

September 2008

SPECIAL MARKET UPDATE

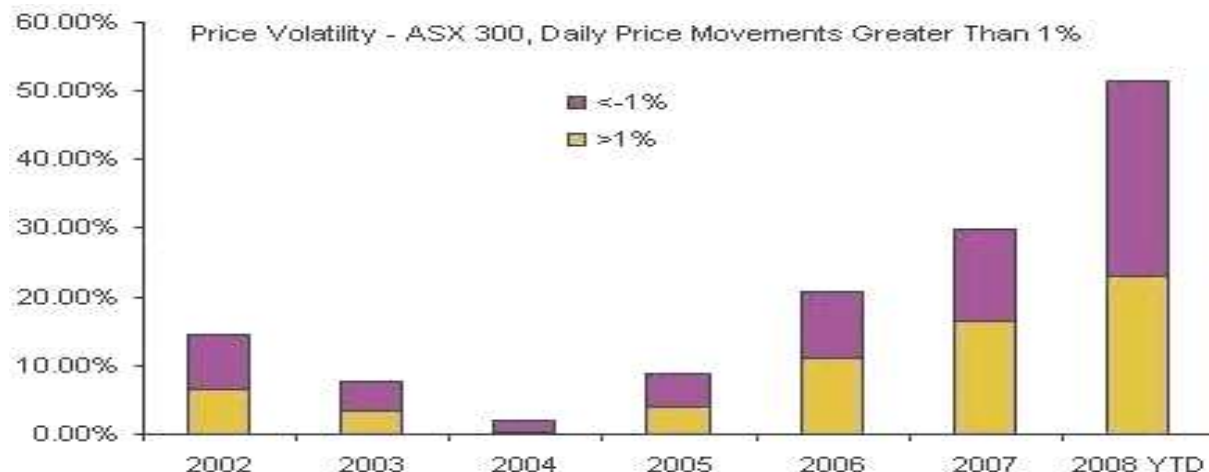
Seeing through the gloom

Gloom is shrouding our financial markets and for many investors it has become extremely difficult to focus on the long term. In recent times it has been commonplace to see extreme volatility in financial markets and the words "sub-prime" and "credit crunch" are now firmly etched in our memory. Whilst there have been many accounts of sub-prime and the resultant credit crunch, we at Strategem thought it would be worthwhile to recap in summary its cause and effect. Please see the article on the back page of this Newsletter.

We believe that, to a true investor, it is the long term that counts. History tells us that markets will recover and the rewards will come again to those who are patient.

Benjamin Graham, one of the most influential economists of the last 100 years said of the market. "In the short run, the market is a voting machine but in the long run it is a weighing machine."

In recent times, share market volatility has been extreme. The news seems to go from bad to worse and then just when you think its getting better somehow it gets even worse. The extreme volatility is illustrated by the Price Volatility chart (below). The chart shows the percentage of days in which the Australian sharemarket moved by 1% or more. So far this year it has happened on over 50% of trading days!



Source: IRESS, Perennial

This volatility has left many people wondering what has happened in financial markets and what is the best way to approach their investments going forward.

From the high in November 2007 the All Ordinaries Index has declined by approximately 33% to today's prices.

All Ordinaries Index September 2007 to September 2008



Source: E*Trade Australia

Whilst the short term chart of the All Ordinaries Index graphically illustrates the decline it is important to keep in mind the long term benefits of the sharemarket.

What should an investor do in these times? At Strategem we believe in difficult times it is important to remember the basics, so here are five fundamentals to keep you on the right path.

1. Don't panic

Many people may be tempted to move their money out of the share market during times of volatility or weakness. But it's important to remember that markets move in cycles. Peaks and troughs are an intrinsic part of investing. While the cycle is unpredictable, history has shown us that recoveries always follow downturns, and vice versa. If you move out of the market, then you won't be there for the recovery, which can sometimes arrive unexpectedly and take off quickly. The 1990s provided a period of stability and sustainable growth for investors, yet by the end of the decade, a series of events that were largely unpredictable had taken their toll on investment markets. The 'tech-crash', September 11, corporate corruption, the global economic slowdown, and the war in Iraq all contributed to volatile conditions in the markets. From 2003 the global economy started its recovery and conditions stabilised, giving markets the opportunity to respond favourably. At the beginning of 2007 the ASX was 83.1% higher than it was at its highest point in the 1990s (source: Reserve Bank of Australia).

