



Financially Speaking

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Don't panic – in volatile times, quality prevails

We have experienced volatile markets in the past and will, no doubt, see them again in the future. One of the trends we've witnessed time and again under these conditions is a panic-and-run reaction. This is where investors with sound long-term financial plans abandon their investment strategies. Often their first reaction is to consider selling – when, in fact, a more appropriate course of action is often to buy more quality shares.

This is because quality shares usually recover after a general market fall, leading to very good profits for those people who invested at a time when most other investors were selling.

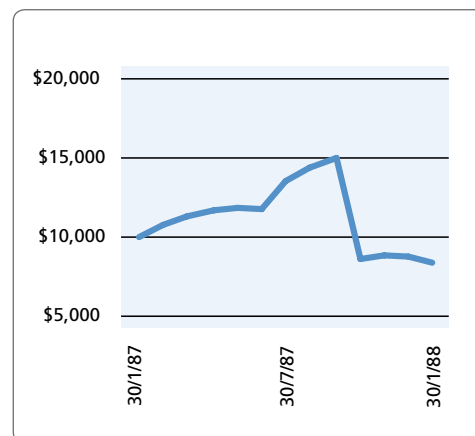
Consider Chart 1, which shows the performance of the Australian sharemarket over a 12 month period between January 1987 and January 1988.

If you considered this chart in isolation, it appears to be a catastrophe. Generally investors take one of two directions:

1. Panic

Some investors may panic and withdraw their investment at a loss. In Chart 1, an investment valued at \$10,000 at the

Chart 1



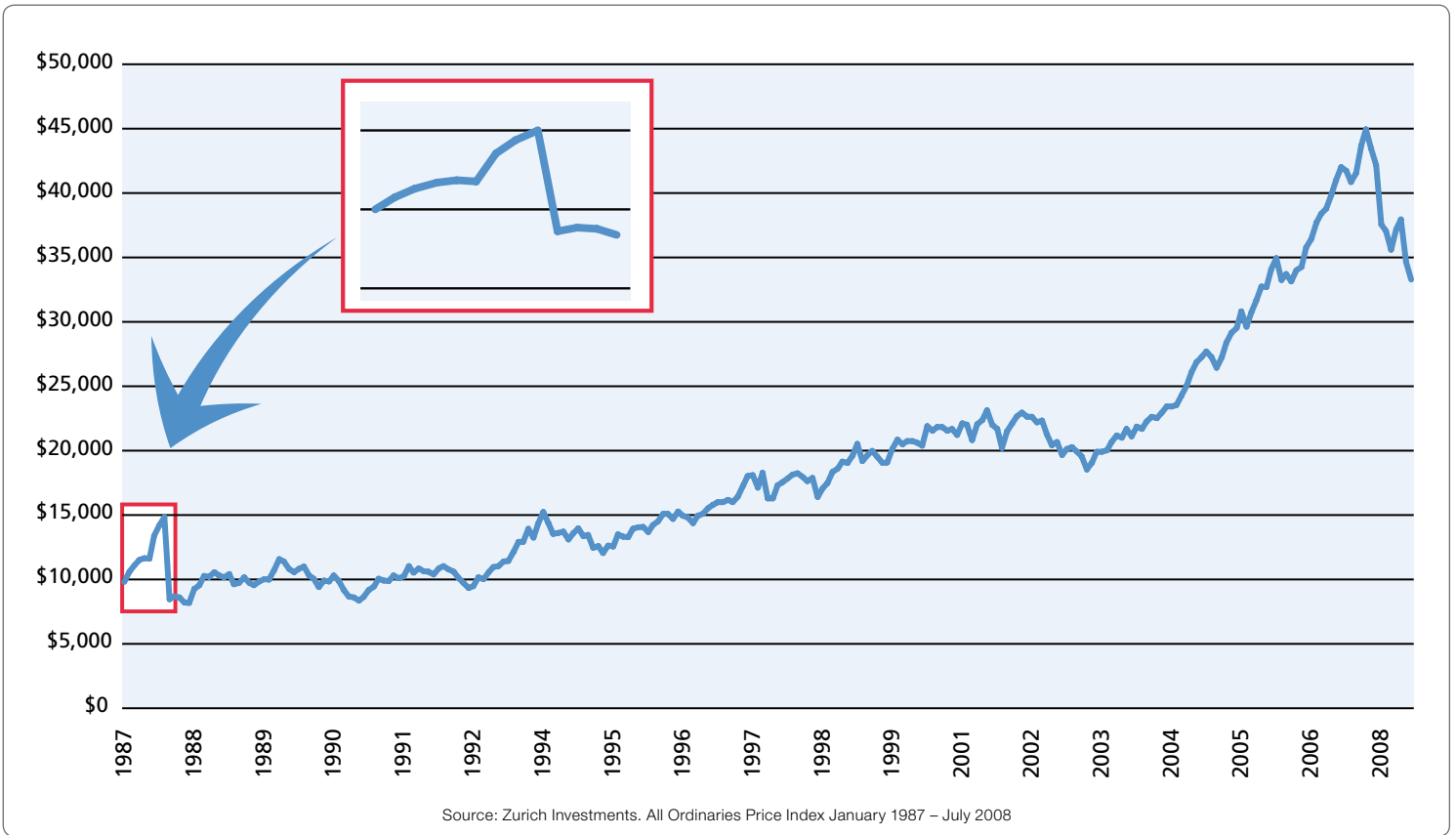
beginning of January 1987 has reduced in value to \$8401 the following year.

