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## Dear Shareholder,

In what has been a challenging six months for equity markets, I am pleased all three of our Listed Investment Companies (WAM, WAX and WAA) were able to increase their fully franked dividend by around 10%. As a Board and Investment Manager, we continue to focus on delivering a growing stream of fully franked dividends to our shareholders.

A topic being talked about in the market at the moment is the long awaited float of Facebook. The valuation is expected to be between \$US80 billion and \$US100 billion. I am fascinated that the human desire to belong and be connected could deliver such paper wealth in such a short period of time. In my view, the floating of Facebook signals close to a top for its valuation.

In this newsletter we discuss a topic that we are frequently asked about by our shareholders – The Australian Banks. We have outlined the current dynamics in the Australian Banking Industry and try to answer the question: 'Are they a sound investment?'

On a lighter note, we have also included a whimsical article from the Sydney Morning Herald stating that 'Intelligent people own shares'.

I hope you enjoy reading this issue of our newsletter and I look forward to seeing you at the upcoming Investor Roadshows in May.

Thank you for supporting us.

Geoff Wilson, Chairman  
WAM Research Limited

# Australian Banks – Are they a sound investment?

Australian bank shares currently offer a historic dividend yield of approximately 7% per annum which is fully franked. This is a very attractive dividend yield, if it is sustainable and if bank earnings can at least be maintained throughout the next cycle.

Investors are questioning the sustainability of bank dividends in this post-Global Financial Crisis (GFC) world and are now asking if the banks will ever return to their former glory days as powerful earnings growth engines. The distress in Europe has only heightened investor concerns further and led to more risk aversion.

In this feature article we examine the status and prospects of the Australian banks.

## Australian banks are indeed facing a number of headwinds

Australian banks today face a variety of difficult headwinds that haven't generally confronted the sector in the past 20 years. Credit growth in Australia has been slowing and is now trending at very low levels. Home lending grew by only 5% in 2011 which is a record low level of growth and business credit in Australia is even softer and is not growing much, if at all.

At the same time, banks around the world are also facing higher regulatory imposts around capital and liquidity under the new Basel III requirements. APRA is implementing tougher requirements in Australia to reflect these Basel III requirements, and APRA's standards will no doubt be at least as tough as any regulatory regime overseas.

## Investors are becoming increasingly concerned about the risks facing banks in Australia

Share market investors have become very concerned that the Australian banks rely heavily on wholesale funding offshore. Concerns have been heightened since the onset of the European debt crisis last year and there is a real concern that the Australian banks' funding could be threatened by a collapse of European debt markets.

There is an increased realisation that the current levels of offshore wholesale debt by the banks represents a significant risk to bank balance sheets in any future crisis period.

Investors are also concerned that a downswing in global economic conditions could bring a second wave of bad debts for domestic banks in Australia. The largest asset class exposure is residential mortgages, and there is a concern that home affordability is problematic in Australia, with a very high ratio of house prices to median income. Investors highlight the risk of residential mortgage distress with particular overseas perceptions of an Australian housing bubble.

Any major collapse in residential house prices would threaten the asset quality of the Australian banks. However, Australian house prices have been resilient for the last 30 years despite a number of difficult economic environments. Theoretically, such a failure would only occur in the event of high levels of unemployment combined with rising interest rates, so this scenario would appear to be quite unlikely in the current environment, but can't be ruled out in the long term.

On the positive side of the bank outlook, we note that:

- (a) credit quality has never been stronger;
- (b) provisioning for impaired loans is very prudent; and
- (c) capital adequacy levels are very strong.

## Old model of Australian banks transformed to a new paradigm

Following the deregulation of the banks in the 1980's, the banking system in Australia enjoyed rapid credit growth and the Australian banks generated exceptional profitability with very high return on equity of 20% or more consistently for over a decade. The banks were keen to facilitate strong credit growth and they achieved exceptionally high credit growth at double digit levels, close to 14% per annum.

But this rapid credit growth couldn't be internally financed by customer bank deposits and the banks therefore sought additional external funding from wholesale sources, particularly from overseas lenders.

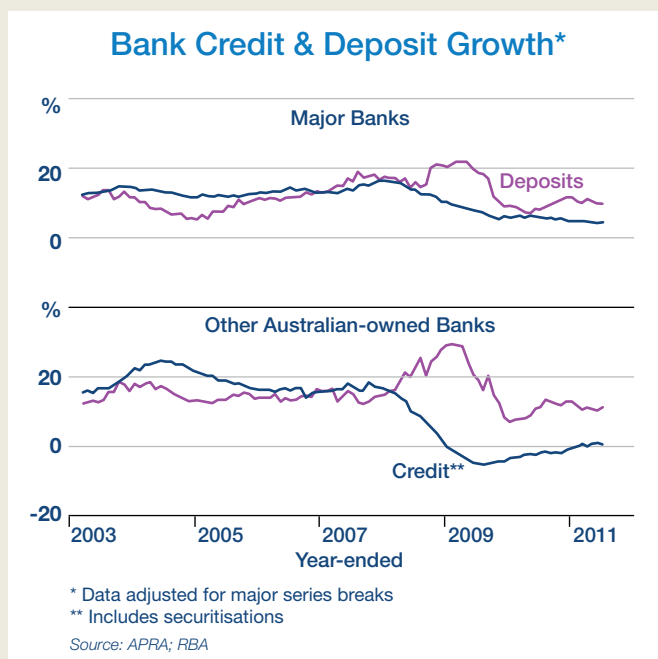
After the onset of the GFC, the availability of overseas debt dried up and customer lending growth slowed dramatically, and so the banks have found themselves facing a challenging new era of customer deleveraging. Both business and retail customers have sought to improve their own balance sheets and have been reluctant to borrow and have tended to repay existing loans.

There has been a step change in wholesale funding costs and the banks have been forced to suddenly reduce their reliance on wholesale funding, which has become more expensive and more challenging to place. The banks have offset the higher wholesale funding costs

with higher lending spreads on loans, and both retail and business loans have been significantly repriced upwards.

As mentioned, the Australian banks now face much tougher scrutiny and increased regulatory requirements in regard to capital, funding and liquidity.

Credit growth for the major banks has continued to slow since the GFC, with no evidence of any pipeline of lending growth re-emerging on either residential mortgages or business. However, deposit growth has



stepped up and has been exceeding credit growth, which significantly helps to alleviate the banks' funding requirements.

## Banks are still overly reliant on wholesale funding

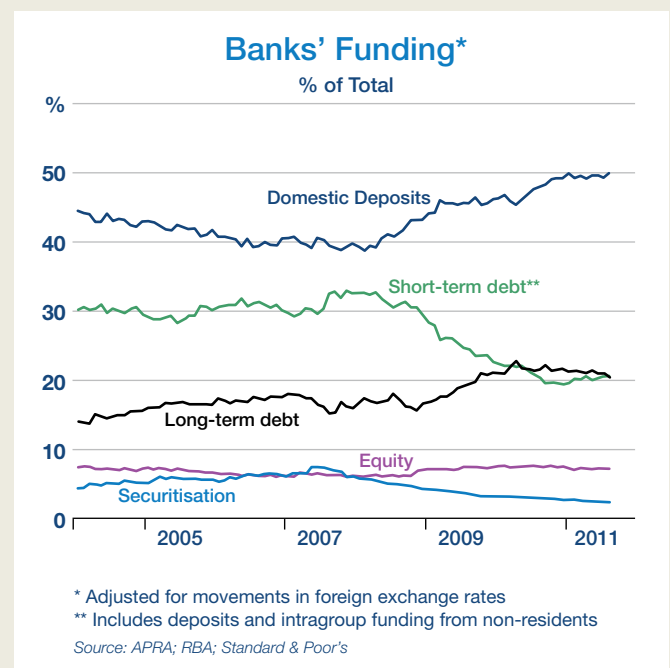
The Australian major banks have a structural weakness in their heavy reliance on overseas debt markets. This could leave the Australian banks exposed to a funding, and potentially a liquidity problem if wholesale debt markets became closed for a prolonged period, as during the depths of the GFC.