By the middle of 2007 however, concerns over sub prime lending in the US had sent shock waves through stock markets across the world. The Australian share market lost nearly 15 per cent between the high reached in July and the low reached in mid-August, but by the end of August it had bounced back to pre July levels. Many commentators are now calling that period of volatility a "market correction". **Throughout any market cycle, those people who hold their nerve, who remain focused on their long term goals and resist making snap decisions, are likely to be the winners.**

2. Markets move in cycles

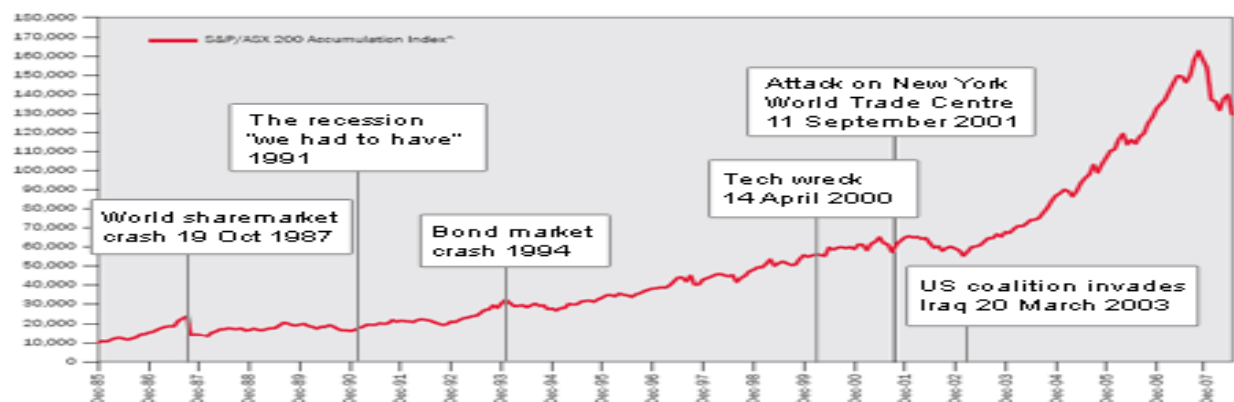
Investment markets move in cycles, and it is impossible to predict when a market will rise or fall. However, by looking at the past we can observe how markets usually perform, and that can help us in the future to put market movements in perspective.

For many investors, the Australian sharemarket delivered 20% plus returns over the four years to June 2007. History shows us that markets are volatile, so it is unrealistic to expect that this outstanding performance could have been sustained.

Before you make any changes to your investment strategy, remember markets have rebounded after major falls in the past:

- 1987 Stockmarket crash
- 1991 The recession we had to have
- 2000 Tech Wreck in the US
- 2001 Terrorist attack on the World Trade Centre
- 2003 US invasion of Iraq.

Perhaps the most publicised of the above crashes and for many the worst, is the 1987 stockmarket crash, often termed "Black Tuesday". On this day the All Ordinaries index opened at 2052 points and closed at 1549 points losing approximately 25% of its value in one sitting. As disastrous as this was at the time it did recover some years later on 14th October 1993 reaching 2062 points. The market has weathered many storms. Vanguard Investments report that since 1978 there have been seven falls greater than 10%. With the average fall being 21.2% taking an average of 8.6 months to fall and 15.3 months to recover.



Source: Asgard

The graph above shows how the sharemarket has gone on to deliver positive returns over the long-term.

Withdrawing after a market downturn may cause you to realise a loss from your original investment. Let’s say you invested money just before the Tech Wreck in 2001 and then sold out just afterwards because the market fell. You would have got back less than you originally invested and missed out on the market gains that followed.

