

# Matrix Client Market Wrap-up



July 2011

***“When it comes to investing, be fearful when everyone else is very optimistic, be optimistic when everyone else is fearful”***

*Warren Buffett*

## What is happening to financial markets?

The quote above is a solid truth in investing from the world's most successful investor (and one of the world's self-made billionaires). Buffett is clearly pointing to those people who 'follow the herd' in investment markets.

Not since the Great Depression of the 1930's and the Oil Crisis of 1974 has the world economy faced a greater economic and financial crisis as that which occurred during the Global Financial Crisis (GFC) which commenced in 2007/8.

In 1974, oil prices rose to such high levels that many people could not afford to buy petrol. This led to energy rationing and large falls in the world share markets where world governments were forced to support institutions buying company shares in order to support markets.

Another major global crisis was somewhat averted through sound management in 1997 with the Asian debt crisis. At that time Asian economies found themselves in a similar predicament to that which Greece finds itself today. Unfortunately Japan has not been the same powerhouse economy since.

What sets this crisis apart from each previous downturn since 1974 is its far-reaching impact on developed economies. There are continuing repercussions in the way many societies manage their personal and public finances. Governments are now having to support markets by taking on much of their population's debt burden.

## How will these events affect me?

The events of the period from November 2007 to today may have you wondering whether your original

investment strategy is right for you and also whether such a strategy will continue to allow you to meet your objectives.

No doubt you have also been looking at your investment balance over the past year with greater scrutiny.

After taking into account your own deductions and inevitable withdrawals for tax, you also might be wondering whether at this time you are better off 'just giving up' and moving away from investment markets and into 'apparently safe' investments like cash and term deposits. Such a decision may have implications on your ability to achieve your objectives.

This paper is aimed at helping you to understand what is currently happening and how you may consider positioning your portfolio for the future. It is presented as general information and you should always consider and discuss personal financial decisions with your Matrix financial adviser.

## Is it different this time?

The four most dangerous words in investing are "It's different this time". That applies to both rising and falling markets.

Prices of shares are usually adversely affected during financial crises in the first year or two, but they typically recover over time. Uncertainty and fear of the future may lead investors to sell their investments and move to cash as they believe that the solution is safety rather than recovery.

This puts downward pressure on share prices as a result of further selling. Investors then face short-term losses and the loss is compounded by their reluctance to buy back into the market, thereby missing out on the potential recovery, which is never possible to see in advance.

## What has happened in the world?

You would already know that the GFC was initially caused by over borrowing in the US, and then a lack of confidence in the repayment of debt across the world. What you may not have known is the over borrowing was caused by consumers in the developed countries spending more money than they earned over a period, which culminated in the period from 2003-2007. This in turn over stimulated asset markets and specifically affected retirement investment savings accounts.

People spending significantly more money than they earn hasn't been a long-term trend. In the 1970's and 1980's, debt was seen as a bad thing. Credit was hard to get and credit cards, home equity loans and low doc loans did not exist (you may remember the 17% home loan rates of 1989?).

In the 1990's and 2000's, interest rates fell and there was an explosion of credit availability. It became easy to have something now, and pay for it later.

When it comes to financial matters our collective memories are fairly short.

As long as markets exist, they will always eventually revert to their long-term trend. This means looking at the overly optimistic period of 2003-2007 as well as the overly pessimistic period since the GFC as not typical of the long-term trend.

The recent shocks (including earthquakes, tsunamis, cyclones and floods as well as debt crisis in Europe and political turmoil in the Middle East), which have plagued the global economy and impacted the confidence of individuals, companies and markets. This results in erratic and swift price movements in both directions. Some of these erratic movements are not based on financial matters but rather, based on people's sentiment and fear of the future.

Since the GFC, the natural human tendency to go from periods of over-consumption to periods of under-consumption has meant that much of the developed world is now too scared to spend money they earn on non-basic items. In contrast, in emerging markets like Asia, consumers have an historical tendency to save high proportions of their income; however, in recent times overspending on speculative assets has had to be limited by their governments as well.

## How does consumer behaviour affect stock markets?

Naturally, with people spending less money, businesses earn less, and of course the values of their businesses reduce. This applies from the smallest greengrocer to the largest companies such as Microsoft. If these businesses are listed on the stock market, their share prices fall in anticipation of a fall in profits and investors don't want to invest in companies that may have lower income (and perhaps low dividends).

