

## Dear Investor

You know the market is sobering up when you read as much about yields as you do about capital growth. This week Robert Gottliebse offers a very strong feature on how to build some "yield" into your portfolio through a judicious mix of bank deposits and bank hybrids. Scott Francis fails to favour the forthcoming BrisConnections IPO because he's not convinced how the float's promised yield is constructed; while Charlie Aitken says yield has met value across the market.

Doug Turek offers a terrific guide to the reality of bear markets. As Doug explains, you can not afford to miss bear market rallies because they deliver performance in highly compressed periods (maybe like earlier this week!). This is a great feature with a terrific range of expertise. Make sure you read it.

There's also Michael Pascoe's excellent interview with the market's number one stock picker for the year to June 2008, Robert Hook of SG Hiscock. Monique Wakelin looks at widening your property portfolio; Madeleine Heffernan looks back at some embarrassing bank forecasts from earlier this year; and there's much, much more.

Your Eureka Report weekly review is ready to print. I hope you enjoy it.

Best wishes,  
Alan Kohler



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# Cash: the deceptive security



By Doug Turek

**PORTFOLIO POINT:** Market volatility can make cash seem a much more attractive option, but leaving the market could be costly.

The longer and deeper any investment downturn, the stronger the instinct to head for the supposed security of cash become. For some this strategy may actually introduce greater risk and leave opportunity on the table. Market timers and cash accumulators take on the risk of permanently missing out on an eventual rebound in stock prices when trying to time their re-entry into the market. Further, portfolios with too much cash or bonds can be anaemic when it comes to fighting the creeping effects of inflation over the long term.

Selling equities during a downturn converts a paper or valuation loss to a real loss. Studies of long-term investing show that perseverance is rewarded with an eventual recovery and further growth of your invested wealth. A precondition for this happening, of course, is that your investments are properly diversified, which is not the case for all investors.

The Australian sharemarket has achieved a fairly consistent long-term annual growth rate of 12.4% since 1900 despite many shocks along the way. This consistency is evident by the generally constant slope in the chart of stock prices since 1900 plotted using a logarithmic scale as in Figure 1. The slope of this line is in fact the annual rate of price growth over the period. A new retiree funding 30 years of living, or a 40 year old planning to do similarly will be an investor over a time frame that represents a third or half the width of this chart.

**Figure 1: Australian shares since 1900**



(Source: AMP Capital investors June 2008)

This 12.4% long-term annual return is only 7.5% (about 5% less) when dividends are excluded. The latter is important to remember because the media often comments on stock price movements, not movements of accumulation indices which account for the income paid to investors as dividends.

Since 1900 there have been 28 years of in which stock prices declined, but only 20 years of less severe accumulation index decline.

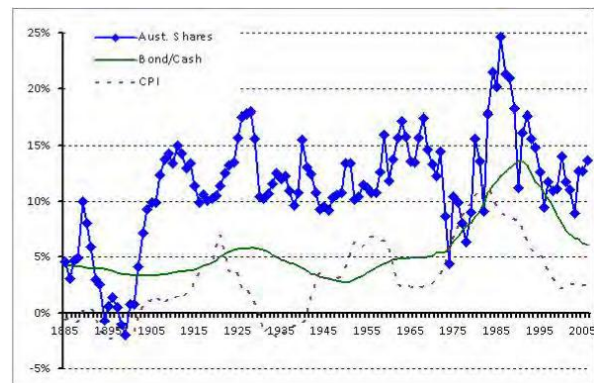
Compared to Americans, Australian investors have received relatively high levels of income from local equity investment, which helps stabilise returns. In recent decades, dividends as a proportion of total investment returns have dropped, making Australian investors more reliant on capital growth. Since dividend imputation was introduced, an extra tax-related boost to earnings has been provided.

## Medium-term investing: cash and bonds vs equities

The rewards from sharing in the profits of listed companies has typically been greater than from lending money to those same entities over both the long and medium term. Looking at the medium term and at over 100 consecutive, 10 year periods since 1895, equities have underperformed bonds in only five of 100 periods (and never in 30 years).

Figure 2 shows annual investment returns for: Australian equities; the 10-year bond yield; and inflation for 100 different 10-year periods beginning in 1875 (shown from the first 10-year period ending 1885). Only during the five, 10-year periods ending 1974 (that is, 1965–1974), 1978, 1982, 1990 and 1996 have bonds beaten equities over the past 100 years. Three of these periods coincided with the onset of high inflation and followed significant stock price declines. If you think we are in for this same fate going forward, it is important to note a significant stock price decline has already occurred, which means the forward outlook for equities is improved. Put another way, it could be too late to reduce your losses now and you're potentially at more risk from missing out on a recovery.

**Figure 2: Annual investment returns**



Annualised 10-year period rolling returns for Australian equities

(assuming dividend reinvestment) and bonds (based on 10-year bond yield) as well as the CPI inflation index since 1875 for periods ending in calendar year shown (eg: 2005 is 10 year beginning January 1996 and ending in December 2005).