2. Head down and hold on tight

For those investors who remained in the market by July 2008 their investment was valued at \$33,496* (see Chart 2 on next page). Despite the difficulties of experiencing constant fluctuations and periods of negative performance, these investors weathered the storm, took comfort in their long-term investment strategy and were rewarded.

*Figures relate to an investment in the price index and excludes fees and any tax considerations.

Chart 2



As an example, consider Chart 3 which shows the performance of the American S&P 500 Index in the year of a major crisis and the one-year period following it. As you can see, those investors who bought more quality shares after a market fall were rewarded.

It's a long-term investment

Sharemarkets by their nature are volatile, which means they go through ups and downs. This is the reason financial advisers recommend that only investors with a long-

term investment horizon (i.e five-years plus) invest in shares. Volatility, however, is generally a short-term problem. Long-term investors, who stay focused on their investment approach, have a greater chance of achieving their goals. While volatility may make the ride a bit bumpy, experience shows that those who stay invested tend to come out ahead.

As such, you need to focus on the big picture rather than a short period of market volatility. One way to illustrate this is to look at the one-year returns from a particular benchmark

and compare it against the smooth trend line achieved over the long-term. In this example, Chart 4, we have used the S&P/ASX 300 Accumulation Index, which demonstrates Australian shares.

You can see from the chart that the one-year performance figures are quite volatile. If you were invested in the S&P/ASX 300 Accumulation Index over the full ten-year period, your annualised return would have been 8 per cent per annum.

Source: Zurich Australia Limited

Chart 3

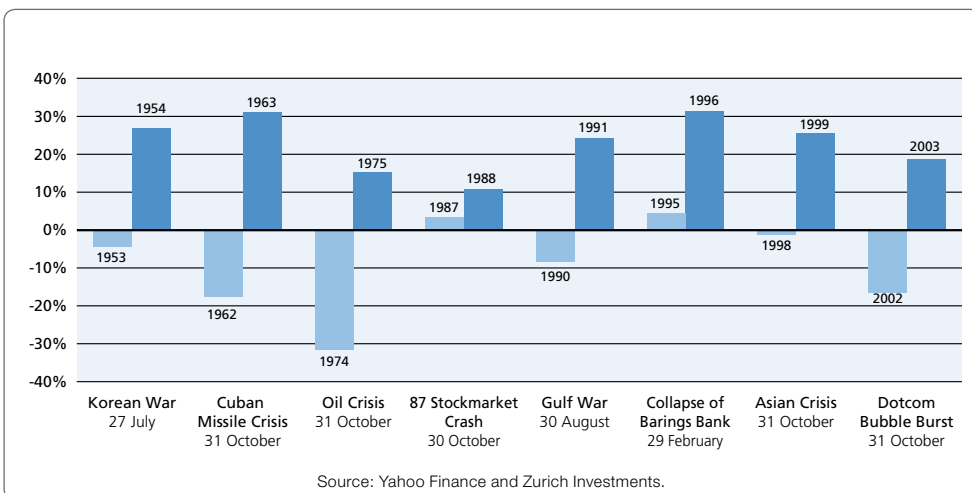
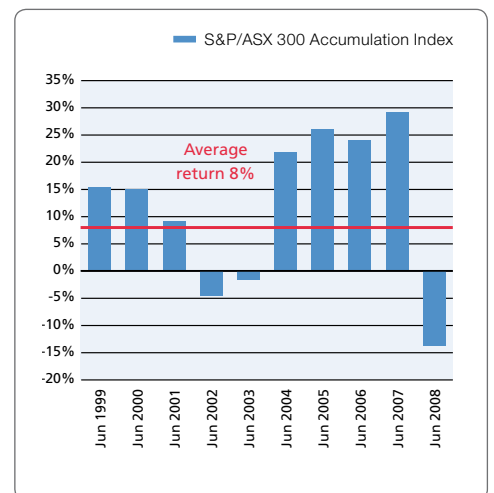


