

economic & investment horizons

2009 Australia finally joins the party

The impact of world wide recession appears to have finally hit Australia.

Large scale cutbacks and job losses are now daily news. Job advertisements have fallen as dramatically as our official interest rates. While not yet “official”, we are now in recession. So, how deep and how long?

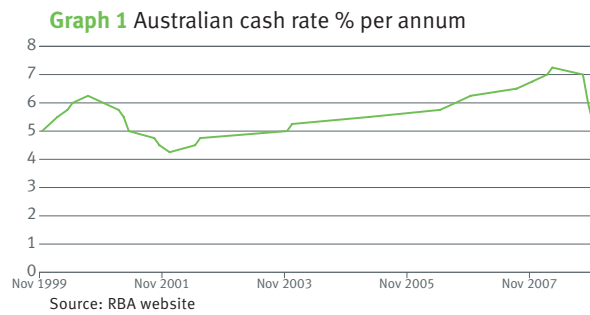
Economists around the world are reflecting on a study by Reinhart and Rogoff* of the impact of 14 severe financial crises in recent history (eg Spain 1970’s, Norway 1987, Finland, Japan and Sweden in the early 1990’s). Their findings below are sobering.

	Cumulative change %	Duration Years
GDP per person	-9.3	1.9
Unemployment	+70.0	4.8
Equity (share) prices	-56.0	3.4
House prices	-36.0	5.0

It can be seen that the economy remained flat for nearly two years. For us that would mean that the economic downturn would not end until December 2010. Until then, businesses will further tighten expenditure, defer investment and repay debt.

Interestingly, long after the economy recovers, unemployment hits its peak. In fact, it has taken nearly five years before employment reversed its trend. However, those with jobs will not see a substantial reduction in lifestyle as interest rates and prices will remain low.

The fall in equity prices has probably already occurred and prices should remain flat until investors realise that the worst is behind them. We anticipate that this shift in attitude could occur prior to the traditional 3.4 years as yields on other forms of investment remain low.



Interestingly, the data also suggests that both domestic and commercial property may have further to fall and it’s trough may be fairly protracted.

Against this potentially dismal backdrop, there remains a challenge to deliver meaningful investment returns. It will be through a long term focus and an associated strategy for asset and sector allocations and careful individual investment selection that will ultimately achieve that goal.

Specifically, the following approach:

- Set a long term asset allocation target for equities (Australia and internationally).
- The target is where the portfolio should ideally be in December 2010.
- Identify the desired selection of listed companies which are financially robust, well managed and whose activities are transparent and well understood.
- Avoid those specific investments where the full effect of the financial crisis is yet to be understood (this currently includes banks).
- Employ a staggered investment program whereby each quarter we incrementally invest in these listed companies, moving a little closer to our asset allocation target.
- In the short run, we expect price volatility to continue. This will obviously affect the short term value of these investments, however we are long term investors.

How low can interest rates go?

The last three months of 2008 saw a rapid decline in Australia’s cash rate to 4.25%. Looking forward to 2009, the burning question remains, how low can interest rates go (Graph 1)?

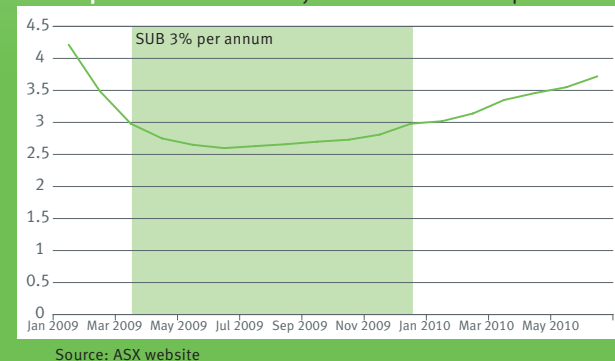
The Reserve Bank of Australia (RBA) has taken pre-emptive action by substantially decreasing the cash rate recently even though usual indicators, such as inflation, remain high. These actions were implemented in order to ensure Australia did not plunge into a deep recession.

However, the fallout from the credit crisis will ensure that rates continue to fall as governments and central banks around the world aim to rebuild business and consumer confidence. While the Australian government has provided an economic stimulus package to help such confidence, this remains a short term measure and we believe the RBA will still need to decrease rates throughout 2009.