Over this same recent 100 year period, the yield from 10-year bonds failed to keep up with inflation in 28 of these 100 10-year periods – or more than a quarter of the time. These include two of the five 1970s periods where equities failed to keep up with bonds, reinforcing how difficult that period was to reliably grow wealth.

This history lesson suggests “cash” over the long term does not reliably offer the security to fight the creeping effects of rising consumer prices. Of course, over shorter time horizons – five years or less – bonds or cash can certainly outperform. But then, if your time horizon for investing is less than five years then you shouldn’t be heavily invested in the stockmarket.

Note here we employ the 10 year bond yield as a proxy for bond or cash returns. However, these are different instruments and this is a simplification. Cash is currently at 7.25%, 10-year bonds are at 6.3%. More often than not the difference is reversed or modest.

It is also important to point out that not all investors “have the ticker” to be substantial equity investors; they need to align their investment approach and expectations to their so-called “risk tolerance”. Importantly, I don’t recommend investing 100% of your long-term assets in equities, including for longevity reasons, and for having liquidity to effect rebalancing (see *Rebalance and realign your portfolio*).

### The challenges of market timing

Those who sell down assets into cash in a downturn, or choose not to continue investing regular amounts of excess cash, face the difficult question of when then to enter or re-enter the market. Often this is done only after there is substantial evidence that markets have recovered. Most investors seem to need this reassurance to become confident the worse is over.

This creates two problems. First, you may invest a large sum of money into a short-term bear market rally or “bear trap” only to be later disappointed (as happened in April and May). Second, you might invest only after prices have risen well past the market bottom, and worse, at a price above when you sold out or began “hoarding” cash. A comprehensive study commissioned by the New York based Towneley Capital Management group puts this danger into startling perspective, showing that markets can lift dramatically in a very short time. For example, in the first three sessions this week, the local market has jumped by more than 6%.

From 1926 to 2004, US stocks earned about 10%

annually, such that an initial \$1 investment would have grown to \$1920 during the period.

Had investors been out of the market during only the one best investment returning month (April 1933, following the crash of late 1929) then this same \$1 would have grown only to \$1388 (9.6% annual return). This is a loss of 28% for being invested over 947 months instead of 948 months

Had investors been out of the market during the best six months, or 0.06% of the time, their investment return would have grown to just \$437, against a potential \$1920.

The statistics are even more painful if daily periods are considered. Investors who missed the best-performing 10 of 10,573 days between January 2, 1963, and December 31, 2004, would have turned \$1 into \$44, not \$74, if they were invested continuously over this 41-year period (a period where daily statistics were available to study).

It is very important to understand that many of the best periods in the market surround the worst periods. They are often periods of recovery from over-selling. They can also occur a few months or years after a substantial decline, when investors expect market returns to improve. During these key recovery events, markets sometimes never return to the then depressed valuations. The stockmarket often moves in a series of incremental back-and-forth moves, and then on occasion breaks upward. A major announcement, event or final wave of optimism, is enough to reset market prices.

In short, if you abandon ship by selling out of the market, you face the unlucky prospect of missing the boat when investment markets recover.

### High returns for the courageous?

Equity returns investing at or near the bottom of the market can be significant. This is the period where news and future prospects can seem the gloomiest. T Rowe Price, in one of their recent US investor newsletters, produced an interesting graphical summary of the S&P 500 price index before and after the 10 officially declared recessions since World War Two (Figure 3). This offers a number of important insights:

Markets usually correctly anticipate a recession by declining in value several months, about six months on average, in advance of the officially declared date

Markets also recover several months before a recession is over; this is what commentators mean when they refer to the stockmarket as a forward looking “great anticipation machine”

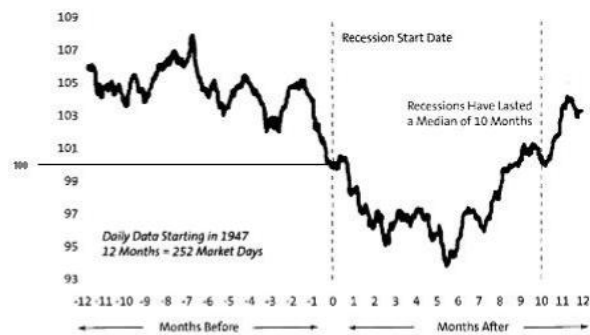
The median or typical US recession lasted 10 months, which is also the duration of price decline. The average peak-to-trough decline in stock prices was 24%, which included a large decline of 45% to October 1974 and a modest 7% decline to March 1980

It took typically 10 months for markets to recover to their pre-recession peak, but on average this took 20 months, the latter figure being weighted by the five-plus years needed to recover from declines in 1974 and 2001

Money invested at the bottom of the market returned on average a positive 24% after six months and 32% after 12 months

**Figure 3: Recovery times**

**Aggregate of S&P 500 'performances before and after US recession since 1945**



Source: T Rowe Price.