We highlight in the following chart that the major Australian banks have indeed improved their funding mix since the GFC with domestic deposits increasing from around 40% to about 50% of funding. Moreover the

banks have all lengthened the term profile of the funding maturities so they face fewer maturities in any given period. Nonetheless the banks still rely on wholesale debt markets for around 40% of funds that they lend to customers.

The majority of their wholesale funding is sourced overseas and a significant amount has traditionally been sourced from European investors and banks. The sovereign debt crisis in Europe has increased concerns about the stability of the funding of the Australia banks.

As the global uncertainty increased last year, the Australian banks found an increased tendency for business and consumer savings, which has significantly boosted the deposit base of the Australian banks and has alleviated the overall funding task facing the banks.



In total the four major banks will need to refinance about \$100 billion of wholesale debt maturities during 2012, although this will ultimately depend on the level of deposits and savings and the level of credit growth.

## Covered bonds facilitate bank funding in 2012

The covered bond market was recently enacted in Australia in October 2011, with the first covered bond issued in November 2011. This development will assist the banks in meeting their funding task. Covered bonds

# Australian Banks – Are they a sound investment?

(continued)

represent an additional credit enhancement to traditional bank debt, whereby lenders receive a pledge over a pool of high quality assets that are ring-fenced.

Investors in the covered bonds have a preferential claim on these earmarked assets and thus effectively rank higher than other creditors in the event of default. But covered bondholders also have an unsecured claim on the issuing bank to meet any shortfall. Covered bonds will enable a lower cost form of borrowing for the banks and also offer investors more security than previously available to wholesale borrowers. Covered bonds will therefore alleviate the funding pressures currently facing the banks.

## Note that a Federal Government Guarantee applies to retail bank deposits

In November 2008, during the depths of the GFC, the Australian Federal Government introduced an explicit and free guarantee on retail deposits issued by any authorised deposit-taking institution (ADI) in Australia.

On 1 February 2012, the maximum limit on this guarantee was reduced from \$1 million to \$250,000 and is not scheduled to expire.

## Improved market structure leads to a more dominant position for the major banks

The market structure has become highly oligopolistic with the four major banks now increasingly dominating lending and deposit markets in Australia over the last few years, as a result of the following factors.

- a) In October 2008, CBA acquired BankWest and in December 2008 Westpac acquired St George Bank. BankWest and St George were the strongest regional bank competitors to the major banks.
- b) Prior to the GFC, banks in Australia faced strong competition from non-bank lenders. Due to the GFC securitisation markets closed and have yet to re-open. This has crimped the ability of non-bank lenders to source adequate funding at economic levels and has led to the demise of non-bank lenders.
- c) Regional banks are lower rated than the major banks and as a result the regional banks face a more difficult funding task. As a result, this advantages the major banks in Australia.

## Conclusion

What remains to be seen is, firstly, whether the banks can maintain their historic dividend yields, and secondly, whether the banks can grow earnings and dividends over the medium term.

Will the banks ever return to become strong profit growth engines or will they simply become high yield plays that are ex growth and effectively boring utilities?

### In our opinion the Australian banks offer the following compelling benefits:

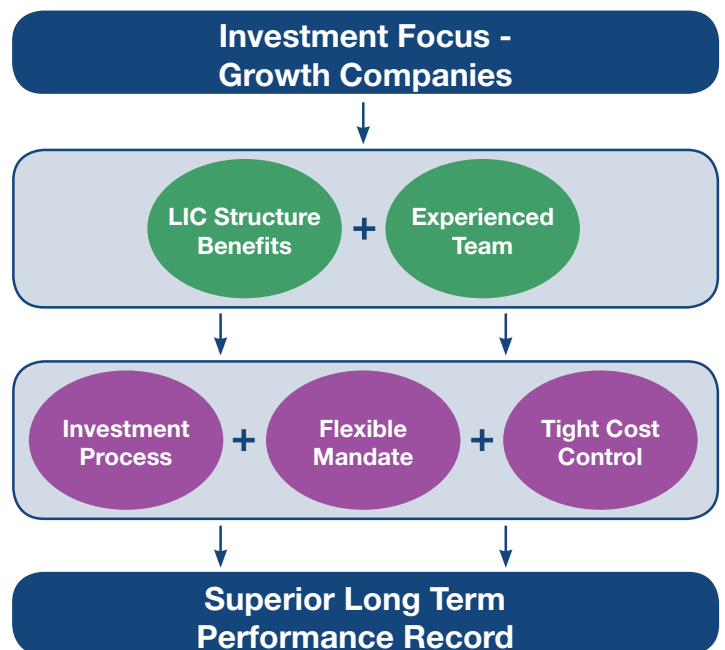
- 1. Improving Operational Efficiency.** Even in the face of low credit growth, well-managed banks will be able to maintain profits through the next cycle if asset quality is sound and if provisioning is prudent. Banks may well confront some margin pressure and face low asset growth but bank profits can be maintained if operating expenses and asset quality are tightly controlled. Bank profits, and hence dividends, will be maintainable if the bank is well managed.
- 2. Dominant Position.** The strength of their market position enables the banks to monetise their high franchise value, despite competition and ongoing political pressure.
- 3. Sustainable Yield.** Australian bank shares typically offer an attractive dividend yield of approximately 7% per annum which is fully franked. We believe this dividend yield is sustainable. Payout ratios are conservative. Banks are well positioned to maintain dividends and the current dividend yield, together with franking, represents approximately a very satisfactory 10% pre tax return to investors.
- 4. Capital Generation.** Although the banks may suffer from benign credit conditions, the low credit growth environment in the context of high return on equity means that the banks will tend to start generating significant free capital. Although APRA is now looking for all the banks to increase their regulatory capital ratios and reduce gearing, this capital generation will eventually become available for either new business investment or otherwise for potential return to shareholders by way of higher dividends or capital returns.

# What Wilson Asset Management Group offers to shareholders

## Funds & Investment Process



## Business Model



## Style

- Quick decision making resulting from a flat structure;
- Increased flexibility due to the relatively small funds under management;
- A broad coverage of various industries, especially at the small to medium end of the market;
- A focus on risk adjusted returns with above average cash positions; and
- Over 50 years of experience in the Australian share market with a high degree of street smarts.

## Structure

- Closed-end funds avoiding the problem of being forced sellers and buyers at inappropriate times;
- An investment vehicle that delivers fully franked dividends; and
- An active Research Driven and Market Driven approach that involves staying very close to the market and an in depth analysis of investee companies (over 750 meetings with companies per year).

