



SMITH COFFEY

VANTAGE Points

Quarterly Financial
Commentary
Summer 2011

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BEAR MARKET

Bear markets are episodes of pronounced and pervasive declines in financial markets prices. Bear markets are widely deemed to exist when broad financial market indices decline by 20% or more.

The declines in global stockmarkets from November 2007 to March 2009 of over 50% were severe bear markets.

Most recently, the decline in the Australian market between April and September of just over 20% was severe enough to be considered a bear market.

In between these two bear markets, Australian markets recovered approximately half their price falls. As a result of all this, at the current time prices remain on average approximately 40% below their November 2007 highs.

Other stockmarkets also remain below their 2007 highs although many people are surprised to learn that the larger US and UK markets have recovered much more of their losses despite their economies faring much worse than Australia's on measures of economic growth and employment.

Price falls can be attributed to falls in company profits, or to a lower price being ascribed to those profits, or to a combination of these. Whilst it is not possible to know which motive is driving market participants, it is possible to quantify the price being paid across the market relative to its profits - either forecast profits or historic profits (for example the last year's profits, or an

average of the last 7 years profits. One year market wide company profits fell substantially and in 2010 were approximately 40% lower than peak 2008 levels (currently still 30% lower). So looking at stock prices compared to the preceding year's profits, much although not all of the declines could be attributed to the decline in company profits, and the balance could be considered due to a reduced price being attached to each dollar of profits. Using forecast future profits (which

are expected to be higher) would suggest that more of the decline is due solely to lower prices being paid.

However, we find that historically, using the last year's profit multiple as a guide to future returns is not particularly useful as profits in the short term are so volatile (partly caused by accounting

conventions), and using forecast profits is prone to large errors in analysts forecasts. Using an average of the past 5-10 years profits (whether adjusted for inflation or not) is intuitively more sensible as it smoothes out business cycles and book-entry fluctuations and has the benefit of historically being quite a good guide to long term returns in the subsequent 10-15 years.

Despite the cyclical downturn in company profits, average profits over the past 7 years in Australia remain relatively robust. Using this or similar measures shows that most of the price declines are due to lower prices being paid per dollar of profit.



MARKET COMMENTARY

The period since our last Vantage Points saw notable declines in stock market prices until early October, a strong recovery through October and another dip in late November. The Australian Dollar tended to follow the same path so that these movements in offshore stockmarkets were more muted in Australian dollar terms. Over the period, aggregate Australian sharemarket prices are almost unchanged, and whilst the main overseas stockmarkets showed notable price movements in local currencies, they too have moved relatively little in Australian dollar terms over the period.

Market uncertainty, as measured through financial instrument pricing, remains reasonably high but appears to have eased from the very high levels of August and September.

All of the above is consistent with the notion that the dramatic socioeconomic events in Europe have been key drivers of stock prices globally in recent times. Monetary and fiscal policy and the stability of the banking and government sectors has been highly uncertain in Europe over this period. During the period there has also been continued uncertainty over similar matters in the USA and increasingly in China.

In Australia, variable interest rates declined over the period in contrast to earlier expectations of further rises, but remain high by developed world standards due to the relative strength in the Australian economy. Australian housing market prices have been consistently declining and this is likely one of the reasons for the rate decline.



Sector	Commentary	Outlook
Australian Shares	Australian shares remain closer to GFC lows than pre-GFC highs.	Australian shares trading at attractive valuations. In addition, the Australian economy is not facing many of the issues confronting US and Europe.
International Shares	Major global markets except Japan and France rose, whilst European currencies declined against the Australian Dollar.	Global shares generally remain fair value in Australian dollars with the benefit of our still overvalued currency. Higher quality stocks and non-US stocks still appear relatively attractively priced.
Listed Property Trusts	Appear to have returned to its traditional role as a less volatile sector.	Valuations look moderately attractive, and quality has improved.
Fixed Interest & Cash	Government Bond markets rose (interest rates fell), whilst corporate credit saw slightly lower prices (interest rate spreads increased).	Long-term Government fixed interest securities appear very expensive in Australia and overseas, with poor fundamentals in some markets. Corporate debt investments appear reasonable, with areas of value remaining.
Alternatives	Gold price declined moderately over the period. Gold stocks experienced volatility along with other stocks and declined in September before recovering. Alternative strategy performance varied.	View gold and gold stocks as cornerstone protection against likely rises in inflation beyond the immediate future. Alternative strategies also continue to have a diversifying role.