Markets have always been characterised by rises and falls. It’s a natural part of the process. Despite the “rollercoaster” ride it sometimes seems to be taking, the historical, longer term trend for markets the world over has been a steady climb.

3. Time in the market, not timing

Strong market gains often occur after periods of weak performance. Large falls tend to follow strong returns. If only you could buy when share prices have reached their lowest point and then sell when they peaked. But even the most highly trained professionals with all the data available to them can’t consistently pick market turning points.

The risk you take trying to time the market will often outweigh the extra return you might generate. Instead you might find that by simply staying in the market you could generate a superior long-term return. Look at the difference in your return if you’d held on to your investments for the whole period compared to selling your investments and missing the best 10, 20 or 30 days.

Average annualised returns over 15 years—effect of missing best days

Market	Index	Stayed fully invested	Best 10 days missed	Best 20 days missed	Best 30 days missed
Australian	S&P/ASX 200 Accumulation Index*	7.6%	4.8%	3.0%	1.5%
USA	S&P 500 Index	7.2%	3.9%	1.3%	-1.0%

Source: Datastream & St.George Investment Solutions at 30 June 2008. *S&P/ASX200 Accumulation Index was introduced March 2000, prior to this the ASX All Ordinaries Accumulation was used.

The table on page 7 shows returns for the major asset classes over the last 20 years. The current value of \$1 invested at the start of the period is generally higher for growth assets (shares & property) than for defensive assets (cash & fixed interest), despite the difference in average yearly returns being relatively small. This illustrates how long-term investors benefit from the compounding of returns over time. The returns shown are pre-tax and therefore do not allow for the significant benefits of imputation credits (for Australian shares).

4. Diversify, diversify, diversify

One of the most reliable ways to maximise your long-term returns and reduce the risk of losing money is by diversifying your investments by spreading your money across different asset classes, regions, sectors and investment managers. By doing this you increase your chance of having some exposure to the best-performing investments. Here’s a simple example of diversification:

Imagine you live on an island whose entire economy consists of two companies: one that sells umbrellas and another that sells sunscreen. You invest only in the company that sells umbrellas. You get good returns on your investment during the rainy season, but poor returns in the dry season. Maybe you should invest in the sunscreen company instead? But by doing that your returns would be good when the sun is out, but not so good when the clouds roll in.

To minimise the weather-dependant risk, you should split your investment between the companies. With this diversified portfolio, generally your returns are decent no matter the weather, because the good returns on one investment will help compensate for the bad returns from the other.

5. Smooth a bumpy ride – keep it regular!

By investing a set amount regularly, you're effectively buying fewer shares when the prices are high and more shares when prices are low. This means you average down the price per unit of your investment, which in turn means you need less growth before you make a profit.

Regular investing removes the emotion from the investment decision and ensures you don't get caught up in the market hype and 'noise'. It also helps you avoid buying when the market is peaking or selling just before a boom. Right now, your regular investment would be taking advantage of the low prices of previously overvalued stocks. In other words, just like the year end sales, you can buy more with less money!



Source: Asgard

Recovery – can we see it from here?

The sharemarket rally in April and May came as authorities around the world stabilised and supported their financial systems, and as the US reduced its official interest rates. Further bank losses in the United States and Europe undermined the rally as did the escalating price of oil.

Despite the gloom in markets we do well to remember that parts of the Australian economy are still booming. The resources sector has seen the prices of coal and iron ore rise significantly. Share prices for the resources sector were higher in July 2008 than they were in July 2007 despite some weakness since June 2008.

Rains over parts of Australia should assist rural incomes and rural exports. The boost to share prices from takeover activity is not dead. In recent months, takeover bids have been made for a number of Australian companies. The bidders believe that at current prices, including a takeover premium, there is value in their takeover target.

The recent easing of rates by the Reserve Bank of Australia, and the prospect of more, will help boost the outlook for the interest rate sensitive sectors of the economy and the share market in general.