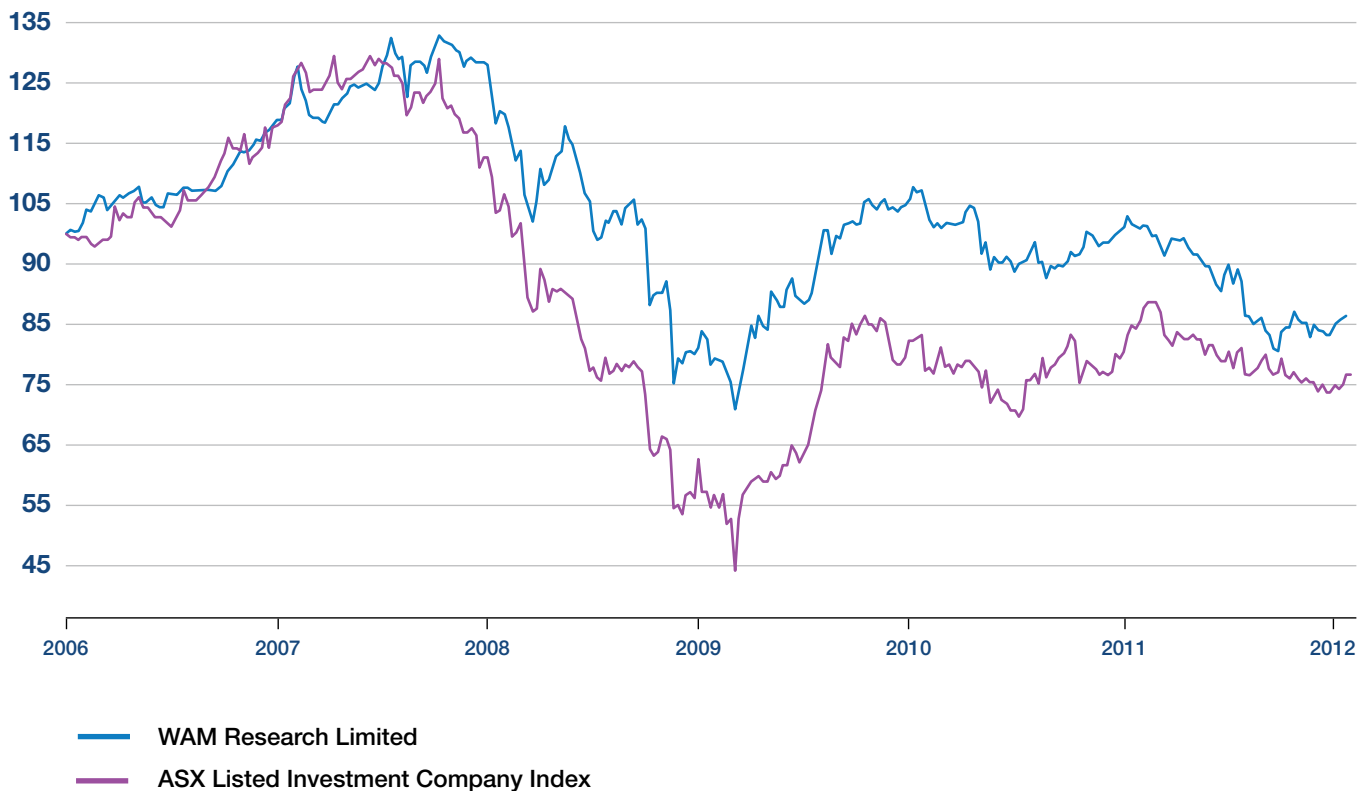
# Listed Investment Company Structure Benefits

Listed Investment Companies (LICs) are structurally superior investment vehicles.

- They provide a diversified portfolio of assets with a range of different strategies and styles (e.g. Australian shares, international shares)
- Studies show LICs outperform managed funds\*
- Closed-end pool of capital
  - Never forced seller of investments/underlying assets in difficult times
  - Never forced buyer of investments/underlying assets in bullish times
- Not beholden to short-term performance: As underlying assets cannot be withdrawn, the manager is more incentivised to deliver long term sustainable performance
- Provide consistent flow of fully franked dividends
- Lower MERs (management expense ratios) compared to managed funds
- Provide additional opportunities – LICs can trade at a premium/discount to underlying assets
- Publicly trades on an exchange (e.g. ASX) which provides intra-day liquidity for buyers and sellers
- Public companies provide more stringent corporate governance and accountability of Directors

\* UK Study Source: Collins Stewart Pty Ltd

## WAM Research Limited vs ASX Listed Investment Company Index



Indicies rebased for comparison. Source: IRESS.

# WAM Research Investment Objectives & Process

The investment objectives of WAM Research are to achieve a high real rate of return, comprising both income and capital growth, within risk parameters acceptable to the Directors.

Our investment process focuses on:

**a) Research Driven investing:**

We undertake extensive research (over 750 meetings with companies per year), focusing on free cash flow then rating the company with respect to management, earnings growth potential, valuation and industry position. We buy when we can identify a catalyst or an event that will change the valuation the market gives to the company. We sell once the company reaches our valuation.