The reality is that most of the largest companies in the world, including those in Australia, have never been more profitable. In Australia, BHP and the 4 big banks are key examples. In the US, key examples are Coca Cola, Google, IBM and Apple (who recently announced a more than 100% increase in profits compared to the same time last year). In Europe, BMW is just one good example.

This higher profitability allows companies to pay down debt, invest for the future and pay out dividends to shareholders.

Share price volatility may have more to do with investor sentiment than with company health and profits, as was the case before the GFC.

Dividends are inevitably linked to company health and profits, as dividends can only be paid out of profits and profits can only be made from sales less expenses.

When all is said and done, company performance and innovation are the only correct ways to assess value and to determine fair value prices of company shares and other listed investment assets.

You may not realise with all the negative media, that balanced and diversified fund returns have been quite solid and those who invested pre-GFC and held their portfolios throughout are generally no longer in the red and have had two good years of performance as discussed below.

## The Australian Landscape

Although Australia is generally acknowledged as having escaped the worst impacts of the GFC, there can be no doubt that business conditions for Australian companies (other than resources and energy) and investment conditions for individuals have become increasingly difficult.

You may be aware that Australia has benefited, and is expected to continue to benefit, from a strong resource and energy sector which sees demand for their product increasing greatly as a result of the growth in China and other emerging economies.

Most companies have, on average, continued to pay dividends to shareholders that remain at or above their pre-GFC levels and are well over 4% of the value of the share. Despite the fall in capital values in recent years, Australia's largest companies have continued to pay higher dividends. For example, our biggest 4 banks have been consistently paying dividends of over 5.5%. This is all before taking into account the tax benefits of owning shares.

Chart 1 below shows the long-term performance of company shares compared to non-productive assets such as cash. This clearly shows that despite price volatility, the dividend earned keeps rising and the share prices eventually return to some resemblance of trend to company earning performance.

## Shares v Term deposits and other cash-based funds

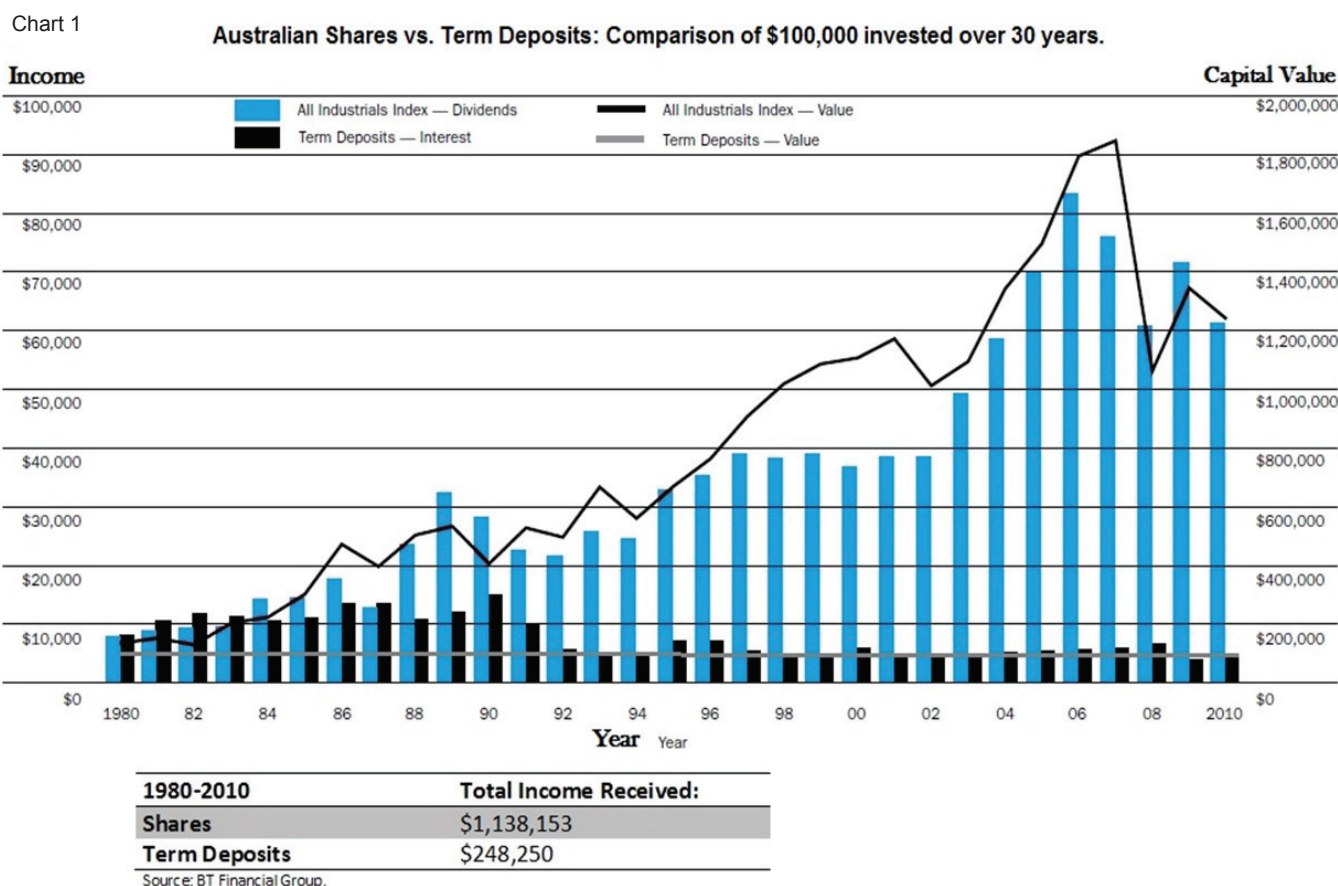
If we compare shares to assets which are perceived

