

News & Views

From George Cochrane

In its 19th year of publication

January 2010: Difficult questions

Some questions are hard to answer. For example, “*Where did the Scots come from?*”

The Latin word *Scotii* originally applied to a Gaelic tribe that inhabited Ireland and, according to current history texts, invaded Scotland in the 5th century, conquering the local Picts.

However, the Scots themselves have a different story. In the 14th century, a petition to the Pope, signed by 38 Scots lords, carried this curious view of history. “*Most Holy Father... from the chronicles and books of the ancients we find, that ... the Scotsjourneyed from Greater Scythia by way of the Tyrrhenian Sea and the Pillars of Hercules, and dwelt for a long course of time in Spain..... Thence they came, twelve hundred years after the people of Israel crossed the Red Sea, to their home in the west where they still live today....they have held it ... ever since. May it please you to admonish and exhort the King of the English, who ought to be satisfied with what belongs to him since England used once to be enough for seven kings or more, to leave us Scots in peace....*”

The document, known as the Declaration of Arbroath, dated April, 1320, thus defines the ancestry of the Scots as stemming from areas around the Black and Crimean seas, quite different to today’s text books (unless the Scythians approached Scotland via Ireland!).

Another example of a difficult question is “*What will the stockmarket do in 2010?*” Again, we might take a look at history.

The table in the following column illustrates the returns from the Australian stockmarket for the years ending in 9 over the past century (apart from 1909 for which figures are not available) and the years ending in zero.

ASX market return in:-	For years ending in 9		For years ending in 0
1909	n/av	1910	0%
1919	10%	1920	5%
1929	-14%	1930	-34%
1939	2%	1940	-2%
1949	4%	1950	26%
1959	34%	1960	-8%
1969	9%	1970	-21%
1979	37%	1980	43%
1989	11%	1990	-22%
1999	12%	2000	0%
2009	33%	2010	?
Average	14%	Average	-1%

How the All Ords performed in years ending 9 & 0

Summarising, only one of the years ending in 9 has provided a negative result and the average return over the 12 months was some 14pc.

Thus the past year, 2009, which saw the Australian stock market rise a total of 33pc, was unusually high, ranking 3rd over the 10 years that form our sample.

By comparison, the years ending in zero have averaged an unpleasant minus 1pc over the past century, with five negative results and two others registering zero.

The textbooks would say that the number of the year should have no bearing on movements in the stockmarket. But mythology may again have a different conclusion. For example, of the five years ending in zero that occur halfway through a US Presidential term (as 2010 will be) i.e. 1910, 1930, 1970 and 1990, four failed to produce a positive result.

On the other hand, the highest return among any of the 20 years covered in the above table was in 1980 and thus falls within this group.

So what can we expect from 2010? I suspect that much will depend on moves in two overseas markets, those of the US and China.

The picture below shows how New York's **Dow Jones Industrial average** of 30 top stocks has behaved since 2000, when it peaked following the "dot com" boom.



The US's Dow Jones bounced up in 2009.

After a fall (which included the 9/11 collapse) to its low in 2003, the index climbed to a historical peak in 2007 before falling again.

It finally turned up in March, 2009, showing the sharp V-shaped recovery seen above. If measured from the low point it reached in March, the Dow has climbed 55pc. However, if we look at the whole of 2009, then the market's advance is a more modest 19pc, illustrating just how sharp was the fall between January and March last year.

Technically, the index has almost climbed back to the neckline formed by the post-2003 recovery. One of my favourite adages is that *vertical rises give rise to vertical falls*. Hence I suspect that the Dow will, at best consolidate for a while or, at worst, fall back as those lucky enough to have ridden it up since March, take some profits.

The major problem vexing the markets is the question of the US national debt, which is in the trillions. Debtors tend to be able to carry their debts until their lenders lose confidence. Such changes in lender psychology tend to be rapid, rather than slow, as belief in the security of their investment disappears in the face of a sudden realisation.

The example I tend to use is that of Alan Bond whose banks sailed merrily along with him, lending billions, until a report out of London, commissioned by a company which Alan was then trying to takeover, Lonrho, denounced him as insolvent. Overnight, his lenders abandoned him and his whole empire of cards collapsed.

I'm hoping something similar will not happen to the US, as the results would be truly catastrophic.

The other country which has the power to seriously affect the trajectory of the Australian economy is China.