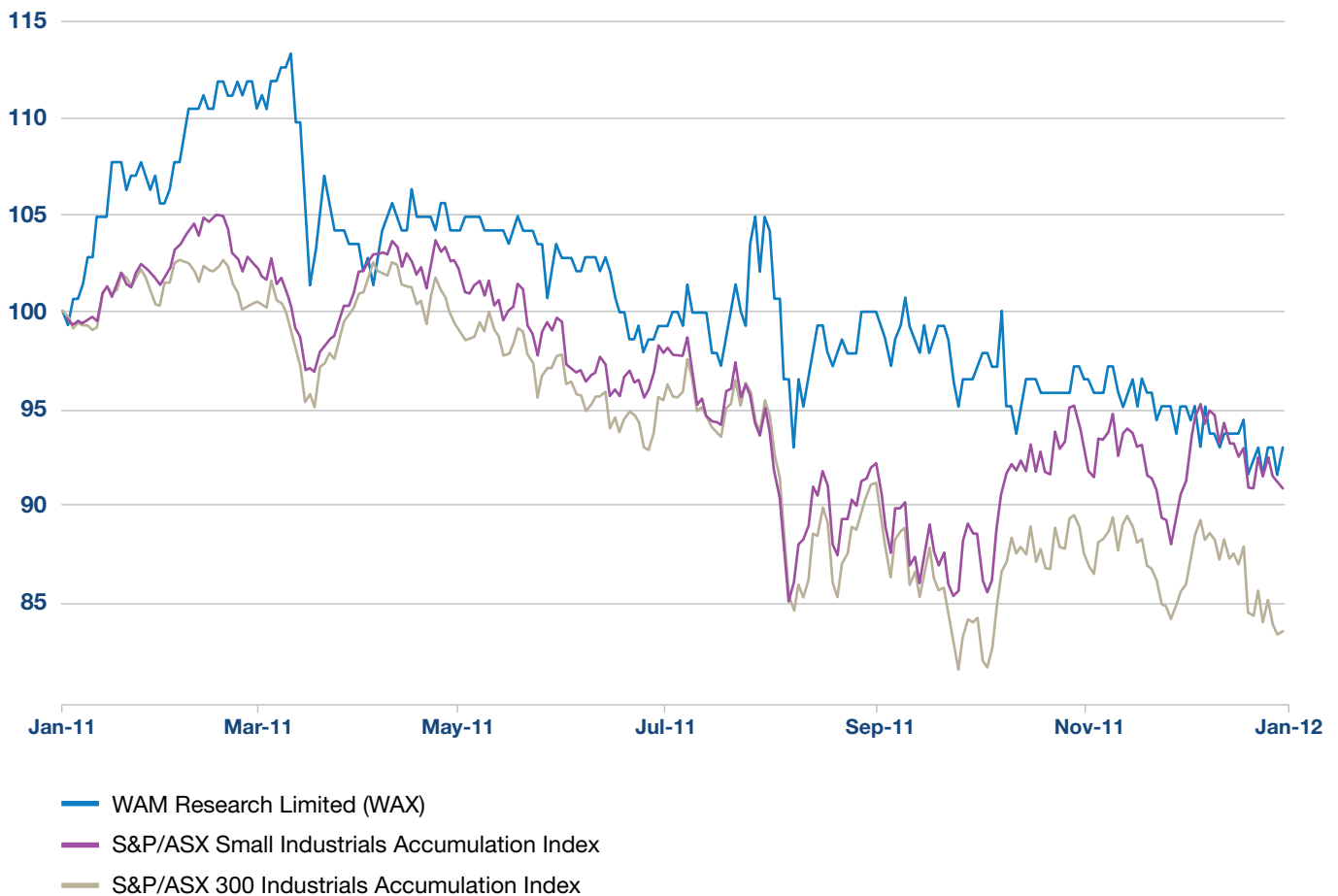
**b) Investment Driven investing:**

The investee company has a sustainable business model, a track record of profit making and dividends, generates positive free cash flow, acceptable financial strength and generates a sound return on equity.

**Risk Management**

WAM Research has no borrowings and has no intention at this stage to take on bank debt. The Company focuses on a diverse portfolio of stocks. The Company also has a low exposure to the resources sector because the Manager considers this sector is subject to extreme volatility and is difficult to value according to conservative accounting and investment principles.

WAM Research Limited Share Price vs Indices



Source: IRESS

# Performance

We are pleased with the portfolio's performance over the half year to 31 December 2011 and since the modification to the investment process. We continue to focus on providing risk adjusted returns to investors in the form of fully franked dividends and capital growth.

In evaluating the Funds performance, we look at three key measures. The first performance measure is used to show how the investment manager has performed and is compared to the relevant Index. These measures are before all costs and taxes. WAM Research's gross portfolio declined 4.7% for the half year 31 December 2011, while the S&P/ASX All Ordinaries Accumulation Index fell by 9.6%. Over the same period, the S&P/ASX Small Industrials Accumulation Index fell 10.5% and the S&P/ASX 300 Industrials Accumulation Index fell 4.6%.

The second measure of performance is the movement in underlying assets (NTA) after taxes, management fees and all other costs. This performance shows the change in the value of the assets which belong to the shareholders over the period. Corporate tax, being 30%, is the most significant item of difference between the gross and the net performance. The franking credits attached to this tax paid are available to be distributed to shareholders through fully franked dividends. WAM Research's after tax NTA, adjusted for dividends, decreased 2.8% for the half year to 31 December 2011.

The third measure of performance is the share price return. The share price adjusted for dividends fell 2.3% for the 6 months to 31 December 2011. This outperformed the broader market driven by the closure of the discount to NTA of the share price.

The above mentioned performance figures are pleasing given the Fund's focus on risk adjusted returns to investors. These returns were achieved by holding an average of 31% cash for the period.

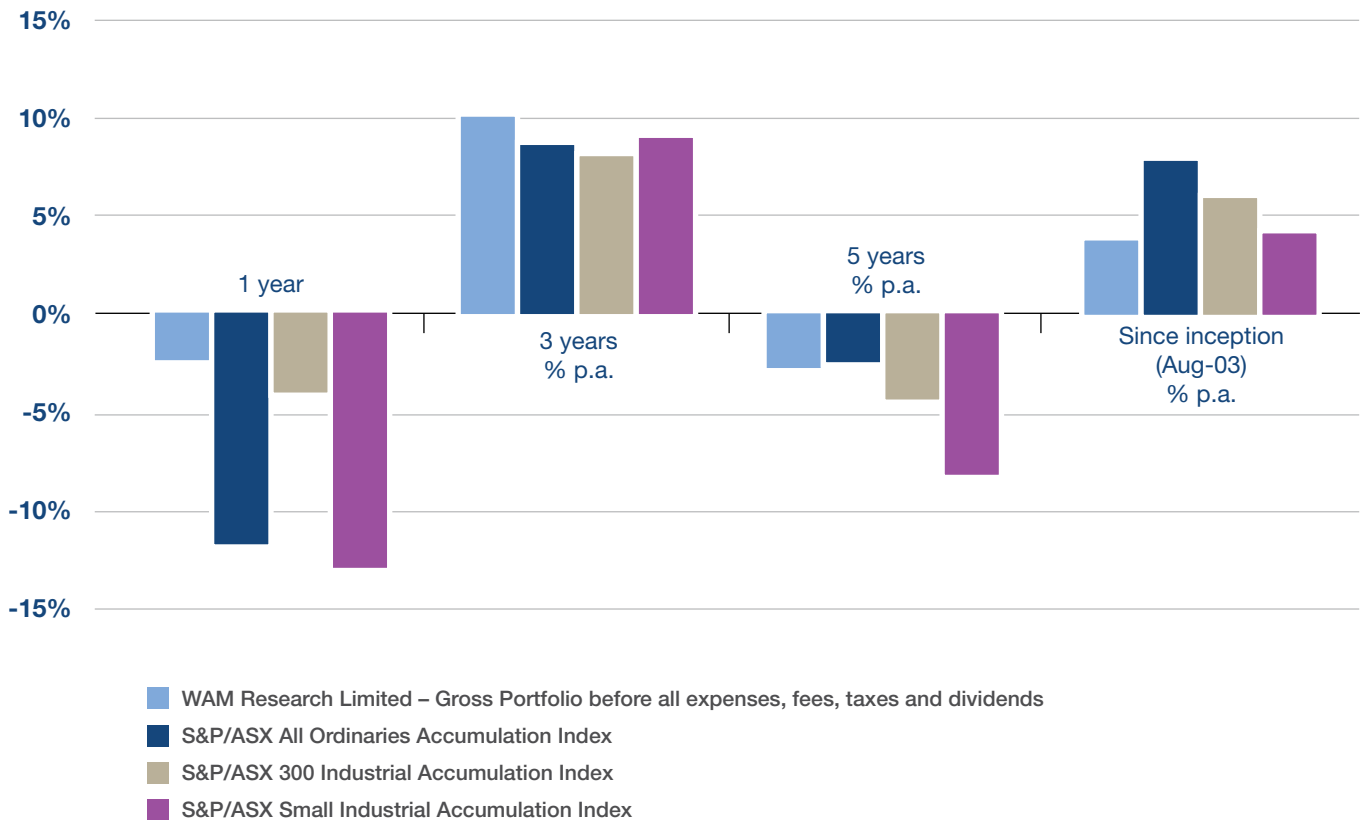
The last six months has proven a difficult period for the small and mid-cap industrial stocks which the Research Driven part of the portfolio primarily focuses on. The softening Australian economy, and the recession-like conditions being experienced on the east coast of Australia, have crimped industrial companies earnings growth. We have managed to add a few stocks in the period, Coffey International (COF) which has been a good performer for the Fund after we participated in the company's capital raising at \$0.38. The best performing research stock for the period was AP Eagers (APE) which was buoyed by stronger car sales data amongst their dealerships resulting in a profit upgrade. The company has the benefit of owning significant parts of land on which the dealerships exist, providing asset support to the valuation. The worst performing stock was Centrepoint Alliance (CAF) which suffered from a profit downgrade after the integration of its recent acquisition of Professional Investment Services proved tougher than first thought. Our positions in Australian and New Zealand Banking Group (ANZ) and Westpac Banking Corporation (WBC) were

realised during the period. We continue to hold National Australia Bank (NAB) and have February \$24 call options written against this position.