to be 'risk-free', such as term deposits over a long-term horizon, the total income received from shares is higher than that earned from term deposits. This may be important to investors seeking to fund their retirement as the income you earn from shares will generally lead to a more comfortable retirement (which you deserve!).

As can be seen in Chart 1 below, if you invested \$100,000 in shares in 1980, you would have earned \$1,138,153 by 2010 (assuming income is not re invested). However, if you decided to go the 'safe' route and invested your hard-earned money into term deposits, you would have earned \$248,250 during the same period. This is a remarkable difference and it can make a noticeable difference to the quality of your lifestyle in the future. A comprehensive graph of how the Australian Share Market has performed against other major asset classes over the past 30 years (when income is re invested) is provided on page 7 titled 'Vanguard 2011 Index Chart'.

However, for retirees and pensioners, who do not have the benefit of additional contributions and may be aiming to protect their capital at the cost of any potential future recovery upside, some additional term deposit investment may be a viable option.

We suggest you speak to your financial adviser who will be able to discuss with you ways to best meet your financial needs.





## The Balanced or Diversified Fund Experience

If you are still concerned about remaining invested in shares due to the risk of market volatility, despite the fact that shares recover over time after various crisis events, then a balanced portfolio (e.g. a portfolio consisting of 60% shares and 40% 'apparently safer' assets such as bonds) may help mitigate the risks.

Diversification is one of the most effective means of reducing risk. One of the main ways to achieve this is by investing across different asset classes, as this can help smooth out returns over time. This is illustrated in the table on page 8 which shows how the best and worst performing asset classes have varied since 1982.

What is clear is that the best performing asset class one year, has no relationship to whether it is the best performing the following year and vice versa. Finally you might be surprised the Australian share market generated over 12% return including dividends in the past year to June 2011.

Your adviser, in conjunction with Matrix research, will assist you in preparing diversified portfolios that contain more than one type of asset or fund.

## Things to be positive about

There are many things that we should be confident about, despite the noise and media frenzy that we sometimes see and hear on TV and in the newspapers.

For instance:

### Global recovery continues

- World growth has returned to near normal historic levels, whilst we recognise the difference to the average between slower growth in developed economies and faster growth in emerging markets;
- Concerted effort by the US government to stimulate the US economy (predominately through low interest rates) to reduce the effects of the global downturn;
- US companies have broadly returned to pre-GFC profitability;
- Many of the world's major companies are producing extraordinarily good and historically strong earnings results;

- Some governments have shown that they are prepared to act, regarding financial problems, such as in Greece and the UK;
- The increased savings rate sets the groundwork for a sustained future long-term period of worldwide prosperity.