Chart 4



Live by the 6 rules

While it's natural to be nervous when financial markets are uncertain, it's important to stick to some basic investment rules to help you keep current market fluctuations in perspective.

1. Take comfort from history — the long-term trend is up

Over the last twenty years or so, there have been at least ten major events that have impacted the Australian share market, including the Wall Street Crash in 1987. While each of these events resulted in a period of uncertainty, the market has always recovered.

Importantly, despite short-term market uncertainty in the past, over the long-term the general trend of share markets is upward. Australian shares, for example, continue to perform very well, up 171%¹ in the last 10 years.

2. Stick to your original investment plan

Understand what you're trying to achieve and how long you're prepared to invest, rather than focusing on what's happening in the market. Keep in mind that the longer your investment timeframe, the more likely you'll experience some form of short-term market volatility. Also, understand how much risk you're comfortable with and make sure it's reflected in your investment plan.

3. Don't react to short-term market movements

Investment markets move in cycles, so it's difficult to forecast when they'll rise or fall. Moving your money in and out of the market during a downturn means you could potentially miss out on any positive bounce gained in a strong market recovery.

4. Diversify your investments to help spread risk

Diversification — or spreading your investment portfolio over a range of asset classes such as shares, property, fixed interest and cash — can help you spread your exposure to risk. So, if one investment or asset class loses ground, it's likely that your other investments may offset the

loss. You can diversify your investment across different asset classes, regions and investment managers or styles.

5. Get advice from a qualified source

A financial adviser can help you decide what you want to achieve with your money and how to meet your goals, while taking into account your needs, objectives and your attitude to risk.

6. Stay informed

It pays to stay informed about your investments and what's happening in the market. For the latest on what's driving the market and tips for investing during uncertain times, visit www.bt.com.au/volatility.

¹ Returns measured by the S&P/ASX 200 Accumulation index to end September 2008.

Source: BT Financial Group



How to make the most of the Government Deposit Guarantee

On 24 October 2008 the Federal Treasurer announced a number of changes to the deposit guarantee initiative originally released on 12 October 2008. In response to actions taken by overseas governments, the Australian Federal Government has responded by announcing a series of measures designed to maintain confidence in the local financial sector.

The key points are as follows:

- Eligibility is dependant
- Eligible deposits of up to \$1m will be government guaranteed until 12 October 2011, free of charge.
- From 28 November 2008, eligible Authorised Deposit-taking Institutions (ADIs) will need to pay a fee to the government to cover deposits in excess of \$1m if they want to maintain the guarantee on behalf of their clients. The fee is based on the credit rating of the ADI with AA rated institutions charged 0.70% per annum; A rated 1%; and BBB rated/unrated 1.5%.
- The "free" government guarantee is \$1m per investor (or entity) per institution which allows investors to spread their funds across multiple institutions and/or account names, each with up to \$1m, and still receive the "free" guarantee.

