



Financially Speaking

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The seven deadly sins of investment decision making



We experience a range of emotions in times of market volatility, which can lead us to make decisions based on short term market movements.

Here we look at the common traps we can fall into and analyse how they can impact longer term investment goals.

The last two years have seen extreme volatility in share markets. From August 2007 Australian shares experienced the worst bear market since 1973-4, followed by a rapid rebound of around 50%, with other asset classes including international shares, fixed income and property following a similar pattern. This has highlighted that there is no simple way to predict the short term direction of markets.

When markets have been consistently rising, we can become over confident, taking greater risks and increasing losses when markets correct. Conversely when we experience loss, we have a greater

tendency to shy away from investments we would normally make or 'panic sell'. While this behaviour helps to defend our financial position, it means we miss out on the bounces and gains in the market, as risk aversion takes over. In the financial world, this is known as behavioural finance.

Here we look at some of the common traps that we can fall into in financial markets and the ways in which they can impact wealth creation strategies. "Behavioural finance is the application of psychology to financial behavior...it exposes the irrationality of investors in general and shows human fallibility in competitive markets." Benjamin Graham. ¹

1. In downturns people forget that the market will ultimately always go up

Most investors understand that businesses go through cycles, and that every now and then there are periods of downturn. When markets do fall, however, we can over react and believe 'this time it is different'.



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Partially spurred on by the short sightedness of emotion, we tend to forget history. Although markets can drop quite dramatically in the short term, they tend to follow the same trend over the long term. Even the Great Depression, which most agree was worse than the current crisis, only registers as a slight dip when placed on Chart 1 below.

The reason many investors disregard history is when they look back on past crises, they view them holistically, and thus are able to see both the causes and the warning signs together. This is a psychological pattern called historical determinism, and produces a tendency to think that historical events should be known in advance. Investors often cannot see the causes or the upside of current events and therefore view them as different to previous events, ignoring historical learnings.

This trap tends to lead to investors refusing to enter the market near the bottom, meaning they miss out on the possible upside as the market bounces back.

2. Investors decide to buy back only once the market has proven it is going up

The second part to this trap is known as the disjunction effect. This is a tendency for people to wait until their views have been confirmed by evidence before acting. Just as investors are tempted to sell out as the market falls, they refuse to buy back in until the market gives them the appropriate signs that it is rising again, meaning they miss out on capital gains.

This is a key reason why many investors who have been sitting in cash or bonds during the economic downturn missed the recent market rally.

3. Investors dislike short term losses more than they like long term gains

You may have noticed that investors become increasingly scared after their investments drop in value. This is particularly the case if their investments have gained substantially in value over the past few years. As illogical as this sounds, when it comes to losses, people are short sighted and when looking at their portfolio they are more likely to focus on short term losses than long term gains.

This short sighted loss aversion can scare us out of good investments when there is short term volatility, causes us to sell after a price drops, and keeps us from investing in strong but volatile markets such as equities. This can be an error when we know that a true driver of wealth creation is long term strategy.

For example in recent months, although markets have been generally trending up, many investors have been concerned by short term volatility, leading them to sell sound investments on short term corrections in the market.

4. Psychologically, if there's one thing worse than being wrong, it is being wrong when everyone else is right

For many, the current volatile market conditions are making little sense, leaving investors searching for answers.

One of the ways that we find answers is a trap called herding. An investor will make investment decisions based on the opinions of friends, family and media rather than follow their own judgement.

This is the reason behind asset bubbles and deep selloffs. As more people herd

towards a particular belief, for instance tech stocks, the more people start thinking along the same lines, causing the price to go up and making more people jump on the bandwagon. This continues both on the way up and on the way down, causing significant volatility in markets.

5. Investors get stuck on the price they paid for an investment, causing decisions to be made for the wrong reason

Investors often compare their share prices to the price they bought the investment for as this is their 'anchor' point. In an investment sense, anchoring occurs when investors base their decisions to sell or buy a stock on a reference point.