We expect the current reporting season will provide a number of new investment opportunities for the Fund, with a focus on companies leveraged to more favourable economic conditions based on interest rate cuts in 2012 from the RBA.

Looking into the new calendar year 2012, we are cautiously optimistic that this will be a better year for equity markets than last. We are well positioned (40%+ cash) to take advantage of opportunities as they arise.

### Annualised Performance as at 31 December 2011



The performance data in the graph above is before all expenses, fees and taxes and is used as a guide to how WAM Research has performed against the various indices, which are also before all expenses, fees and tax measures.

# Interim Dividends

On 8 February 2012, the Board announced a fully franked interim dividend of 3.25 cents per share to be paid on 23 April 2012. The shares will trade ex dividend on 10 April 2012. This is an 8.5% increase on the prior years interim dividend.

“ *The interim fully franked dividend of 3.25 cents per share, which includes a 2.5 cent LIC capital gain dividend represents an annualised fully franked dividend yield of 9.0% based on the 16 February closing price.* ”

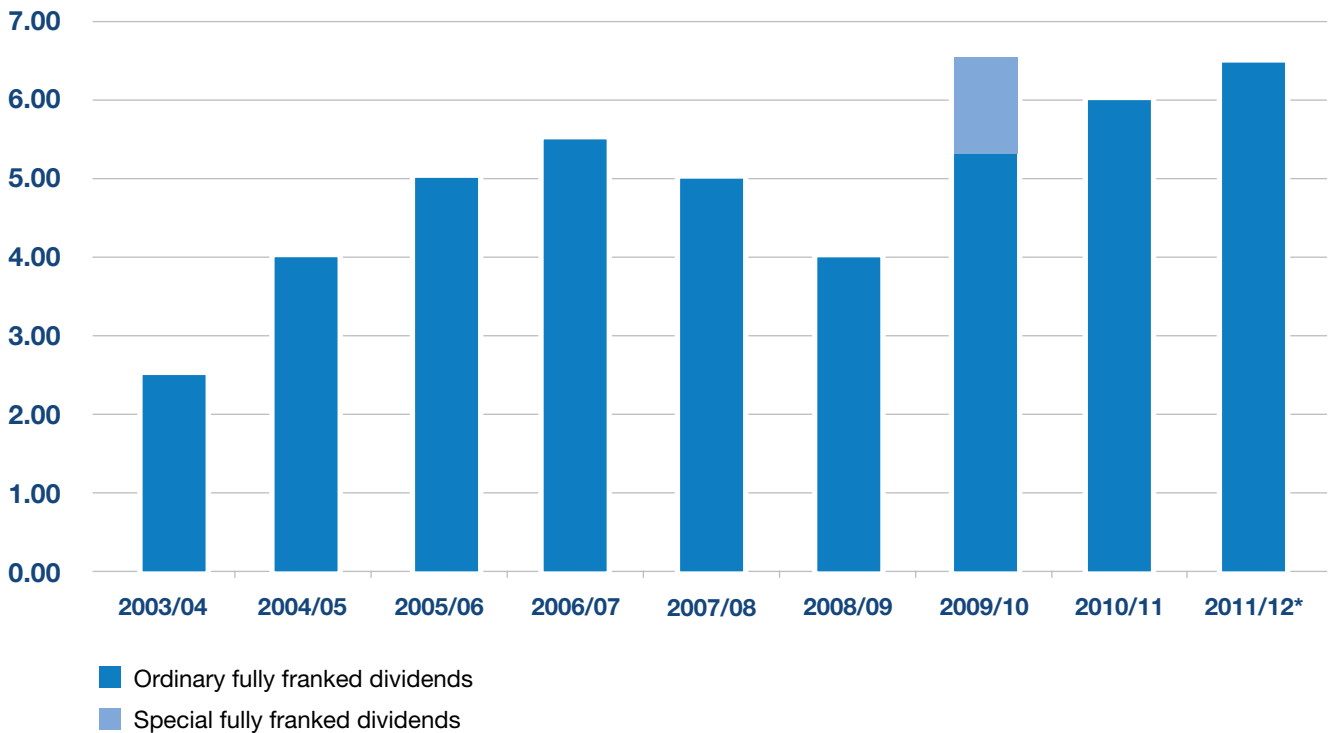
The interim dividend includes 2.5 cents LIC capital gain which will enable some shareholders to claim a further tax deduction. Details will be included on shareholder statements.

The Board is committed to paying an increasing stream of fully franked dividends to shareholders provided the Company has sufficient franking credits and it is within prudent business practices. It must also comply with Government legislation and the ATO’s interpretation of a company’s ability to pay franked dividends. Dividends are paid on a six-monthly basis.

Government legislation introduced in June 2010 now enables companies to pay dividends if the company is deemed solvent. Dividend payments will be made with consideration to cash flow, cash holdings, available franking credits and ability to pay franked dividends. Essentially, WAM Research will always be in a position to pay dividends providing it is solvent.



Cents per share



\* Annualised interim dividend

## A closer look at our holdings

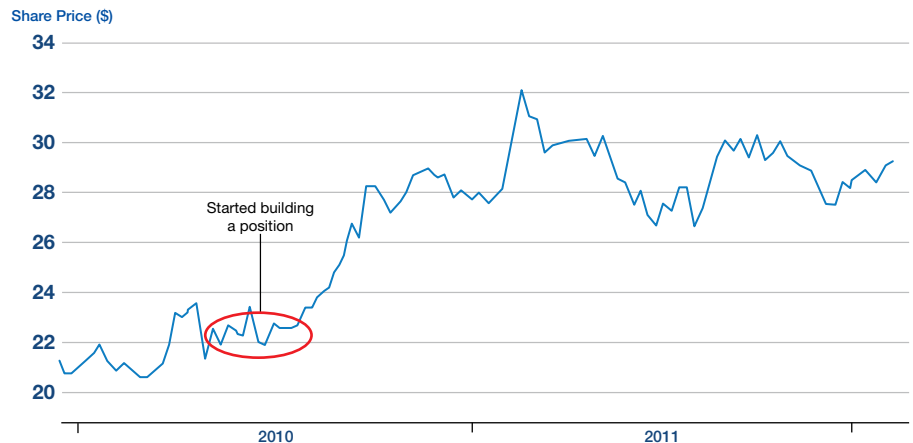
### Blackmores Limited (ASX code: BLK)

Blackmores Limited (BKL) is a distributor of branded vitamins and supplements in Australia and South East Asia.



Blackmores position their products at the premium end of the natural healthcare market. Products are distributed primarily through retail pharmacies, supermarkets, health food stores and professional outlets.

Despite having attractive growth characteristics, traditionally Blackmores has traded on high valuation multiples. Our opportunity to buy Blackmores came when the market went into free-fall and the stock was de-rated along with the rest of the market. This was our time to buy a quality business at a reasonable price. We commenced buying in January 2010 at an average price of \$22. As well as trading on a historical low multiple, there were other factors which we thought would support the appreciation of the share price, one being that Blackmores had appointed a very impressive CEO, Christine Holgate. Christine was put in charge of injecting new life into the company and re-invigorating the management within Blackmores. After meeting with Christine several times, we were convinced that she had the appropriate skills and enthusiasm to make a positive contribution to the group.