### China and emerging markets

- The GFC has accelerated the transition of relative economic powerbase from Western to Eastern economies;
- The Chinese government has shown that it has the willingness and the capability to act to manage its economy, including significant economic stimulation as well as targeted cut backs in lending and expenditure at different times in the past 5 years;
- Industrialisation & urbanisation, combined with younger and growing populations (when compared to the West) has resulted in a longer term trend of stronger growth in the developing nations;
- China is expected to be the largest economy by 2016 and it is expected that above-average growth should last for decades;
- India and Brazil are also expected to challenge China for speed of economic growth in the coming decades.

### Australia

- Stronger economic position compared to most other developed nations when the GFC hit, and when it did hit, the government at the time acted swiftly to soften impact ("go hard, go early, go help households");
- We are also buffered by the demand for our resources from the developing economies. At present the terms of trade are about 85% above their 20th century average. Note that there are positive spillover effects to other industries including:
  - > Utilities, transport, engineering, accounting, legal, exploration.
- Interest rate adjustment and budget policy power are available to the government if global economic recovery stalls;
- Dividend rates are at higher than average levels as companies have high levels of cash and very low levels of debt.

## Things that need improving

There are some concerns that need to be resolved or reduced in order for the world economy and markets to once again resume a sustainable recovery and growth path. These include:

### Political management and instability:

- Poor government performance e.g. US, Australia, Euro Union inaction and infighting;
- Middle Eastern countries uprising.

### Worldwide debt issues:

- The challenge to materially and sustainably reduce worldwide debt levels in a manner that does not stall global economic recovery.

### European growth needs to be improved:

- Political European Union vs European Economic Union issues. The Euro currency is not allowing individual countries to adjust to meet issues on their own;
- Greece & some other Mediterranean Euro countries have severe sovereign debt issues;
- Bailouts from IMF & EU (“re-profile/restructure” – default government debt). The European central banks and governments are pushing the problem into the future without actually solving the debt issue;
- Social unrest from European government plans to introduce high taxes and fewer government services for the population to reduce expenditure and pay down debt.

### US:

- US debt is being poorly managed because of political infighting between Republicans and Democrats.
- US consumers are struggling, with stubbornly high unemployment and continued poor property values materially off their peak;
- Record government debt levels, artificial support for the US economy and the questionable long-term impact of ‘bandaid’ solutions.

### Australia:

- The high AUD which is undermining the confidence of foreign investors and harming the huge domestic tourism, retail and hospitality industries.

### ... and importantly there are two speed economies throughout the world:

- In Australia, it’s resources/energy vs other industries;
- In the US, it’s the large corporate vs the consumer;
- In China, it’s the rich eastern metropolitan areas vs the poor rural western areas;
- In Europe, it’s Germany/France vs Mediterranean countries (like Greece and Italy).

## What are some conclusions you might come to?

In the short term, the global and Australian investment environment is undoubtedly challenging.

However, if you are investing for a period greater than two or three years, particularly those currently accumulating and saving for their future, you should be comforted by the fact that your investments are earning high levels of income, some economies are finally facing up to resolving the issues of over-spending and that many global companies that have survived the GFC are much stronger and are in a much better position to withstand competitive and other pressure in the future.

These large companies are also in a much stronger position, as some of their competition is gone and they have been able to acquire other competitors at lower prices leading to stronger market share (again, consider the big 4 Australian banks).

For those who are currently drawing a pension from investments, the main focus could well be to assess the levels of income you can earn from quality Australian shares vs cash and term deposits, and to match your portfolio to those income needs.

Another cause for keeping a long-term strategic plan is that ironically, worldwide consumer behaviour is showing the first signs of sustainable cash flow management for some time.

People across the world are deleveraging (paying down debt), and whilst this adjustment process is painful as it reduces the new income to companies, it also sets up a period of long-term sustainable economic health. For example, the Australian savings rate is now close to 10% which is significantly higher than its average over the past 20-30 years.

This gives us reason to believe that the medium to long-term investment prospects favour productive entities like companies over cash investments.

## So What to Do?

Now for some tough questions you might have and what we at Matrix believe based on everything we've discussed above.

### Has there been a disaster in markets?

There have definitely been some painful falls in markets since 2007. However, the industry average balanced fund (as measured by Morningstar) has made 4.82% per annum for the last 10 years, and 7.29% over the past 12 months to 30th June 2011. Even over the 3 year period from May 2008 to May 2011, the average balanced fund has made 0.64% per annum.