Although it is likely the US is in a yet-to-be-declared recession, the Australian economy is not and is performing differently. Nevertheless, our market inevitably becomes infected by any US or global downturn. There is some evidence that the Australian sharemarket is buffeted slightly more during global and local downturns.

The average and median peak-to-trough fall in the All Ordinaries index since 1970 may be about 28% (versus 24% for the US market), which includes a painful decline of 53% to August 1975. To put current events into perspective, a fall of the November 2007 peak of the ASX S&P 200 price index then at 6700 to 4800 is a decline of 30%.

### Retirement funding anaemia

Holding high levels of cash in a portfolio that is funding retirement can put at risk the ability of those assets to cover expenses that are inflating over the long term, or require that a more modest standard of retirement living be targeted.

This is evident if we look at how various retirement portfolios would have lasted historically for people retiring between 1950 and 1980. Let's compare the historic longevity of portfolios depending on whether they: earned solely the income from 10-year bonds offered each year at that time; or invested wholly in Australian equities, achieving each year's relevant returns.

Figure 4 shows the balance of an initial \$1 million lump

sum after funding an initial \$60,000 pension amount (6%) and then successive payments, which increase each year to cover the actual cost of inflation in those years. An allowance of 1.5% for investment costs and taxes is included. Data for retirements starting in 1950 and every five years thereafter until 1980 are shown. This preliminary work shows:

- All-bond portfolios (dashed lines) generally funded only about 15 years of retirement – a lower draw down percentage would lead to greater longevity.

- The exception is an all-bond portfolio funding retirement that began in 1980 following the inflationary period of the 1970s, which allowed that portfolio to fund nearly 25 years of CPI-adjusted living

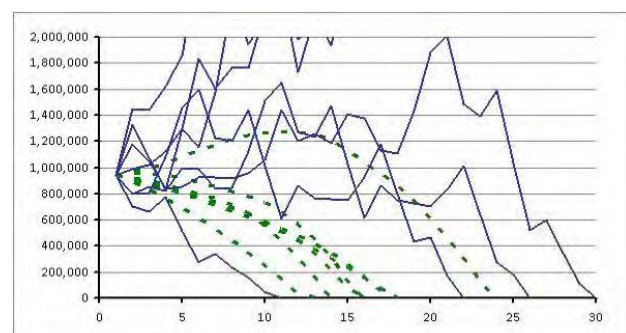
- All-Australian equity portfolios (solid lines) fund a longer retirement in most cases.

However investing retirement savings 100% in equities makes for an extremely bumpy ride; most should blend in an allocation to bonds and other assets to smooth returns and importantly guard against the small probability of monies running out early (see next).

In some situations an all-equity portfolio will not last the distance. An all-equity investor who retired in 1970 would have had their money run out after only 10 years unless corrective action was taken. This historic scenario is particularly relevant if we enter into an inflationary or stagflationary period like which occurred in the 1970s.

For a lucky few, the growth potential of equities is such that assets were not depleted for these drawdown assumptions leaving a sizable inheritance.

**Figure 4: Retirement balance performances**



Retirement balance of \$1 million following initial \$60,000 (6%) withdrawal then after annual withdrawals increased by CPI, for investments 100% in Australian equities (solid line) and 100% bonds (10 year bond yield), shown as dashed line. Each line is for a retirement beginning either in 1950, 1955, 1960, 1965, 1970, 1975 and 1980 based on historic returns for each following year. The horizontal axis is the number of years since commencing retirement. Source: Professional Wealth preliminary.

### What to do

Unfortunately we are not provided with a "You are here"

sticker on charts to describe our position in the current market downturn (Figure 3). If we had then we would know when to sell out (or have sold out) and when to buy back in.

While the current sharemarket average yield is about 4–5%, the opportunity cost of holding money in the sharemarket versus earning a 7–8% cash yield perhaps isn't as high as you think; this provided you can look past swinging prices and will stay invested for the long term even if events get worse. It's best that you emotionally plan that they will stay grim for awhile.

Most professionals recommend individuals stay invested during difficult periods. Most shouldn't also abandon regularly investing, especially those who are saving for a retirement that is more than five years away and have an asset allocation properly aligned with their needs. If not acting is too difficult to do, then some should use this time to rebalance their portfolio back to its long-term orientation, which may entail buying back some domestic and international equities and listed property. International equity investors also benefit from a strong Australian dollar, which may not persist beyond this interest and commodity cycle.

Those close to retirement, or in retirement, have to tread more carefully. Long-term bear markets can be very difficult periods to safely fund retirement. Investment portfolios need to be robustly designed and only a prudent amount of assets should be withdrawn. Those in this situation should reaffirm or seek expert advice about their preparedness to weather investment markets that could be as challenging as the mid-1970s.

The saying "May you live in interesting times" certainly applies to today's investment environment. I hope you see this investment approach offers more fortune than misfortune, at least for some. ◆

*Doug Turek is managing director of personal advisory firm [Professional Wealth](#) and speaks and writes on wealth management.*