Another reason for buying the stock was that alongside the Australian business, Blackmores has been developing a presence within South East Asia. They had been in Asia for a reasonable amount of time, but only in recent years did they start to really accelerate the distribution and roll out into new markets. The growth numbers we are starting to see from their Asian businesses are impressive. Asian sales now make up around 20% of group revenue.

We expect these operations to grow at a greater rate than the Australian business. The flat Australian market makes the success of the Asian expansion very significant. In recent

times, there has been talk about Blackmores exploring China as a potential new market and this would obviously have a strong impact on the growth outlook for the company.

The stock is trading at 16.6x FY12 earnings with EPS growth of 10.7%. We are expecting another good result from the company as we enter reporting season. As the stock currently doesn't rate we have been reducing our position.

## MyState Limited (ASX code: MYS)

MyState Limited (MYS) is a Tasmanian based listed diversified financial group.



It is a holding company with three businesses:

- MyState Financial (MSF), an Australian Deposit Institution;
- Tasmanian Perpetual Trustees (TPT); and
- The Rock Building Society (The Rock), Australian Credit License holder.

An opportunity to buy MyState arose when they purchased Tasmanian Perpetual Trustees (TPT). The rationale behind the acquisition was that the combined group would gain economies of scale and cost synergies from the combined group. After meeting with the company over the years, we had a good understanding of the business and thought there were catalysts which might see the share price re-rated. We commenced buying in August 2009 at an average price of \$2.50.

There were also other favourable characteristics that made the stock attractive in our eyes, in particular there were no institutions on the share register. This is important, as these undiscovered stories will often experience a rise in the share price after institutions discover a stock



like MyState and start purchasing the shares. Another thing we paid attention to is the quality of the management team. The CEO of MyState, John Gilbert, impressed us with his strategies to extract synergies from the TPT acquisition and his determination to cut costs and expeditiously integrate the two businesses.

The recent acquisition of The Rock, will allow MyState the opportunity to access the Australian mainland and open up new growth opportunities. The acquisition should also allow MyState to access a cheaper cost of funding which will benefit the

MyState Group. In addition, The Rock's computer system is expected to provide a significant saving in IT costs as MyState were looking at developing a new computer system.

MyState is trading on a current multiple of 9.3x FY2013. There will be one-off restructuring costs from the merger in this year's result. The majority of synergies are likely to be seen in FY2013.

# An insight into our Research Driven process

Matthew Haupt, Equity Analyst

## Karratha and North West Shelf WA Site Visit – November 9th 2011

As part of our research process we regularly visit company sites to see what is going on at ground level. With the mining and energy companies significantly increasing their capital expenditure on new and expansion projects, we thought it was timely to see some of their projects in the North West Shelf region of Western Australia. We had a full site visit on Day 1 and meetings with the companies on Day 2. Here is a summary of our visit.

### Day 1 – Mermaid Marine's (MRM) Dampier Supply Base

The trip commenced with a tour around Mermaid Marine's Dampiers supply base. The supply base is crucial for operators working in the North West Shelf region. All the major local and global engineering companies have slots allocated in the supply base. There is talk about a future expansion of the base to cope with the huge demand likely over the next few years. The picture below is a small sample of the amount of drill pipe on site. The drill pipe will be used in the LNG projects that are being developed in the North West Shelf.



*Drill pipes located at the Dampier supply base*

While we were in the supply base, Mermaid Marine offered to showcase one of the newest additions to their fleet. The vessel was called the Mermaid Leveque. It is a Platform Supply Vessel (PSV) and used in transporting gear to remote offshore locations. The vessel cost over \$30m and was very impressive. Here are some interesting statistics about the PSV. The vessel is 75

metres long, weighs 3,100 tonnes, has 6,700 brake horsepower, maximum speed of 14 knots and can accommodate 40 people.



*Mermaid Marines' PSV Vessel located at Port Hedland*

### Day 1 – Rio Tinto Cape Lambert Processing Site tour NRW Holdings (NRW)



*Earthworks being conducted by NRW at the Rio Tinto Cape Lambert expansion*

The next part of the trip was with listed mining service stock NRW Holdings. We were transported from Karratha to the Rio Tinto Cape Lambert expansion site. NRW Holdings primarily do civil and drill & blast work. NRW was awarded the early earthworks from Rio Tinto on this project. The CEO of NRW Holdings provided some good insight into the ins and outs of civil works. We toured the site and were shown the projects that NRW are working

on. It is a huge project and there are multiple contractors on site. The picture on the previous page shows the size of the site with the iron ore processing equipment in the distance. The project is valued at \$101m to NRW over 88 weeks with likely scope extension.



*Ground being prepared for blasting at Cape Lambert*

Above is a picture of a site being prepared to be blasted. Once the site is blasted, the rubble is removed and transported off site. This process is being handled by NRW as part of the earthworks contract. The advantage for NRW is they have the skills to conduct drill and blast so they can offer an integrated solution.

The earthworks are for an expansion of the Port Hedland site so Rio Tinto can process more iron ore out at the Port given their aggressive expansion plans. The following pictures are of a reclaimer which is used to pick the iron ore stockpiles and transfer the iron ore onto the conveyor belts. The iron ore is then transported to the jetty which is then loaded onto the waiting vessels.

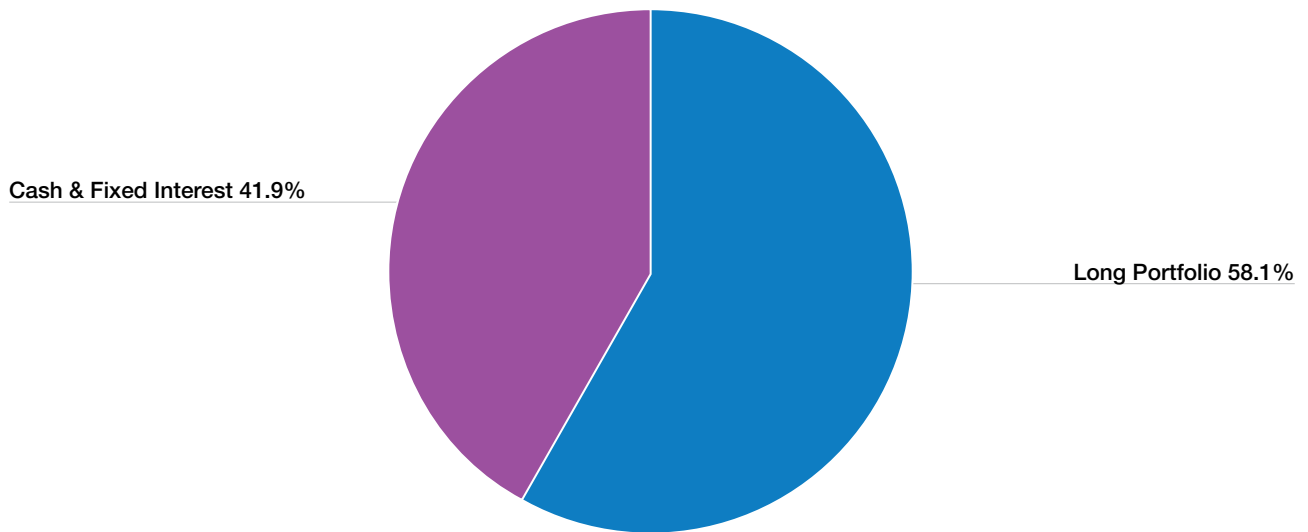
We would like to thank Euroz Securities for organising the tour and also NRW Holdings & Mermaid Marine for allowing us to visit their site and tour their operations.