Matrix's own model portfolios have performed better than the results above.

Of course it's very important to take into account your own withdrawals as well as government taxes and charges when assessing the success of your investment strategy.

### When should I expect the markets to show signs of improvement?

As you would have noted above, there is a lot to be confident about, especially in Australia, emerging markets, and in many of the largest companies in the world. The trouble is, the lack of decisiveness by many of the world's governments is dragging out the time that markets are volatile.

A familiar saying goes: 'A week is a long time in politics' and that is how quickly markets can turn for the better. As investors, we are better off sticking to our strategy amongst all that noise.

Without a crystal ball it's impossible to know when things will turn for the better and stay that way, but we

don't need a crystal ball to know the wisdom of regular investing.

### Why shouldn't I just put all my money in TD's and cash for the next 12 months and get 6.0% income with no volatility?

If the past 10 years or so has taught us anything about investment markets, it's that the speed at which events happen is increasing and the markets can go up and down faster than an investor can react. By the time the best part of a recovery in markets happens, it is far too late for most people to realise it and even later for them to do something about it.

The vast majority of people we come across who try to judge the best time to get in and out of the markets, lose money by selling assets at or near the bottom and then buying at or near the top. Often this occurs when they don't need the cash that the sale would give them.

We believe that the best way to achieve long-term comfort and prosperity is to continually invest, up to the level that your monthly or weekly personal cash flow will comfortably allow while maintaining a reasonable lifestyle.

If you are in pension mode, we believe that as long as you have set aside at least 2-3 years' worth of cash to support your day-to-day living expenses, then the best outcome is to maintain quality income producing assets like large quality Australian shares for as long as possible.

### A final word about your Matrix adviser

Your Matrix adviser is not just there to help you put together long-term sustainable diversified investment portfolios, but to help you stick with your strategic plan and your other financial matters, including managing your personal insurances, assisting you to maximise superannuation and tax efficiency, helping you manage your cash flow and budget as well as helping you make sure that your estate is properly managed for the benefit of your loved ones.

It's important that you look at your entire financial well being when making any decisions and remember that past performance is no indication of future performance.

All of us at Matrix look forward to continuing to help you achieve your financial and personal goals.