Of particular interest are the profits of banks. This group of companies makes up around 20% of the sharemarket and their businesses have come under short-term stress due to rising interest rates. Banks have had to pay significantly more for the funds they borrow in global capital markets and this will affect the demand for loans by their customers for at least the remainder of 2008. By 2009 however, banks are likely to have picked up a larger share of lending as competitors struggle to raise funds at competitive rates.

The road to recovery in sharemarkets requires US house prices to stop falling. Falling house prices and low demand for US housing lie behind the losses that US banks have been reporting for the last nine months. A further cut in US interest rates may help, but official US interest rates have already been cut substantially.

Recovery will come when the market for corporate borrowing, known as the credit market, becomes fully operational again. At present, the desire to lend to companies is low. Trust needs to be re-established so lenders will offer interest rates that reflect the true risk of each transaction.

Issues still to be faced relate to the pace of economic growth in the US and Australia and continued financial stress encountered by large organizations and the impact that this has on other organizations and investors but we believe Australia remains well placed to grow over the next five to ten years.

History may not always repeat but it will rhyme.

Fear, greed and patience are some of the dominant emotions associated with the sharemarket. After a brief respite in April and May this year, fear appears to have regained the upper hand. Over time, history has shown it is the patient investor who benefits from any upside that follows. Despite the recent falls in the Australian sharemarket, share prices are still up 8% since the beginning of 2006 and up 70% since the beginning of 2003.

Whilst history suggests that prices may take some time to reach previous levels, it is worth noting that once shares bottom, the rebound in the first 12 months is usually very strong with an average gain of 32% in Australian shares. Given the rebound normally occurs against a backdrop of extreme uncertainty (with shares climbing the classic "wall of worry") the obvious risk for investors switching to cash in the hope of getting back in when the outlook is clearer is that they simply miss out on the best part of the rebound.

In the current environment before you make any major decisions, think through the issues and speak to a Strategem adviser about your individual circumstances.

MARKET UPDATE

At the time of bringing this Newsletter to you, stockmarkets in the US (and Australia) have rallied strongly, relieved by government plans to restore calm to the financial system by rescuing banks from billions of dollars in bad debt. Also, in an attempt to bring some order to volatile markets, Australian regulators have banned short selling for a period of 30 days. Short selling is where traders seek to profit by selling the shares of companies which they do not own, with a view to buying them back, at a lower price. This process has been blamed for recent sharp falls in stocks such as Macquarie Group and ABC Learning. These new measures could significantly improve market sentiment moving forward.

Performance history of asset classes and respective returns since 1 July 1986

Year	Cash	Fixed Interest		Shares		Property	CPI
To 30 June		Aust	Int'l	Aust	Int'l		
1987	17.2%	12.9%	5.3%	54.0%	33.5%	41.3%	9.3%
1988	12.5%	16.9%	6.9%	-8.6%	-9.2%	-2.8%	7.1%
1989	15.7%	5.9%	9.0%	3.5%	18.6%	-1.1%	7.6%
1990	18.4%	16.2%	4.6%	4.1%	2.4%	15.2%	7.7%
1991	13.5%	22.3%	10.6%	5.9%	-1.1%	7.7%	3.4%
1992	9.1%	22.1%	13.3%	13.3%	7.5%	14.7%	1.2%
1993	5.9%	13.9%	14.3%	9.9%	33.1%	17.1%	1.9%
1994	4.9%	-1.1%	1.5%	18.5%	0.0%	9.8%	1.7%
1995	7.1%	11.9%	10.7%	5.7%	14.6%	7.9%	4.5%
1996	7.7%	9.4%	8.3%	15.8%	7.2%	3.6%	3.1%
1997	6.8%	16.8%	9.9%	26.6%	29.0%	28.5%	0.3%
1998	5.1%	10.9%	10.6%	1.6%	42.1%	10.0%	0.7%
1999	5.0%	3.3%	4.3%	15.3%	8.6%	4.3%	1.1%
2000	5.6%	6.2%	3.1%	13.7%	24.1%	11.9%	3.2%
2001	6.1%	7.4%	7.0%	8.8%	-5.5%	13.9%	6.0%
2002	4.6%	6.2%	5.7%	-4.5%	-23.0%	14.9%	2.8%
2003	5.0%	9.8%	9.2%	-1.1%	-17.9%	12.1%	2.7%
2004	5.3%	2.3%	-0.3%	22.4%	19.9%	17.2%	2.5%
2005	5.6%	7.8%	8.3%	24.7%	1.1%	18.1%	2.5%
2006	5.8%	3.4%	-2.2%	24.2%	20.6%	18.0%	4.0%
2007	6.4%	4.0%	2.1%	30.3%	8.8%	25.9%	0.4%
2008	7.3%	5.5%	3.2%	-13.4%	-20.6%	-36.3%	4.2%
Value of \$1 invested 20 years ago	\$4.77	\$6.59	\$3.81	\$6.99	\$3.57	\$6.24	\$1.95
Increased purchasing power over 20 years	144.1%	237.2%	94.9%	257.6%	82.7%	219.4%	0.0%
Annualised return over 20 years (%pa)	8.1%	9.9%	6.9%	10.2%	6.6%	9.6%	3.4%
Real annualised return (%pa)	4.7%	6.5%	3.5%	6.8%	3.2%	6.2%	0.0%
Sector performance rank over 20 years	4	2	5	1	6	3	