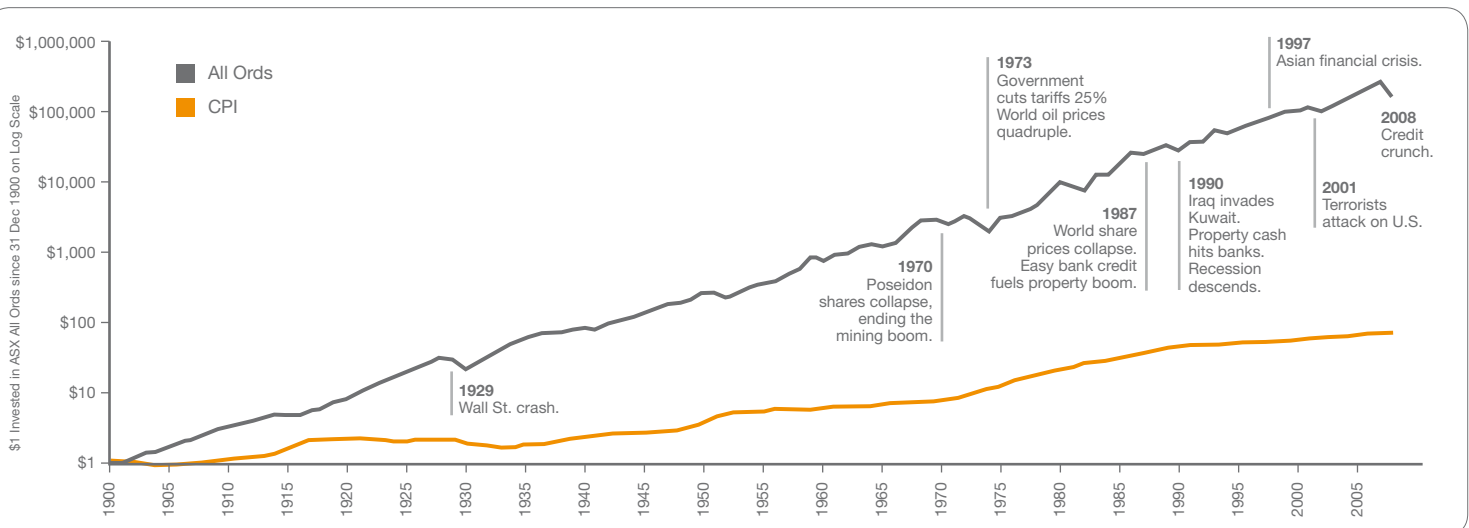
This trap causes investors to sell a good stock too early as it rises (as they compare it to the price they bought it for and think it is a good profit) and conversely to hold on to bad stocks for too long on the way down. As investors are unsure about the appropriate value for their investments, they substitute this for something they do know – the price they paid.

6. Investors believe that trends will continue indefinitely over the short term

The market is always going forward and back. Yet investors have the habit of getting caught up in the most recent direction of the market. This is a psychological trap known as representativeness, and represents our ability to see patterns in random data.

This bias can cause us to make decisions based on meaningless patterns. This may lead us to poor decision making, leaving us vulnerable to poor judgement.

Chart 1:
Key global financial events from 1900





7. Just as investors can become over confident in boom times, they become under confident in slumps

The final decision making flaw is confidence. Confidence plays a huge part in financial decision making, as it is the fundamental reason people invest – they are confident their choice of asset will bring them a strong return. This is also a key factor in asset bubbles, as the higher a stock price gets the greater price an investor is willing to pay, which drives up the market, further increasing confidence. Under confidence has its own unique challenges.

It tends to make us question our assets and delay getting back into the market. This will tend to drive us towards safe assets such as cash, which in times of low interest rates such as now will not benefit from any rally in the market.

Conclusion

It is well known that investment markets are not always rational. It is human nature for investors to want to protect against losses when markets are volatile and get back into markets when they are on the road to recovery. However, the traps outlined above show that when making investment decisions it is important to keep your long

term goals in mind and have a disciplined investment process.

Over confidence and taking a short term view can lead to a failure to spot investment bubbles, while under confidence could mean missing out on some of the best returns, as evidence shows that markets typically produce the strongest results in the early days of a rally.