## Financial year total returns (%) for the major asset classes

|              |                   |                      |   |                  |                  |  | Best            | Worst                      |   |
|--------------|-------------------|----------------------|---|------------------|------------------|--|-----------------|----------------------------|---|
| Year         | Australian Shares | International Shares | International Shares (Hedged) <sup>14</sup> | US Shares        | Australian Bonds | International Bonds (Hedged) <sup>12</sup> | Cash            | Australian Listed Property | International Listed Property <sup>13</sup> |
| 1982         | -29.0             | -4.0                 | -10.4                                       | -0.6             | -5.1             |  | 18.1            | 3.6                        |   |
| 1983         | 34.7              | 72.7                 | 49.6  | 88.4             | 25.6             |  | 15.5            | 23.7                       |   |
| 1984         | 13.5              | 2.3                  | 2.0   | -3.2             | 21.4             |  | 12.6            | 35.3                       |   |
| 1985         | 36.5              | 61.6                 | 29.9  | 69.5             | 17.0             |  | 14.0            | 11.8                       |   |
| 1986         | 42.5              | 55.2                 | 34.5  | 33.5             | 20.5             | 29.2                                       | 18.3            | 23.8                       |   |
| 1987         | 54.0              | 32.6                 | 33.2  | 17.7             | 12.1             | 17.6                                       | 17.3            | 41.3                       |   |
| 1988         | -8.6              | -10.0                | -5.3  | -15.5            | 19.4             | 12.5                                       | 12.5            | -2.8                       |   |
| 1989         | 3.5               | 18.1                 | 18.3  | 26.7             | 3.0              | 16.3                                       | 15.7            | -1.1                       |   |
| 1990         | 4.1               | 1.9                  | 5.3   | 11.5             | 17.8             | 13.1                                       | 18.5            | 15.2                       |   |
| 1991         | 5.9               | -2.0                 | -5.8  | 10.3             | 22.4             | 15.3                                       | 13.5            | 7.7                        | -15.9                                       |
| 1992         | 13.3              | 7.1                  | -3.0  | 16.3             | 22.0             | 15.8                                       | 9.0             | 14.7                       | 6.9   |
| 1993         | 9.9               | 31.8                 | 17.3  | 26.6             | 13.9             | 14.7                                       | 5.9             | 17.1                       | 28.3  |
| 1994         | 18.5              | 0.0                  | 6.7   | -6.5             | -1.1             | 2.1  | 4.9             | 9.8                        | 8.4   |
| 1995         | 5.7               | 14.2                 | 3.7   | 30.0             | 11.9             | 13.1                                       | 7.1             | 7.9                        | 7.5   |
| 1996         | 15.8              | 6.7                  | 27.7  | 12.9             | 9.5              | 11.2                                       | 7.8             | 3.6                        | 2.4   |
| 1997         | 26.6              | 28.6                 | 26.0  | 42.6             | 16.8             | 12.1                                       | 6.8             | 28.5                       | 35.7  |
| 1998         | 1.6               | 42.2                 | 22.1  | 58.2             | 10.9             | 11.0                                       | 5.1             | 10.0                       | 25.0  |
| 1999         | 15.3              | 8.2                  | 15.9  | 14.2             | 3.3              | 5.5  | 5.0             | 4.3                        | -6.8  |
| 2000         | 13.7              | 23.8                 | 12.6  | 18.2             | 6.2              | 5.0  | 5.6             | 12.1                       | 14.1  |
| 2001         | 8.8               | -6.0                 | -16.0                                       | 0.5              | 7.4              | 9.0  | 6.1             | 14.1                       | 38.2  |
| 2002         | -4.5              | -23.5                | -19.3                                       | -26.3            | 6.2              | 8.0  | 4.7             | 15.5                       | 7.5   |
| 2003         | -1.1              | -18.5                | -6.2  | -15.2            | 9.8              | 12.2                                       | 5.0             | 12.1                       | -5.2  |
| 2004         | 22.4              | 19.4                 | 20.2  | 15.4             | 2.3              | 3.5  | 5.3             | 17.2                       | 28.7  |
| 2005         | 24.7              | 0.1                  | 9.8   | -4.1             | 7.8              | 12.3                                       | 5.6             | 18.1                       | 21.2  |
| 2006         | 24.2              | 19.9                 | 15.0  | 11.6             | 3.4              | 1.2  | 5.8             | 18.0                       | 24.2  |
| 2007         | 30.3              | 7.8                  | 21.4  | 5.6              | 4.0              | 5.2  | 6.4             | 25.9                       | 3.0   |
| 2008         | -12.1             | -21.3                | -15.7                                       | -23.4            | 4.4              | 8.7  | 7.4             | -36.3                      | -28.6                                       |
| 2009         | -22.1             | -16.3                | -26.6                                       | -12.5            | 10.8             | 11.5                                       | 5.5             | -42.3                      | -31.2                                       |
| 2010         | 13.8              | 5.2                  | 11.5  | 8.9              | 7.9              | 9.3  | 3.9             | 20.4                       | 31.3  |
| 2011         | 12.2              | 2.7                  | 22.3  | 3.7              | 5.5              | 5.7  | 5.0             | 5.8                        | 9.2   |
| <b>Best</b>  | <b>54.0 (4)</b>   | <b>72.7 (3)</b>      | <b>49.6 (3)</b>                             | <b>88.4 (6)</b>  | <b>25.6 (3)</b>  | <b>29.2 (3)</b>                            | <b>18.5 (2)</b> | <b>41.3 (2)</b>            | <b>38.2 (4)</b>                             |
| <b>Worst</b> | <b>-29.0 (2)</b>  | <b>-23.5 (3)</b>     | <b>-26.6 (3)</b>                            | <b>-26.3 (5)</b> | <b>-5.1 (2)</b>  | <b>1.2 (2)</b>                             | <b>3.9 (5)</b>  | <b>-42.3 (4)</b>           | <b>-31.2 (4)</b>                            |

(X) denotes the number of times each asset class was the best/worst performer during a financial year ending between 1982 and 2011.

Note: For the sources used in the table above, please refer to source notes on previous pages. Assumes 100% reinvestment of distributions. Returns shown are before fees and taxes.

Source: Vanguard

## Disclaimer

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