- The government guarantee has effectively created a homogenous product for guaranteed deposits providing investors with the choice of approximately 160 ADIs with AAA backing. This has created competition and kept deposit rates high. From 28 November 2008, most ADIs offer a guaranteed and a non-guaranteed rate of return with the difference in rate approximating the cost of the guarantee.
- Non-guaranteed deposit holders are effectively subordinated by a new class of creditor being the federal government (i.e. APRA) who will recoup certain amounts paid out under the guarantee before ordinary depositors and other creditors are able to claim in a liquidation scenario. This will lead to lower recovery rates for non-guaranteed deposit holders and ordinary unsecured creditors in the case of an ADI failure. With this risk in mind, it is recommended that investors ensure all their deposits are government guaranteed, which can be done without reducing the overall return.
- The guarantee has presented a unique opportunity to get an AAA rated cash portfolio but at a similar return to non-guaranteed deposits. As at November 2008, guaranteed term deposits were paying up to 3.5% more than the Government bond yield for essentially the same risk and maturity!

Your questions answered:

Is this guarantee fee pro-rata? So, if you have \$2m to invest, is the fee only paid on that portion OVER \$1m?

Yes, the fee is pro-rata, so any amount invested over the \$1m threshold is either NOT guaranteed or requires the fee to be paid to ensure that it is guaranteed.

What happens if interest is compounded, taking the amount over \$1m?

Anything over \$1m is not covered or requires a fee to be paid.

Can an investor have \$1m spread amongst a number of different ADIs and all of the accounts are guaranteed?

Yes.

Who does the Government charge?

The ADI is charged, not the depositor.

Is the fee a flat fee or per annum?

The fee is an annual fee paid monthly in arrears, charged to the ADI.

How does repayment of guaranteed deposits happen in the event of a wind-up?

The government will repay the full amount owing to the depositor within a short period of the ADI failing. The depositor does not have to wait until the scheduled maturity date. It is expected that any accrued interest would also be paid.

Is the Australian Government, now providing guarantees to foreign bank deposits if they pay the fee?

Yes, but limits apply and there is no \$1m threshold, the guarantee fee has to be paid on the entire deposit amount.

Do deposits made in different names qualify for the guarantee? That is Mr X has a deposit for \$1m, Mrs X has a deposit for \$1m and Mr and Mrs X have a deposit for \$1m? So there are three different accounts each totaling \$1m that are all guaranteed at the same institution? The sum total being \$3m.

The limit is \$1m per entity per ADI. In the above example, Mr X can have \$1m free deposit guarantee and Mrs X can have \$1m free deposit guarantee. The maximum free deposit guarantee in this case would be \$2m, with \$1m in each separate name.

Your financial planner can assist you in planning for your future. Call your financial planner today.

Source: TermDeposit.com.au



Global Agribusiness – the business of feeding the world keeps on growing

Global agribusiness – the business of feeding the world, is driven by long-term secular trends that are bigger than the current problems besieging global markets. We expect that these trends will be a force long after the current global financial problems are resolved, thus providing opportunities for investors with a three to five year view.

Long-term trends

DWS Investments believes there are five inevitable trends driving global agribusiness for at least the next three to five years.

1. Soaring population growth

A fast-expanding global population is fuelling increasing demand for land and food. By 2030, the world's population is projected to hit 8.13 billion, up 26 per cent from 2005's tally of 6.45 billion.¹

2. Rising incomes

Around three billion people have moved from an income below US\$1,000 a year to in excess of \$3,000 a year. The inevitable consequence of rising incomes in developing nations is increased consumption of food and a change in the composition, in favour of high-cost sources of calories such as meat and dairy products and away from cereals. This is creating a multiplier effect in demand for cereals as it requires more grain to feed meat-producing animals. For example, it takes about eight kilos of grain to produce a kilo of beef.²

3. Limited amount of agricultural land

The world is losing agricultural land through global urbanization and the impact of salt degradation and the encroachment of deserts in regions and countries such as Africa, China, Australia and the USA.

In 1950 we only had 2.5 billion people on the planet which meant we had over half a

hectare per person to feed the world. In 2020 we will have an area of only 20% of a hectare to sustain one person for their entire life.

4. Biofuels

The use of biofuels – a type of renewable energy source, has increased dramatically over the last two years and is placing additional pressure on crops that would have traditionally been used for food – such as corn.