Always speak to your financial planner when making investment decisions.

¹B. Graham, Securities Analysis, 1934

Source: AMP Capital Investors

The bigger picture

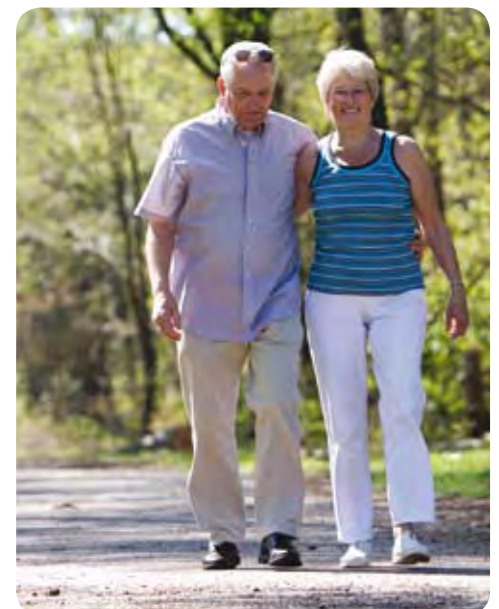
For some investors approaching retirement, there is a belief that 'growth' investments should be sold in favour of 'safer' cash style investments. BT investment specialist, Michael Bailey offers a slightly different view.

Having once known a recently widowed 69 year old lady who was advised to buy term deposits with the money her husband had left the family, Michael Bailey, one of BT's most experienced investment specialists, spends much of his time explaining why that was such bad advice.

"Well, we all thought it was good advice at the time – cash was safe and generated a small income, and the lady was at an age when many investors were winding back their exposure to growth assets.

The problem was that the cash investment didn't generate enough income to support the lady in her 22 years of widowhood. So, she had to tap into her capital as well. By the time she died at age 92, there wasn't much left. She had wanted to leave some money to her children, so even at her age, the advice she received failed to take account of her long-term goals. Despite being a 'senior citizen' at 69, she was clearly still a long term investor."

Michael tells that story because the lady in question was his mother and the 'bad' adviser was himself. Michael's father died in 1974, which was a year when share markets fell heavily. The 'OPEC' oil crisis of 1973 created an environment which 'spooked' investors and advisers alike.



Michael, himself a stockbroker in London at the time, was similarly 'spooked'. He explains that he failed to take into account the long history of share market behaviour which suggested then, and continues to suggest today, that share prices do recover after a fall.

There is plenty of evidence to suggest that investors are just as worried today about the recent volatility in share markets, particularly the 'spookiness' of 2008 when global share markets fell dramatically. But Michael's view is that if we form an opinion based on statistical evidence of just how long the 'long term' may actually be, we can feel far more confident.

Michael endeavours to reassure nervous investors, citing himself as an example and explains why 'long term' to him means a minimum of 36 years. "As a 65 year old male, statistical evidence says that I'm expected to live till I'm 84, so my investment timeframe is at least 19 years. However, my wife is 12 years younger than me, and her life expectancy when I'm 84 will be another 17 years (women typically live longer than men). Unless I want to leave my wife with nothing, I need to consider myself a 36 year investor (ie $19 + 17 = 36$).

If there were children or grandchildren to consider, the term would perhaps be infinitely longer. That's why I'm still a long term investor."

Even so, it's still a hard sell convincing anyone who's seen the value of their investments fall over the past two years that share-based investments such as 'Balanced Funds' really are a good long term investment vehicle. Michael stresses this point.



"To really understand the power of the share market in contrast to cash, you need to look at how the share market has performed over its very long history — not just the individual booms and busts that attract the media's attention. Yes, there have been falls; the big falls of 1929-30, 1973-74, 1987, 2002 and 2008 are all significant. But over the course of the 100 years of history of the Australian share market, we've experienced about 80 years of positive annual returns and only about 20 years of negative annual returns. Even if you look at more recent history, since 1980 the market has generated a positive annual return for 20 of these 29 years."

Michael acknowledges that cash investments will always have their place in a balanced, diversified investment strategy.