BEAR MARKET (CONTINUED FROM PAGE 1)

Many discussions of bear markets focus on whether the current point in time is part of a continuing bear market or whether the tide has turned and markets will rise. Historic data does not exactly answer this question but two interesting observations can be made. On the one hand, periods of low prices per dollar of profit tend to cluster together, so despite the price weakness now having continued for four years, it would not be unusual if this persists for some time yet. Over longer time periods, investing (whether remaining invested or increasing investments) at relatively low valuations such as the current time has historically provided very attractive returns over the following 10 and 15 year periods.

The practical implications for investors are very poorly understood and depend very much on their time horizon or investment phase.

The lower prices go and the longer they remain there, the higher the subsequent returns

Those who are still acquiring investment assets (including reinvestment) are favoured by bear markets. In fact the lower prices go and the longer they remain there, the higher the subsequent returns have been (excluding permanent

or semi-permanent collapses due to the collapse or reduction of entire societies, of which examples do exist).

For investors who are living off the income their investments generate without selling down assets, lower valuations alone make little difference,

although where lower prices are due to lower profits they maybe negatively impacted as income may decline.

For investors who are drawing more income than their investments produce, they are gradually selling their investments and are therefore disadvantaged by price falls. The lower prices fall and the longer they remain low, the worse the impact is.



Our office will remain open other than the designated public holidays for Christmas Day, Boxing Day, and New Years Day, being Monday and Tuesday (26th-27th December) and Monday (2nd January 2012).

On behalf of the team at Smith Coffey, we wish you and your loved ones a safe and happy festive season and continued success in 2012. As always, rather than sending out Christmas Cards, we will be making a donation to the Hands Across The Water charity.

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Winners will be notified by mail and their names printed in the next edition of Vantage Points.

A sample of some of the superb films this year are shown below



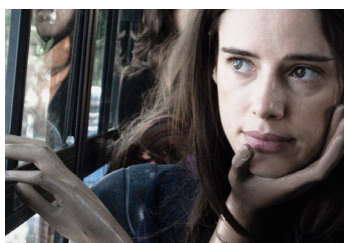
Romantics Anonymous — (France/Belgium) In French with subtitles
Director Jean-Pierre Améris, 80mins TBC

Reclusive chocolate factory owner Jean-René needs a miracle to save his failing business. Luckily, chocolatier Angélique has finally plucked up the courage to ask for a job. Though clearly made for one another, making their feelings known is an often hysterical challenge for these two painfully shy romantics. Funny, frothy and utterly charming.



King of Devil's Island — (Norway) In Norwegian with subtitles
Director Marius Holst, 116min TBC

Winner of Norway's top film prize in 2011, *King of Devil's Island* is a gripping drama based on the true story of an uprising that required military intervention. Set on the hauntingly desolate island of Bastøy in 1915, two new arrivals at a prison for delinquent youth upset the fragile balance between inmates and their often harsh overseers. Seventeen-year-old Erling is determined to escape, and when events turn tragic, his cause turns both popular and violent. BEST FEATURE, BEST SUPPORTING ACTOR, BEST MUSICAL SCORE, AMANDA AWARDS 2011 (NORWAY'S FILM AWARDS)



Medianeras — (Argentina/Germany/Spain) In Spanish with subtitles
Director Gustavo Taretto, 95min, M

Though they cross paths almost every day, computer programmer Martin and window dresser Marianna are divided by both the isolation of modern life and a medianeras (dividing wall) that keeps their apartment blocks out of sight from each other. The Buenos Aires-set love story is unique to the Argentine capital, yet universal in theme.



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