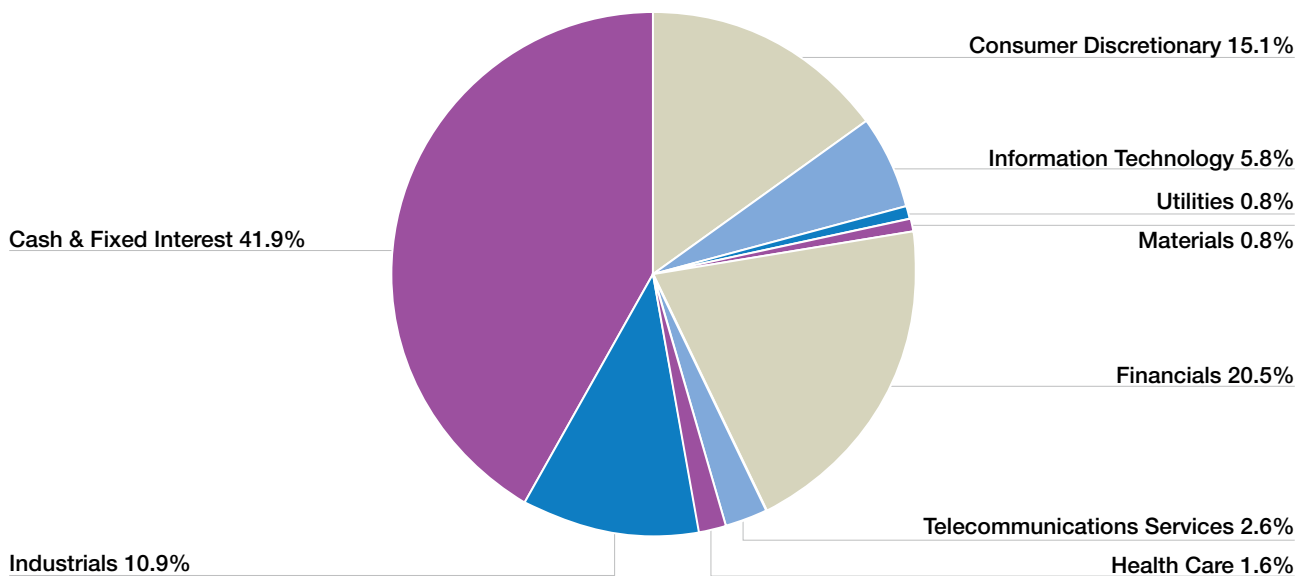
*Reclaimer at Cape Lambert moving the stockpiles of iron ore*

# Portfolio Summary as at 31 December 2011

## Asset Allocation



## Sector Allocation



## Stocks by Market Capitalisation

Category	Weighting
WAM Research Limited	
ASX (Top 50)	8.4%
Mid Cap (ASX 50-100)	0.0%
Small Cap (ASX 100-300)	12.1%
Ex-Index (Micro Cap)	37.6%
Total ASX Listed Equity	58.1%
Cash & Fixed Interest	41.9%
<b>Total Gross Assets</b>	<b>100.0%</b>

## Top 10 Stocks as at 31 December 2011

ASX Code	Company Name	Sector	Market Value \$m	% of Gross Asset
NAB	National Australia Bank Limited*	Financials	5.4	5.5%
APE	AP Eagers Limited	Consumer Discretionary	4.1	4.3%
RKN	Reckon Limited	Information Technology	3.8	3.9%
MMS	McMillan Shakespeare Limited	Industrials	3.4	3.5%
MYS	MyState Limited	Financials	3.1	3.2%
ANZ	Australia and New Zealand Banking Group Limited	Financials	2.7	2.8%
BRG	Breville Group Limited	Consumer Discretionary	2.6	2.6%
ARP	ARB Corporation Limited	Consumer Discretionary	2.2	2.3%
WBB	Wide Bay Australia Limited	Financials	2.1	2.2%
SGN	STW Communications Group Limited	Consumer Discretionary	1.7	1.8%

\* February \$24 Call Options have been sold against position.

## Best Performing Stocks Half Year to 31 December 2011

ASX Code	Company Name	Sector	Unrealised / Realised Gains
APE	AP Eagers Limited	Consumer Discretionary	\$656,114
BKL	Blackmores Limited	Health Care	\$194,419
TLS	Telstra Corporation Limited	Telecommunication Services	\$160,992
AGI	Ainsworth Game Technology Limited	Consumer Discretionary	\$148,518
RHG	RHG Limited	Financials	\$138,746

## Worst Performing Stocks Half Year to 31 December 2011

ASX Code	Company Name	Sector	Unrealised / Realised Losses
CAF	Centrepoin Alliance Limited	Financials	(\$691,190)
WBC	Westpac Banking Corporation	Financials	(\$541,043)
ALS	Alesco Corporation Limited	Industrials	(\$535,613)
MMS	McMillan Shakespeare Limited	Industrials	(\$493,295)
SSM	Service Stream Limited	Industrials	(\$466,342)

## Current Issues

We regularly get asked questions from shareholders relating to a number of macro economic factors. Here we aim to cover the most topical.

“*The Australian economy has slowed in the last six months which, in our view, will see more interest rate cuts.*”

**Interest rates:** At the time of writing, the cash rate remains at 4.25%. The Reserve Bank of Australia (RBA) commenced its loosening cycle in November with a reduction of 0.25% and followed this up in December with another 0.25% cut. The bond market is anticipating a 1% further reduction in interest rates in 2012. We view this as optimistic. The Australian economy has slowed in the last six months which, in our view, will see more interest rate cuts, however not at the pace the bond market is predicting. However, if we see further downside in Europe, this could trigger the RBA into further rate cuts than anticipated. The question will be: will these be passed on in full by the major banks? Given the recent rise in funding costs, we expect that any further rate cuts will not be passed on to mortgage holders in full as banks look to try and retain margins. This has been seen recently with all four Australian major banks lifting the standard variable mortgage rate higher independent of the RBA.

**House prices:** Recent data has seen continued weakness in Australian house prices, down 1% for the December quarter. The softer macroeconomic environment and the deleveraging of consumers have put downward pressure on prices. We anticipate house prices will remain relatively flat over the coming 12 months. Lower interest rates may encourage first home buyers to re-enter the market, which could provide a stimulant to the affordable end of the market. Affordability remains the key. Wages growth is anaemic, the savings rate continues to rise and unemployment is increasing. These factors in our view could see house prices remain flat in 2012. We don't see Australian house

prices 'crashing', as some overseas experts predict. The shortage of new housing stock and net migration will see prices rise longer term.

**Corporate activity:** Australian corporates remain well-capitalised. Gearing levels are low and many companies have excess cash to deploy in assets, enhancing returns on their equity. We expect, given most industrial companies' earnings growth is currently sluggish, that some will seek acquisitions to drive earnings growth. One example is Super Retail Group's recent acquisition of Rebel Sport. The higher Australian dollar may encourage Australian companies to venture overseas for value accretive opportunities.