5. Global Warming and climate change

Global warming and climate change are long-term problems for agriculture as rising temperatures should ultimately create a loss of agricultural land. Of more immediate concern are the increasing and more violent weather related incidents that are having an impact on agriculture. These include extended periods of drought in Australia and hurricanes such as Katrina in the USA. It appears that weather related incidents are having a larger impact than in previous years.

Investment Opportunities

It is almost impossible to place a timetable on the longevity of the tailwinds supporting global agribusiness such as strong population growth and food demands of the developing world. This is a positive for a host of agribusiness companies around the world.

Investors eager to take advantage of the myriad opportunities in agribusiness should take note of the steps in the production and consumption process – land, planting, fertilising, harvesting, crop protection, irrigation, storing, packaging, transportation, marketing and selling. Companies involved in this process are among those which have strong potential to benefit from higher agricultural prices.

The most prudent approach for investors seeking broad exposure to the trend in agriculture is through investment in a well diversified global fund with a long-term



focus. Diversity – geographically and sectorally, and high-quality, stable income streams are critical for agribusiness funds.

For example, a fund based on the agricultural sector of one country or region would be savaged in the event of adverse weather conditions in that part of the world like a long-running drought or an unexpected weather-induced disaster.

A fund with global exposure, however, would have offsetting income streams from other parts of the world. Also, it would have access to high-growth international markets – an important quality.

Moreover, investors who are serious about reaping rewards should be in for the long haul and that means investing for five years or longer. Choosing a fund manager with a long-term view and the ability to invest in different parts of the world may increase chances of outperformance.

Will there be setbacks given an uncertain global climate? Yes, but any hurdles to price gains in agriculture are likely to be temporary – mere short-term noise. Prices don't move constantly in straight lines either. In the case of the agricultural sector, any volatility should be viewed as a potential opportunity.

¹ Department of Economic and Social Affairs Population Division, (2005), 'Population Challenges and Development Goals', United Nations

² 'Food and Agricultural Organisation of the United Nations, (2008) Conference on Fighting Food Inflation through Sustainable Investment' United Nations.

The sub-prime credit crisis – could it happen here?

The deteriorating condition of the US sub-prime mortgage market sparked a wave of panic that culminated in a global credit crisis. But how robust is the Australian mortgage market and could the same thing happen here? We focus on the key drivers that caused the US sub-prime crisis and reveal why we believe the Australian mortgage market is in a much healthier position and unlikely to repeat the US experience.

How the US mortgage market works

The US mortgage landscape is characterised by three distinct categories. Prime or ‘conforming’ mortgages are ones that meet the underwriting standards for entry into mortgage pools. These are sponsored by the Federal National Mortgage Association and the Federal Home Mortgage Corporation, better known as Fannie Mae and Freddie Mac respectively. The remaining non-prime mortgage market can be grouped into two segments: the ‘near prime’ or highest credit quality segment such as Alt-A (alternative-documentation loans that rely more on credit history than proof of income etc) or Jumbo credit (loans that are US \$500,000 or greater) and the genuinely ‘sub-prime’ category.

Alt-A borrowers may have only minor credit contraventions in their history. Sub-prime borrowers typically bear a much more tarnished credit history and are at higher risk of being unable to service a loan. Non-prime originations reached over 20% of total US mortgage originations in 2006, and are now estimated to account for approximately 13% of total outstanding mortgage debt.

Growth of sub-prime

One of the major features of growth in the non-prime area was the introduction of an array of non-traditional mortgage products including interest-only, negative amortising loans and adjustable-rate mortgages (ARMs). ARMs became increasingly popular

in the US from 2003. They are often referred to as 2/28 and 5/25 loans indicating that the initial two or five year periods are fixed before the interest rate is reset to a much higher variable rate.

Supply

Low initial rates on ARMs reflected aggressive pricing by lenders, particularly for non-prime products. The real cost of these products was hidden by larger upfront fees and prepayment penalties designed to prevent refinancing after the initial interest rates were reset to variable rates. The effect of structuring the loans this way was to delay the real servicing obligation of the loans past the initial few years.

