



Share Watch

Client newsletter Number 2007/7

The key to achieving sound investment returns from equity investments is to build a diversified portfolio with a focus on “blue chip” quality shares, in companies producing sound and sustainable profits.

With the recent volatile movements in international and domestic share markets, we thought it appropriate to reassure clients, and remind you of the key principles we use in structuring our clients' investment portfolios. These principles are sound, and do not change despite market volatility. These include:

Quality Focus – Our recommended investments, in either the International or Australian markets, represent investments in quality companies that are financially sound, with strong performance histories, strong earning flows and a stable financial base. We do not recommend clients invest in speculative or unproven companies. Our focus is always in Blue Chip companies.

Diversification – Your investments are not concentrated in one single stock, but are in a broad mix of quality companies. We also recommend diversification across asset classes, as well as management styles. These principles are designed to best protect your portfolio returns in periods of market instability.

Long Term Focus – Our aim is to recommend client portfolios that grow over the long term. The key to this goal is to invest in quality companies whose earnings also grow over the long term. As earnings grow, so do distributions, and the value of the companies themselves. This effectively means that in good and bad times, you will profit from investing in these companies in the long term, despite short term movements in stock price.

Independent Research that is consistently reviewed - We keep an eye on market conditions, and receive

expert advice on companies and managers, through our Fund Watch and Stock Watch processes. These processes are designed to keep your investments on track and to ensure that you are investing where you should be. Our research is current and independent.

The market has been extremely volatile over recent weeks. This volatility is on the back of extraordinary growth, particularly in the Australian market, over the past 2-3 years. Despite this strong growth, our fundamental principles have not changed. Investing in solid companies, within a strong diversified portfolio, will always yield strong results in the long term.

With this in mind, we bring to your attention the following commentary as recently issued by industry expert Anton Tagliaferro, Investment Director with Investors Mutual. We endorse his commentary.

Should you need to clarify any aspect of your current portfolio, please do not hesitate to contact your Client Service Manager or Kate and Sara from our Financial Services team.

Anton Tagliaferro discusses last week's share market drop and the outlook for the period ahead.

The Australian share market dropped by more than 5% last week reflecting large losses on Wall Street, which fell back on concerns about the state of the US mortgage and housing market and its impact on consumer spending and the economy after continued poor news on the sub prime (i.e. below investment grade) mortgage market.

IML investment director, Anton Tagliaferro, says: "What is happening today in the US had unfortunately become inevitable and reflects the very loose credit standards used by many lenders there for many years. With defaults now inevitably rising in the once booming sub prime market, credit spreads on corporate debt are blowing out as investors require a higher return for the risk. As a result, global credit markets are in turmoil. As we mentioned at our Adviser Briefings earlier this year in February and March, the amount of consumer debt taken over the years in the "sub prime" markets in the US as well as the narrowing of spreads on junk bonds made the current shake out inevitable".

So what does the current volatility mean for longer term investors?

Tagliaferro said: "We have always been big believers in holding quality stocks in our portfolio. By quality we mean companies that have a recurring earnings stream, a solid management team and a good balance sheet. While much is written about the fact that our share market is backed by good fundamentals, in our view there are many areas where this is not true at the moment as a result of many investors having lost focus of the risk attached when investing in the share market".

"For example, today there are currently dozens of mainly speculative mining stocks that make absolutely no money and which are currently being valued by the share market at billions of dollars. Clearly the losses in this area will be significant when share market sentiment is not as bullish as it has been over the last few years and the holders of stocks such as these begin to question the wisdom of continuing to hold these speculative companies. In other areas too, such as the mining contractor area, in our view many stocks are priced at ridiculous levels given the level of risk and volatility of the earnings of most companies in this sector."

Clearly in weeks like last week where share markets are falling as many geared investors seek liquidity, almost every

share fell. It didn't matter whether you were a hundred year old liquor company like Fosters, or a lower risk toll road operator like Transurban, or a much higher risk company like three year old mining hopeful Fortescue, or contracting company Transfield."

"The reality though is that those companies that have real assets and real earnings will recover their losses over time, while many other companies which have zero earnings will inevitably trade at fractions of what they are trading at today at some stage in the future."

Is this the end of the bull market of the last four years?

"This is always a difficult question to answer. The main problem with bull markets is that eventually they mature and excesses occur as many investors throw common sense to the wind and do not invest in a sensible manner. Inevitably bull market excesses always disappear when investors become more cautious. There is no doubt that valuations in some areas of the share market today are excessive and at some stage these valuations and excesses will unravel."

Having said this there are many good quality companies like Fosters, Transurban and IAG that our analysis indicates are very attractively reasonably priced at the moment for an investor with a three to five year horizon and we are very happy to use our Fund's cash holdings at times of duress in the share market, such as now, to add to our holdings in these high quality companies".

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