Source: Asgard- Please note: 1. Returns are shown as a percentage per annum compound. 2. Investments can go up and down. Past performance is not necessarily indicative, nor a guarantee, of future performance.

Credit Crunch – Cause and Effect

“There is more to come (from the credit crunch). The initial effects are felt by people who did the silliest of things, but the ripple effect is felt by people who might have done quite sound things.”

Warren Buffet May 2008

The words “sub-prime” and “credit crunch” are now part of the daily consciousness of investors. In a nutshell, the ‘credit crunch’ is the name given to the ‘snowball effect’ financial institutions have had and are continuing to experience due to a lack of available money across the market. As money becomes tighter, banks are no longer able to lend or borrow from one another, and financial institutions compensate for this shortfall through their customers by increasing fees and rates on their mortgages, loans, and credit cards.

The beginnings of the credit crunch can be traced back a year ago to the US, when people with a poor credit history were allowed to take out mortgages, called sub prime mortgages, which they were later unable to repay. With falling house prices and rising interest rates, these people missed repayments, which led to a vast increase in repossession levels.

Many of the US mortgages, which people with poor credit history were eventually unable to repay, were sold on to other US banks and then on to other banks and investment banks across the world. Because these so called ‘sub prime’ mortgages have been sold and resold many times over, banks simply do not know how much bad mortgage business they have bought, let alone what the impact has been on other banks. As a result, banks don’t want to lend money to each other anymore and the continuous movement of money, what bankers like to call ‘liquidity’, has dried up creating what is now known as the credit crunch.

In commenting on the credit crunch the head of the US Federal Reserve noted “For every \$1 of losses made by banks, they will cut lending by \$10”, and when you consider losses from sub prime stand at approximately \$500 billion, it’s quite obvious that a liquidity shortage was imminent.

The ripple effect of the credit crunch has crippled many corporate institutions and spread fear and nervousness amongst investors across the world.

Australian companies such as Allco Finance, ABC Learning and Centro Property Group became victims of the liquidity shortage as their highly leveraged books attracted the brunt of both banks and investors, in the form of higher interest rates and shattered confidence respectively. Compounding this oil and food prices worldwide began to surge and the average consumer was spending more money on the necessities.

How long will the credit crunch last? This is hard to gauge however many market commentators are suggesting that the worst is now over and we have moved from the acute stage to the tail of the storm. The issue of regaining confidence is the largest unknown. Moreover the end is highly dependant on what is happening in the US, in particular the stability of housing prices. So far the effect of the credit crunch has spanned a full year and we expect it may have some time to go perhaps another 6-12 months or longer.

Disclaimer

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