The real point he's trying to make is that investors of all ages need to step back from their short term emotional responses to short term share market movements and concentrate on an understanding that share markets tend to be reasonably predictable when we really do look at the big picture.

"Just ask yourself what you really want from your investments? If it's creating wealth over the long term, then cash isn't the solution. Warren Buffet said it perfectly when he said that cash might make you feel comfortable but it's a terrible long term asset, paying virtually nothing and certain to depreciate in real value (after inflation)".

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

Source: BT Financial Group

How do the new concessional caps for super work?

This year's Federal Budget introduced some new restrictions on the amount of annual concessional contributions you can make to superannuation.

What has changed?

Concessional contributions are now limited to \$25,000 a year (indexed) if you are under 50 years of age. If you are aged 50 and over, you can contribute \$50,000 a year (not indexed) until 30 June 2012.

After that date, the \$25,000 annual limit (indexed) will apply to people aged 50 and over as well. Note that if you are over 65 and under 75, you can only contribute to super if you have been gainfully employed for at least 40 hours within a period of 30 consecutive days during the relevant financial year or if the contributions are mandated employer contributions (eg superannuation guarantee (SG) contributions). If you are aged 75 and over, further restrictions also apply.

What is classified as a concessional contribution?

Concessional contributions include employer contributions, salary sacrifice contributions and any other contributions where a tax deduction is claimed (e.g. by self employed people). These types of contributions do not include contributions from a source that has previously been taxed, for example contributions from your after tax salary or the sale of an investment property.

These are referred to as 'non concessional contributions' and they have a separate annual cap, which is currently \$150,000 per year, or \$450,000 for lump sum contributions over three years if you are under age 65 at any time during the financial year.

What is the benefit of a concessional contribution?

Provided you do not exceed your concessional contributions cap, these kinds of contributions are only taxed at 15% rather than your personal tax rate which could be as high as 46.5%. Consequently, they can be a very tax effective way of accumulating money for your retirement.

What if I accidentally contribute too much?

Concessional contributions in excess of your concessional contributions cap will be taxed at an additional 31.5%, and will also count towards your non concessional contributions cap. If you are making significant salary sacrifice contributions, it is important to take into consideration how much your employer is contributing on your behalf (e.g. contributions to satisfy their obligations under SG and any applicable awards or employment contracts).

Essentially, these changes mean you may no longer be able to wait until the verge



of retirement to put large sums of money into super, to quickly boost your retirement savings. Super has now become more of a long distance race requiring a longer term strategy to make the most of its inherent tax benefits and generous government incentives.

In order to avoid being subject to extra tax, seek the advice of your financial planner when planning your super contributions.

Source: Colonial First State

Summary of contribution caps

	Concessional cap*	Transitional concessional cap*	Non-concessional cap
2009-10 financial year	\$25,000	\$50,000	\$150,000
2008-09 and 2007-08 financial year	\$50,000	\$100,000	\$150,000
Tax on amounts over the cap	31.5% (in addition to the 15% paid by the super fund)	31.5% (in addition to the 15% paid by the super fund)	46.5%
Other information	Any concessional contributions in excess of the cap will also count towards the non-concessional contributions cap	Any concessional contributions in excess of the cap will also count towards the non-concessional contributions cap	If you are under age 65 at any time during the financial year the contribution is made, you can bring forward two years of contributions, effectively allowing you to contribute up to three times the cap at once, or at any time during the three financial years.

Source: Australian Taxation Office, www.ato.gov.au

*The \$25,000 concessional cap will be indexed annually from 2010-11 onwards to average weekly ordinary time earnings (AWOTE) and rounded down to the nearest multiple of \$5,000.

*The transitional concessional contributions cap is for those aged 50 years or older and is available until 30 June 2012.

If you are considering making extra contributions to super, ensure you understand all the implications by reading this document.

Last Modified: Thursday, 3 September 2009



Is heart disease in your genes?

Do you have a family history of early onset heart disease? Get yourself checked out, says Heart Foundation Ambassador Tania Curtis, who was recently diagnosed with the same heart problem that killed her father 28 years ago.