Demand

On the demand side, the attitude to US property had changed in recent years. The rapid appreciation in house prices across the

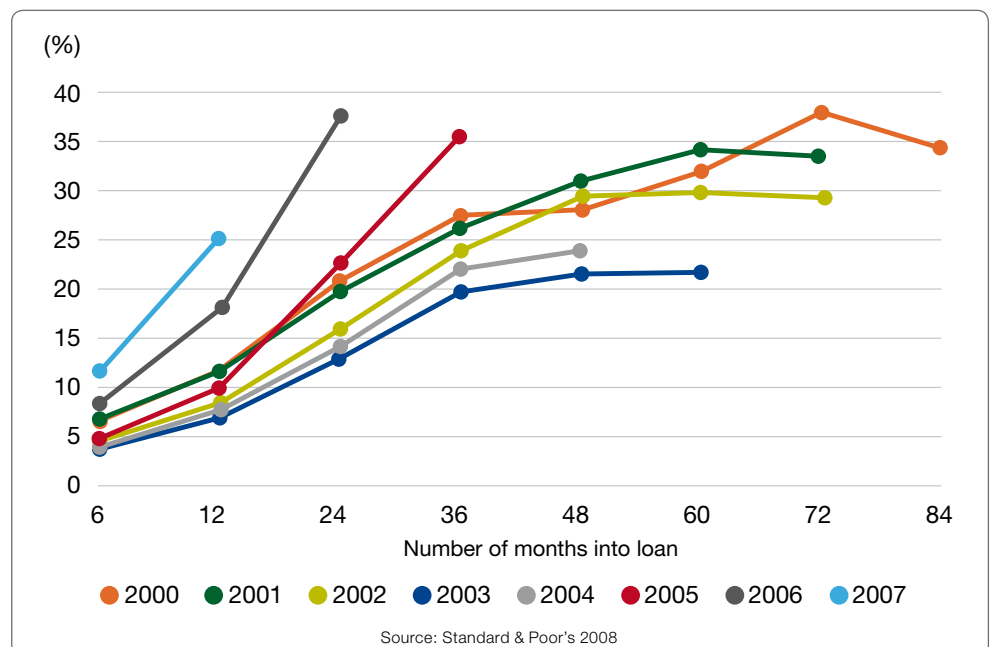
US from 2003 to 2006 resulted in property becoming a very attractive investment option. By 2007, 17% of all non-prime loans were for investment, with 28% of these loans in Alt-A loans and 9% in sub-prime.

Why the crisis?

A number of factors contributed to the sub-prime credit crisis of 2007 and 2008.

Interest rate reset shock: A considerable share of sub-prime mortgages were ARMs featuring low introductory rates. These rates generally applied for the initial fixed period of the loan, usually one or two years, and were often as much as 5% below the rate that would apply for the remaining life of the loan. Typically, investment buyers aimed to sell the properties before the higher interest rates kicked in. Interest rate resets were an important trigger in the sharp rise in sub-prime delinquencies, as shown by Chart 5 (below).

Chart 5: US sub-prime residential mortgage-backed securities total delinquency comparisons



Deterioration in underwriting

standards: From around 2006, mortgage originators accelerated loans to those who were previously considered unable to service a loan. Originators were paid on the volume of loans written and quality suffered as a result. The loans were then sold to another entity, generally an investment bank that packaged the loans into residential mortgage-backed securities. These securities were sold to investors globally such as other banks, investment managers and government authorities. The originators had no long-term incentive beyond their reputation to ensure that the underwriting standards were adequate.

Poor risk assessment by lending

institutions: A study by the US Federal Reserve indicated that the average difference in mortgage interest rates between sub-prime and prime mortgages (the risk premium) fell from 2.8% (280 basis points) in 2001, to 1.3% (130 basis points) in 2007. This happened even though sub-prime borrower and loan qualities declined overall during the 2001-2006 period.

House price falls: Rising house prices allow borrowers, who originally were unable to service their mortgages, the possibility of using their new-found equity to re-finance their loan and use the equity to meet payments or to sell without any loss to either them or the lender. This is not the case when house prices fall. With the extent of price falls in parts of the US, borrowers have been advised in some cases to walk away from the loan and the house, particularly if they are an investor rather than an owner-occupier. To make matters worse, in several US states (and unlike Australia), there is no recourse for the lender to other assets of the borrower in the event of default.

