causing havoc in markets heightening volatility. Regrettably, we expect more of the same over the next 12 months.

The European deleveraging and austerity measures will inevitability lead to a European recession in 2012. Only its severity and longevity is unknown. Political gridlock in the US will defer their day of reckoning to 2012/13. Under the weight of what is readily apparent, it should be easy to understand why markets are depressed and prices low. But is the painful action now being involuntarily undertaken the first step in addressing global imbalances and planting the seeds of recovery?

Q & A

Most people today believe they are well informed. Let's put that opinion to a test with a few simple questions:

(a) Which G20 country has the biggest trade surplus as a % of GDP?
(b) Which G20 country has the smallest govt debt as a % of GDP?
(c) Which G20 country has the largest budget surplus as a % of GDP?

Think you know the answers? Hopefully you picked: (a) Germany (b) Russia (c) Brazil. If you didn't, maybe you need to reconsider how much you think you know about global economics?

GLOBAL GROWTH & EMERGING COUNTRIES

Clients should be aware that the OECD forecasts 2012 global GDP growth in excess of 1.5% despite the anticipated European recession. Other reputable institutions forecast growth closer to 3%. This indicates continued confidence that the BRIC (Brazil, Russia, India and China) and Asian economies will grow in 2012. Increasingly, these economies are trading with each other rather than the developed nations, thereby making them more resilient to tepid western growth.

In any discussion of emerging countries, we would all do well to remember that planet earth currently has more people enjoying a **rising income** than falling income. This makes fear of a global depression seem simplistic, naive and dangerous to your wealth.

Contrast with the 1930's

In the 1930's the strongest countries, the US and Britain, basically borrowed and speculated too much and went bust. There was no country in waiting able to extend a lifeline. In 2012, the West is again bankrupt, but this time there are billions of other people who now produce most of the world's manufactured goods. These people are younger, have unity of purpose, high aspirations and prodigious savings. In the years to come they will buy the assets of the fallen Western nations with the proceeds of those asset sales used to retire debt. We believe these economic and human conditions more resemble the rise and fall of empires than the ingredients for a global depression.

Reluctantly, Europeans (and eventually Americans) will adapt to their more modest and affordable future standard of living. It is only a matter of time. They will most likely earn less income for their labour, pay more taxes and work more years before retiring. Once they have accepted this, their economies will be restored to balance and life will go on largely as before. It is not the end of Europe or the West, merely a new beginning.

There can be no assurance that the transition we expect will proceed without any shocks. For this reason we remain cautious and mindful of short term downside risk. But make no mistake that we are living through a time of profound change that will see the best businesses in Australia and the world become more profitable, not less profitable. More valuable not less so. This is why we continue to encourage all investors to buy and hold quality assets.

Zanacorp's Diversified Portfolios

Every client under the advice of Zanacorp Elsternwick holds in their managed portfolios companies of the calibre of BHP, CBA, Wesfarmers and Westfield together with overseas titans such as Google, Microsoft, Samsung, Royal Dutch Shell and Johnson & Johnson.

The current prices of each of these companies (and many others) with strong Balance Sheets and growing profits does not correctly value their future earnings capacity. In other words they are relatively cheap and remain so every single day that investors fret over Europe. They are available to each of us today in any quantity and yet there they sit, undervalued. We understand they may yet get cheaper in 2012, but they are unlikely to go broke. This forms the basis of our proposition that investors should remain patient and steadfast. Selling these quality assets out of fear is emotional not logical.

TIMING THE MARKET

As is always the case, all investors must assess their choices from their current position based on what is known at the time. Anyone young or old, presently invested in growth assets should continue to hold as the option to sell merely transfers future wealth to someone else.

Last week was a reminder to all of how quickly cheap markets can rise. Between 28th November and 2nd December shares recorded the following gains:

Australia ↑ 7%	United States ↑ 7%
UK ↑ 8%	Eurostoxx ↑ 11%

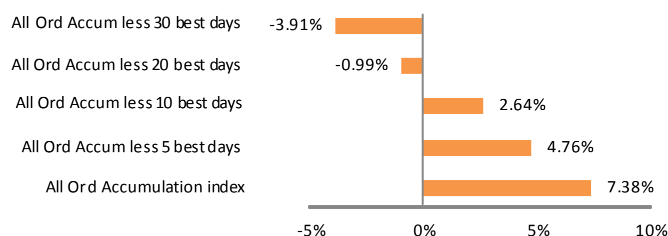
This represented Australia's 3rd best week in over 20 years and the best weekly gain of the last 3 years.

THINK IN YEARS, NOT DAYS

Ever wonder why some investors never seem to make money even over long periods of time? This result usually occurs when people sell assets in weak markets fearing loss of their capital. Then as markets inevitably recover, they re-invest in growth assets, feeling they are then safer to hold. In fact, the opposite is nearly always true.

It is totally impossible to predict market movements on any particular day. However, any decision to simply sell and invest in cash is extremely risky, as missing the best market days will lower returns.

The following chart covers the 10 year period June 2001-2011, so all the memorable events are built in to the figures from the 9/11 terrorist attacks, Iraq invasion, the boom and the bust.



Source: IRESS, Colonial First State. All Ordinaries Accumulation Index used.

Over the period, the annualised GAIN for the S&P/ASX All Ord Accum Index was 7.38% pa. However, if you missed the 5 best performing days, that return drops to 4.76% pa. Missing the 30 best performing days (out of 10 years) would have resulted in an annual LOSS of 3.91% pa. The gap between the best and worst outcomes is 11.29% pa. Can anyone afford to lose that?

Our long investment experience demands we encourage people, wherever possible to buy quality when markets are low. Gradual accumulation via a dollar cost averaging program or salary sacrifice will mitigate timing risk should markets continue lower in the near term.

Retirees should draw their income from defensive assets to enable growth assets the time needed to recover their prior value. In the meantime, we understand watching prices go down is unnerving but we must reiterate our confidence that patience will be rewarded.

Accumulators and high income earners should be buyers over the next 18 months which may prove to be the buying opportunity of this decade.

We continue to expect 1 year in the next 4 will deliver a return in excess of 25% pa. We also expect that very few investors will be able to predict the year in which it will occur. When it happens those people trapped in cash will be unable to regain lost performance and will be haunted by the knowledge of their missed opportunity and the fear of getting back in too early or too late.

As the curtain is drawn on 2011, we extend our best wishes to all clients for a safe and happy Christmas and a better New Year.

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.