When Tania Curtis was told that she had an 80 to 90% blockage in her left main artery and a blood clot lodged in her heart, she thought the angiogram operator at Sydney's Sutherland Hospital was joking.

A week earlier, the 47 year old mother of four had been jogging with her personal trainer around an oval in Kurnell when she experienced a sharp pain in her chest – “like a bolt of lightning” – that radiated down her left arm. While the pain lasted only a few minutes during which she “turned grey”, the trainer sent Tania home and told her to get a check up before exercising again.

As fate would have it, Tania already had a doctor's appointment booked for the next day simply for a general check up. And while her electrocardiogram and blood tests came

back normal, the doctor fast tracked an appointment for Tania to see a cardiologist.

Tania was convinced that the episode in the park was just a bad bout of indigestion, even when the cardiologist insisted she undergo an angiogram, which was booked in for 18 March 2009 – her 20 year wedding anniversary.

But instead of spending that evening celebrating the milestones with her husband John and their children – Ryan, 19, Stephanie, 17, Linden, 13, and Kathleen, 11, Tania found herself in Prince of Wales Hospital waiting and being prepared to undergo an emergency double bypass operation the day after her angiogram.

Eight months on, Tania is back in the pink of health and pursuing the fitness program that she had started six months before her life changing episode in the park.

“I came very close to dying and feel very lucky to be here,” says Tania. “My father Norm died from a heart attack in 1971 aged 38. When I found out that I had to have open

heart surgery, I was really concerned about how my mother, Dorella, would react”.

“Being a woman, I never thought this would happen to me. Women in their early 40s tend to put on weight in the tummy region as oestrogen begins to leave their bodies. The reason I started my fitness campaign was because I wanted to lose this weight, which I thought was to blame for some breathlessness I'd begun to notice when I walked briskly.”

Tania, who has been a vegetarian since she turned 20 and doesn't drink or smoke, says that her genetic predisposition made her a prime candidate for heart attack; it was just a matter of time.

“My other arteries were perfectly healthy, so lifestyle factors weren't to blame for my condition,” says Tania, who is now an Ambassador for the Heart Foundation. “I smoked when I was young but gave up 21 years ago. Had I kept smoking, like my father, or had a bad diet then this would have happened to me a lot earlier”.

“The cardiologist described my blockage as the ‘widow maker’.

Had I not sought medical attention when I did, he says I would almost certainly have died within a week or two.

“Everyone’s signs of an impending heart attack are different. Some people experience a pain in the ear; others get breathless or have a heavy, crushing feeling in the chest.

My father had tingling pain and a heavy feeling in his chest for six months, which the doctors attributed to indigestion because he didn’t fit the profile of someone at risk of heart attack”.

“My advice is to listen to your body and if it gives you signs, no matter how subtle, that something’s not right, see your doctor. It’s better to have a heap of tests that come back negative than leave your family motherless or fatherless because you were too embarrassed to see a doctor about some seemingly trivial symptoms.”

Tania says a CT scan, a less invasive procedure than an angiogram, which is often covered by private health insurance, can sometimes rule out or confirm any artery blockages. “In light of our family history, I’ll make sure all of my kids get tested for heart problems when they’re older,” she says.

Tania, who went back to her part time job at Kurnell Public School Before & After School Care a couple of months after the operation, says being fit not only helped her pull through the operation but also sped up her recovery.

“The ambulance officer who looked after me on the trip from Sutherland Hospital to Prince of Wales said I had the best ECG results for someone with a 90 per cent blockage that he’s ever seen,” says Tania.

“I didn’t really have time to get too upset between when I was told about my heart condition and the operation because everything happened so fast”.

“What was really scary was waking up at 2am the morning after the surgery in a great deal of pain and not being able to talk or move my head because I had an incubation tube down my throat. All I could do was whistle”.

“Apparently, this had been left in because I was experiencing problems breathing and waking up after the anesthetic.”

The day after surgery, Tania was walking in her hospital room; within a week, she was convalescing at home.