Central banks around the world have continued to decrease official cash rates. Rates are already 0% and 0.25% in Japan and the USA and they are no longer able to use interest rates to stimulate their ailing economies (Graph 2). Graph 3 shows that current trading on interest rate futures has already factored in a mid-year rate of under 3.0%. We believe that this could well go lower.

For portfolio investment exposed to interest bearing securities, a significant reduction in yield (especially where invested in cash and short term securities) will severely impact returns and purchasing power. A carefully planned approach is required to manage risk exposure, margins, resulting yield, maturities and fixed and floating combination. Fordham Investment Management undertakes such an approach for its clients.

Graph 3 Australian 30 day cash rate futures % per annum



* “The Aftermath of Financial Crises” by Carmen Reinhart and Kenneth Rogoff

Interest rates for borrowers...

How quickly the world can change!

Six months ago, Australians confidently predicted that the Aussie dollar would hit parity with the US dollar. It never quite made it.

Interestingly, while expectations are focussed upwards, the price of protection from a fall can be cheap. Importers could have protected their prices at 90 cents for next to nothing. Those who didn't now pay the penalty. As with interest rates.

Borrowers are enjoying the new trend. The question arising is now, **should we lock in?**

The market expectation is for short term rates to bottom around mid-year. That may or may not be the bottom. To a large extent, long term rates have already factored in this fall. So it may not make a huge difference anyway.

Whether corporates or households, we would recommend a combination of fixed and floating facilities. Perhaps half of core debt locked in over five years, half floating to enjoy any further falls in rates. For the floating half, you can purchase a "cap" (or a "collar and cap") from your bank in order to limit your downside (or downside and upside). While everyone's focus is on falling rates, such products are relatively cheaper.

Such protection strategies can provide relatively cheap peace of mind and a known outcome.

Toll Holdings Limited

Toll Holdings Limited is a highly focussed logistics and distribution business operating in three business units: Australia and New Zealand Integrated Transport and Logistics, Asia Contract Logistics and Global Forwarding. They operate on road, rail and sea, and include services such as refrigerated freight services, bulk liquid transportation and warehousing. They service high quality customers like Coca-Cola Amatil, Unilever, Woolworths and Wesfarmers, along with the Australian Defence Force and Rio Tinto.

During FY2008, Toll Holdings divested Asciano and Virgin Blue, resulting in a streamlined business focussed on their core strengths of logistics and distribution. Share

price performance over the past year has been on par with the market return, which was -37.93% over the 2008 calendar year. Fordham have been interested in Toll Holdings for some time, but their non-core assets and high valuation were a deterrent to inclusion in the portfolio. These factors have now been corrected and Toll Holdings became a Fordham Investment Management recommended stock in December 2008.

The future appears promising for Toll Holdings thanks to their technological capabilities, global reach and strong customer relationships. Their financial structure is robust and well placed in the current economic environment.

Private portfolio management...

More than a quarter of a century ago, we made the observation that investing in financial markets, even during the calmest of waters, can be an emotive experience for many investors, particularly when markets are driven by greed and panic!

We continue to provide an investment framework that can allay this inefficient "natural" irrationality. With a steadfast focus on meeting the objective of long term economic returns for clients, where risk mitigation is paramount, we have dedicated ourselves to a set of investment principles. It is the disciplined application of these principles through the volatility of market conditions that has allowed us to remain focussed on what is most important for our clients.

The three core elements in achieving our mission objective for clients are:

1 Asset allocation as it relates to the split of funds between the varying asset classes including equities, property and interest bearing securities. This is the single largest determinant of long term economic returns and is formally reviewed at Fordham every three months.

This must be considered in conjunction with risks inherent in active businesses already owned by most of our clients.

2 Investment selection as it relates to the selection of investments within each asset class. This selection process is made through our two tier selection methodology using in-house expertise and resources.

3 Portfolio implementation including our staggered investment program for new funds for underweight (or overweight) positions, price limits for all purchases, minimal trading to reduce brokerage charges and ongoing quarterly reviews of portfolios to ensure adherence to asset allocation.

Overlaying these three elements is a unique ongoing communication program which provides our clients with monthly reports, written quarterly reviews, six monthly meetings with their investment manager and daily access to our dedicated client service team.

The financial landscape has changed significantly over the last 12 months and we recognise that some clients may feel the pull of emotion regarding their investments.

Ultimately, a long term investment strategy based on **disciplined application of tried and tested investment principles and proven theoretical knowledge remains the best means of long term wealth creation.**

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