**Australian economy:** Productivity remains extremely weak and continues to decline, which is a concern for the economy longer term. The two-speed nature of the Australian economy continues, with the east coast of Australia experiencing recession-like conditions while the mining boom, particularly in Western Australia, gathers momentum. Inflation has declined to 2.5%p.a which remains in line with the Reserve Bank's target of 2-3%. Unemployment has increased recently to 5.2%. Large job losses have commenced, especially in the banking sector, which will see this figure rise in the coming months. We expect further interest rate cuts will stimulate the industrial sector in the coming months, while Chinese growth, albeit at a slower rate, will continue to support higher than average commodity prices.

# Market Outlook

In the first 6 months of this financial year, the Australian share market posted a decline of 9.6% as measured by the S&P/ASX All Ordinaries Accumulation Index. Equity markets worldwide were dragged down, primarily by the European sovereign debt crisis and the inability of European governments and the ECB to coordinate a credible and robust response.

The European sovereign debt crisis appears, on the face of it at least, to be slowly reaching some form of conclusion. The ECB's near 500bn Euro lending programme to commercial banks just before Christmas seems to be having the desired effect, with yields falling considerably in the January 2012 debt auctions. Continued real progress on the debt crisis and further falls in yields, will remove a strong headwind which has been buffeting equity investors for the last few months. Any resolution in Europe could be a positive for equity markets in the coming months. However, at this stage this is far from certain.

In the US, there has been a steady increase in positive economic data points. We have seen unemployment drop from 9.0% to 8.3% whilst housing, GDP and manufacturing data have also all shown modest improvements. This suggests a nascent recovery may be underway in the world's largest economy. A US recovery will have positive effects into the broader world economy, offsetting the drag from the Euro zone. US companies balance sheets are in good shape, with high levels of cash, which has the potential to be put to use through corporate activity and expansion of products and hiring. The US economy is certainly one to watch carefully in the coming months, especially for

Australian companies exposed to the US market, such as James Hardie, Breville and Billabong.

With regards to Australia, the RBA has responded to the slowing down in the domestic economy by cutting interest rates by 0.50% in the period. Looking ahead, we expect further rate cuts in 2012 from the RBA. This will reduce funding costs for companies and could provide a springboard for increased levels of corporate activity in the coming year. It will also reduce the term deposit rates offered by banks, and this may turn investors' attention to higher yielding assets, such as shares and provide a boost to equity markets generally.

Equity analysts and market strategists have moved to a more conservative stance in recent months with regard to earnings and the outlook for the Australian economy. The consensus earnings estimates for Australian industrial companies for FY2012 are now 6%

compared to 14% a few months ago. This indicates that analysts have adjusted their earnings expectations downwards. In the current interim reporting period, we expect to see more earnings surprises to the downside rather than the upside. These results, we believe, will see analysts adjust downwards FY2013 earnings expectations for industrial companies.

There is still a reasonable amount of uncertainty about how Australian consumers will respond to the rate cuts and whether this nascent recovery in US economic activity can be sustained and improved upon. China, for now, appears to be ticking along at a more moderate pace, but strong enough to keep the mining boom intact in the medium term. Europe though, continues to remain a key issue. With this backdrop, we are cautiously optimistic that 2012 will be a better year for equity markets.



# Intelligent people own shares

Source: Sydney Morning Herald Business Day

The smarter you are, the more stock you probably own, according to researchers who say they found a direct link between IQ and equity market participation.

Intelligence, as measured by tests given to 158,044 Finnish soldiers over 19 years, outweighed income in determining whether someone owns shares and how many companies they invest in. Among draftees scoring highest on the exams, the rate of ownership later in life was 21 percentage points above those who tested lowest, researchers found. The study, published in last month's *Journal of Finance*, ignored bonds and other investments.

Economists have debated for decades what they call the participation puzzle, trying to explain why more people don't take advantage of the higher returns stocks have historically paid on savings. As few as 51 per cent of American households own them, a 2009 study by the Federal Reserve found. Individual investors have pulled record cash out of US equity mutual funds in the last five years as shares suffered the worst bear market since the 1930's.

"It's what we see anecdotally: higher-IQ investors tend to be more willing to commit financial resources, to put skin in the game," said Jason Hsu, chief investment officer of Newport Beach, California-based Research Affiliates LLC. "You can generalize a whole literature on this. It seems to suggest that whatever attributes are driving people to not participate in the stock market are related to the cost of processing financial information."

## 'So Strong'

While intelligence influenced things that might naturally increase equity ownership such as wealth and income, the authors said IQ determined who owned the most stocks within those categories as well. Among the 10 per cent of individuals with the highest salary, "IQ significantly predicts participation" in the stock market, they wrote. For example, people in the highest-income ranking who scored lowest on the test had a rate of equity market participation that was 15.7 percentage points lower than those with the highest IQ.

"If you look at the significance of IQ related to other factors like income or wealth, certainly it plays a very large role," Keloharju, a finance professor at Aalto, said in a phone interview. "It's very difficult to get around that problem, but the results are so strong here. We are playing with lots of different controls and lots of different specifications, and all the time things work really well."

## Financial Education

Hsu of Research Affiliates said an explanation for why draftees with lower test scores owned less stock is that they found it harder and more expensive to receive financial education. Getting people information on investing at a younger age may help limit the disparity, he said.

"The costs to achieve that are certainly higher if someone isn't providing that at an earlier stage in one's education," said Hsu. "If we

could provide advice, or provide education, to help reduce the cost of acquiring financial knowledge, that would seem like a good thing."

The paper is part of a broader debate about the role individual characteristics such as affluence and education play in investor actions. In the 1980s, so-called behavioural economists broke away from theorists such as Sharpe, who tended to think of all investors as rational.

Greg Davies, head of behavioural finance at Barclays Wealth in London, said his team tries to gauge clients' risk tolerance with personality profiles and investment strategies that appeal to "emotional needs."

## Implications

"As advisers, of course, we see our role in overcoming the irrational, emotional, inaccurate elements on behalf of our clients," said Davies. "But the implications of this for the mass markets are much greater."

Markowitz said the argument that intelligence and personality sometimes trump rationality in guiding investors has little bearing on his work. His theory comes down to the view that anyone hoping to get the highest payout at the lowest risk should broaden their asset ownership.

"It's advice for the individual investor," Markowitz, 84, said in a telephone interview. "I am delighted to learn the more intelligent a person is, the more likely they are to act in the spirit of what I wrote."



**WILSON**  
ASSET MANAGEMENT

Wilson Asset Management is an independently owned boutique investment manager established in 1997 by Geoff Wilson. Wilson Asset Management is based in Sydney, Australia.

The Wilson Asset Management Group (WAM Group) employs five investment professionals who have a total investment experience of over 50 years.

The WAM Group is the manager of three listed investment companies and one unlisted fund, with funds under management of approximately \$320 million.

In August 1999, the first of the three listed investment companies WAM Capital Limited (WAM), was established and has grown from \$22 million to approximately \$168 million today. WAM predominantly invests in growth companies with a focus on small to medium sized companies listed on the ASX.

The second listed investment company, WAM Research Limited (WAX), was established in August 2003. Funds under management are currently \$97 million. Previously known as Wilson Investment Fund, WAX predominantly invests in growth companies with a focus on small to medium sized industrial companies listed on the ASX.

WAM Active Limited (WAA) is the most recent addition to the Group which was listed in January 2008. Funds under management are currently \$17 million. WAA is an opportunistic investor with high turnover and a focus on absolute returns.

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