Tania said that while her husband had to go back to work straight away after her operation, she had a lot of help from her family – her two brothers, mum and sister in law – while she underwent eight weeks of cardiac rehabilitation as a day patient at Sutherland Hospital. The program involved a couple of hours of education per week, as well as several hours of supervised stretching and aerobic exercises.

“In hindsight, blindly embarking on an intensive exercise program with my family history of heart disease, fitness level and tummy fat was a bit foolhardy,” says Tania, whose only visible side effect from the surgery six months down the track is a deep vertical scar on her chest that will fade with time. “If you’re very unfit, it’s always a good idea to have a medical check up before pushing yourself too hard on the exercise front.”

Tania says she didn’t have to make too many lifestyle changes after her health scare, though she is still trying to shed a few kilos and now takes several forms of medication in addition to the blood pressure pills she was already on. She began exercising again in earnest after rehab finished and now jogs and does several boxercise classes per week.

“The only real change I’ve made is to try not to worry so much about trivial things,” says Tania, “to let things wash over me, as my mother likes to say.”

Cover for heart disease and other traumas.

Insurance cover is available to help you and your family cope financially if you are diagnosed with heart disease or other serious trauma. Speak to your financial planner to find out more.

Source: Zurich Investments.



The outlook for investment markets

Listed property

Australian real estate investment trusts (A-REITs) have been severely beaten back from overvalued levels, reflecting the sector's high levels of indebtedness and complex financial engineering. Looming debt maturities and falling valuations continue to plague the sector, and further announcements regarding breaches of loan covenants are anticipated. Increased vacancies will also drag earnings down over the course of the economic slowdown. However, much of this bad news is known and has been priced in by the market, and many A-REITs have rallied hard from near capitulation selling in March 2009. Quality A-REITs caught up in this vicious selling now offer good long term value for patient investors.

Residential property

Residential property has benefited from rising rents and an increase to the First Home Owner Grant, providing some support (distortion) for prices. Once government grants and stamp duty holidays are fully phased out this activity may slow as high house price to disposable income ratios continue to adjust.

Cash

The Reserve Bank of Australia (RBA) slashed interest rates from 7.25 to 3.00% in a succession of quick moves as the credit crunch took its toll on the local economy. The RBA has subsequently raised cash rates three times by 25 basis points, leaving the official rate at 3.75%. More rises are imminent as the RBA begins to march towards neutral levels.

Bonds – Australian and international fixed interest

Yields remain attractive on high quality corporate debt, which could result in a degree of spread compression when confidence reverts to more normal levels. Until then, investors should closely monitor default rates in the sector. Government bonds also enjoyed good returns as rates were cut across the globe. However, rising yields may be the source of short term pain when the rate cycle turns.

Australian shares

The Australian market has rallied more than 50% off its March lows. While a correction of sorts cannot be ruled out after such a strong bounce, the market has been supported by improving economic conditions and a better than expected reporting season, primarily off the back of aggressive cost reductions. However, the share price rally of some companies should be treated with caution, given that the problems of highly leveraged balance sheets have not gone away. On the other hand, opportunistic companies, which have raised additional capital to the tune of \$90 billion in recent months, find themselves better placed. While our banks remain in relatively good shape, attention must be paid to bad loan provisions, although recent outlook statements from a few of the 'big four' banks suggest that this cycle may be close to peaking. Dividend cuts across financial shares are indicative of the need to preserve capital. Evidence of earnings stabilisation could provide a positive backdrop for shares for the remainder of 2009, albeit at a more subdued pace.

International shares

The green shoots of recovery have put a fire under global markets at a time when most investors were pondering how much further things could fall. From March lows, equity markets across all the major regions are up in excess of 40%. The US recently reported GDP growth in the third quarter bringing their recession to an end, although unemployment rates have moved through the 10% mark to a new 26 year high. US equities have all but completed their latest round of quarterly earnings, with the majority of corporates beating expectations. Global markets are factoring in a robust economic recovery, though some expectations are more subdued. It is possible that disappointing data could halt the market's march, along with any withdrawal of expansionary policies. Investors should continue to look to companies with strong market positions and that are capable of generating solid cash flows.

Source: Zurich Investments, November 2009

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