The Australian mortgage market

While the average debt-to-income ratios are similar in Australia and the US, the distribution of debt is very different. Sub-prime lending makes up a small share of the Australian mortgage market (about 1%). Additionally, the majority of household debt in Australia tends to be owed by those with the highest incomes who are most able to service their debt.

Could it happen here?

Our view is that it is unlikely that Australia will experience a mortgage crisis as seen in the US for several reasons:

- Currently, the supply and demand fundamentals are very different here; Australia tends to have an undersupply of housing whereas the US has an oversupply.



- Australian prime and non-conforming loans have lower delinquency rates compared to US prime and sub-prime loans. We believe this reflects the relative strength of the Australian economy, particularly a historically low unemployment rate, growth in household income and better underwriting standards by lenders.
- Australian non-conforming loans have a less risky structure than US sub-prime loans. The average loan-to-valuation ratio (LVR) on newly approved Australian non-conforming loans is around 75%, which is lower than the average 85% LVR on US sub-prime loans. The greater a loan's LVR, the higher the possibility of default.
- In the Australian legal system, a lender has recourse to all of the borrower's assets in addition to the house. This provides the borrower with a stronger incentive to repay their loan.
- In the US, the tax regime provides no incentive for a US owner-occupier borrower to repay additional principal off their mortgage as interest is tax deductible. In Australia, interest is not tax deductible for an owner occupier, giving the borrower the incentive to repay the principal back quickly.

Conclusion

While household debt levels in Australia and the US are broadly comparable, the composition and distribution of the debt is not. The sub-prime market is much smaller in Australia than it is in the US and there are other features pertinent to the US sub-prime market that are not present in Australia. These include low introductory rates, a marked decline in lending standards and a loan origination and distribution model that reduces the incentive for quality. Consequently, arrear rates differ significantly in the two countries.

While the Australian financial system has had minimal direct exposure to the US sub-prime market, it has been affected by the global credit turmoil, particularly in the form of higher borrowing costs. However, the strength of the Australian banking system relative to those in a number of other countries, particularly the US, and the strength of the domestic economy more generally, has resulted in a stronger position for the Australian mortgage market.

Source: AMP Capital

Income Protection through super

Funding disability insurance premiums through super is now an even more attractive option for clients at financially vulnerable life stages who can't otherwise afford cover.

There are many stages of a client's working life when funding Income Protection through superannuation makes good sense. The most obvious scenario is a cash-strapped parent with significant debts and dependants. However, a person trying to boost their nest egg at the tail end of their career can be just as vulnerable given their future quality of life can be compromised if they are forced to retire early due to disability.

The sobering fact is that one in three working Australians will be disabled and unable to work for more than three months before age 65.¹ That's why Income Protection is an essential ingredient in the financial plan of the majority of working Australians, whether they be young people paying off car loans, DINKs (double income no kids) couples saving for their first home, primary breadwinners of young families or empty nesters preparing for retirement.

Unfortunately, the people who most need Income Protection insurance are quite often those with the least disposable income, for whom premium affordability is an issue. The good news for clients in this situation is that recent Australian Tax Office changes have removed the last remaining barrier to



holding all your income protection insurance through super.

Whereas previously the majority of super members could only obtain disability insurance with a two-year benefit period from their super fund – primarily for tax reasons - that's no longer the case. While there's no net tax benefit difference in paying the premium from within or outside the super environment, the latter has a timing benefit (that is, you don't have to wait until financial year end to claim the tax deduction). In turn, clients experiencing cash flow problems can use their compulsory employer Superannuation Guarantee (SG) contributions to help fund the premium.

¹ Calculations based on data from the Institute of Actuaries Australia Interim Report of the Disability Committee, 2000

Source: Zurich Australia Limited

Suggested actions

- For clients with some Income Protection insurance within super and some outside, consider 'combining' the two in super.
- Consider extending the Income Protection benefit period within super from two to five years or to age 65 for clients with additional cover needs.
- Determine whether clients with self-managed super funds (SMSFs) could be better off holding their Income Protection within the super environment. (Before making any changes, ask your financial planner to check whether your Trust Deed allows for release of benefits without a two-year restriction.)

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