



20 April 2010

Dear shareholder

Welcome to our annual investment letter in which we outline to shareholders our views on the Australian share market. We hope you find the letter informative and a talking point leading into our six monthly shareholder presentations which will be held at the end of May and start of June this year.

The Australian share market has, at the time of writing this letter, risen 59 per cent over the last 14 months after hitting a low on March 9, 2009. Despite the rise the benchmark S&P/ASX All Ordinaries Index is still approximately 37 per cent shy of its all time high. The stunning rally began at a time of peak pessimism among investors and has steadily climbed a colossal wall of worry since that day. This worry has been primarily focused on the possibility of a double dip occurring, which is a fashionable way of saying that western economies will fall back into recession once public stimulus policies come to an end.

We are not believers in a double dip occurring, especially in the United States, which is the key share market in the world. The US economy, while hamstrung by tight bank lending policies, has begun a recovery after its most severe downturn since WWII. Through a combination of historically low interest rates and major government funding, the US economy has broken the recession with above average growth since August 2009 and looks set to continue this momentum for some time to come. Investors have correctly predicted this recovery, with the S&P 500 index up approximately 79 per cent since hitting a low on March 6, 2009.

The global economic environment has also been boosted by the dramatic recovery of the Chinese economy. As is well documented, the Chinese economy has become a core growth engine for the world and in particular the Australian resources sector. After feeling the pinch of the global economic downturn in late 2008 and early 2009, the Chinese Government approved plans to stimulate its economy, resulting in a boom in capital goods demand. The major beneficiary of this move was, and continues to be, the Australian resources sector, especially the bulk commodities of coking coal and iron ore. Both of these are used to make steel. More recently, the Chinese Government has started to voice concerns about inflationary pressures which need to be kept in check. The consensus view is that authorities will be able to bring the inflation fear under control without having to correct economic growth significantly.

What does all this mean for Australian shares? In historical terms Australian shares are not expensive if you measure them on a price to earnings multiple. It can be argued that they are historically cheap on the alternative valuation method of bond yields versus equity earnings yields. If we break the share market down into sectors - resources and cyclical industrials companies are relatively expensive while financials and defensive stocks are relatively cheap. Given that we are close to the end of financial year 2010, these valuation assessments are based on earnings for the year to June 30, 2011.

This all sounds extremely positive for the share market in the future, especially with a domestic and global economic recovery gathering momentum. However, we believe the time to be cautious is now upon us. We believe the key variable that needs to be kept in mind is interest rates. In Australia, official interest rates have been on the rise since October last year. The Reserve Bank of Australia has raised official interest rates 5 times and at the time of writing the newsletter the rate stands at 4.25 per cent. Most economists believe the rate will continue to rise to around 5 per cent by the end of calendar 2010. Since the RBA began lifting rates the S&P/ASX All Industrial Index has struggled, trading in a range, and currently sits slightly below its high reached on October 15, 2009. For the most part the industrial index is dependent on economic activity in Australia, and the recent struggle to move higher reflects concerns about slowing economic growth in the

future. In comparison, the resources sector, which depends more on global activity, has risen approximately 9 per cent since October 15, 2009. Interest rates among the major economies around the world are yet to start rising, as has been the case in Australia. Investors are encouraged by the US Federal Reserve comments that rates in that country will remain at historic lows for an extended period.

The underperformance of the industrial sector is an indicator of how investors react to rising interest rates. Professional investors try and look 12 to 24 months ahead in a bid to forecast future earnings growth. This means that attention has now turned to earnings for the financial year 2012. With local interest rates rising, investors have become cautious about an economic slow down and the impact it will have on earnings in 2012. If rates behave like the market expects and top out at around 5 per cent we would expect industrial companies to trade sideways until towards the end of 2010. If, however, it becomes clear that interest rates will move higher than expected, investors will continue to shy away from industrial stocks that generate most of their earnings in Australia.

In regards to the mining sector, investors have become extremely bullish, based on the belief that China and to a lesser extent, India, will continue to demand ever increasing levels of commodities to fuel their economic growth. With interest rates in the US and Europe at historic lows investors are pouring money into the Asian region to get exposure to its growth, and Australian resources are a primary beneficiary of this move. The boom times of 2007 are already back.

This scenario makes us cautious. Mining companies are trading above long term average valuations at a time when demand for their products are elevated. We would expect that as the stimulus applied by the Chinese Government and the US authorities is removed over the course of the next 12 months the demand for resource companies by investors will decline.

Overlaying this scenario, history tells us that share markets do not automatically hit new historical highs following a major crash as experienced from November 2007 to March 2009. In previous major bear markets it has taken between 5 and 7 years to reach those old highs. The reason behind this phenomenon are varied, but in general terms bull markets, as the one of 2003 to 2007, result in many excesses in the general economy. These excesses, usually surrounding debt levels, need time to work through the system. A point in case was in 1987 where the Australian share market crashed in October before bottoming out in February 1988. The market then rallied following cuts in interest rates around the world. The interest rate cuts also fuelled a monumental boom in residential property, forcing the RBA to change tact and start lifting rates. This brought to an end a 40 per cent rally by the share market in just an 18 month period. From the middle of 1990 to the start of 1992 the Australian share market fell approximately 30 per cent. In the middle of a severe recession in 1992 the share market started to rally, a trend that continued for the next decade. The end result was that it took the Australian share market around 9 years to breach the peak it hit in 1987. We believe this current cycle will run a similar course.

In lieu of this cautious view, we have slowly been building up our cash levels in WAM Active Limited (WAA). When specific trading opportunities appear such as well priced capital raisings we look to take advantage of them, otherwise we park our funds in cash. In the future we will look to take specific short positions to take advantage of a declining share market. Currently, WAA holds approximately 50 per cent of its funds in cash.

Thank you for your support and we look forward to seeing you at the investor presentations.

Yours sincerely,

Geoff Wilson, Matthew Kidman and Chris Stott