How the Shanghai index has moved since 2005

The Chinese stockmarket took a much larger beating than did those of most advanced economies, falling some 73pc between its peak in October 2007 and its nadir in October 2008, some five months before the US and Australian markets turned.

Thus as the year 2009 began, Chinese shareprices were already off their lows. Overall, the **Shanghai Composite Index** closed on December 31st having risen 80pc in calendar 2009. However, the picture shows how the Index in fact peaked in August, after it had climbed 91pc since January 1st, and has been consolidating ever since.

The triangular consolidation pattern shown tends to lead to further rises, so I would estimate that the Chinese market is likely to keep climbing once it emerges from its current sideways movement.

How are these two likely to affect the Australian sharemarket?

The picture in the following column illustrates moves in the Australian sharemarket's **All Ordinaries Index** since 2003.

If we look at 2009 alone, the All Ords opened the year at 3,659 points and then fell to a low of 3,091 on March 10. By closing on December 31, 2009, at 4,883, the Index rose a total of 33pc. If measured from its low point in March, the Index has risen almost 60pc. While this is phenomenal, it is really just a bounce from an oversold position.



How the All Ords has moved since 2003.

However, the climb really stopped in mid-October, when the All Ords touched 4,898 and, in fact, has yet to surpass that peak. Thankfully, the traditional “Christmas Rush” kicked in early in the month and, measured from its low point in December, the All Ords has climbed nearly 270 points or 5.8pc. It still seems to be rising although, looking back at the previous January 2009, the Rush petered out after the first week and the market went on to collapse to its March low point.

Technically, the picture above shows how the Index formed a “mountain peak” between 2006 and 2008, before falling through the neckline drawn in. The textbooks say that, after falling through such a line, an index will return to the line in a majority of cases, only to fall away again.

While this is obviously something to watch out for, I am not yet ready to forecast that it is about to happen. I am hoping that the December rise will continue through January. One of the things I will be watching for is just how much further the index will climb. If it gets past the 5,250 level, the left “wing” of the V-shaped pattern seen in the past year, I’ll start to feel a bit more relaxed.

In conclusion, the behaviour of the Australian sharemarket seems to mirror that of the US market far more than it does that of the Chinese sharemarket.

So although Shanghai can be expected to show a positive return over 2010, the uncertainty being shown by the US market is more likely to be reflected in ours, hopefully to a lesser extent.

As ever my approach will be to watch any downturn closely and try to warn clients ahead of any major plunge. So keep a careful watch on the mail and be prepared to act promptly.

Property prices

The company, RP Data, reports that median house prices for the 11 months to November, rose 17pc in Melbourne, 15pc in Darwin, 14pc in Hobart, 12pc in Sydney and 6pc in both Brisbane and Perth.

This is to be expected as the lack of new construction restricts the availability of housing in the face of surging immigration. I don’t expect interest rates to begin to bite until mortgage rates climb above 8pc. Right now, with standard variable home loans around 6.75pc, that’s another 1.25pc to go.

The Reserve Bank’s official Cash rate is at 3.75pc while the the RBA’s desired “business neutral” level is around 5pc. Given the sharp rise in house prices, I wouldn’t be surprised to see that reached before the end of 2010, adding 1.25pc.

However, this is unlikely to stop any surge in property prices until new supply kicks in. Readers may remember that variable mortgage rates were pushed as high as 17pc in the late 1980’s.

Ongoing investment strategies

In order to summarise my analyses of various investment markets, *News & Views* offers the following table of recommendations, updated each month.

Where to invest in the current investment climate	
Low risk investors	50pc Balanced: 50pc Cash
Medium risk investors	25pc shares/equity funds incl selected “Big 4” banks, 75pc Balanced
Higher risk investors	70pc equity funds/ongoing shares, espec the “Big 4” banks/30pc small cap funds, resources & geared funds.

Don’t forget that managed funds can be readily switched into Cash if the stockmarket starts showing heavy falls.

Investors who don’t like to move their money around overly i.e. see themselves as long term investors, should stay put. Others, especially those in volatile geared funds, who want to minimise the risk of being caught in an unexpected market slide, may switch to Cash temporarily, and accept the risk they may not get in again until the market is higher than it is now.

By “selected shares” I mean a handful of strong, high income-paying shares. By “ongoing shares” I refer to those clients who doggedly stick with their share portfolio through thick and thin, regardless of the surrounding investment environment. **Remember that this is generalised advice and may not apply to your specific circumstances. To get personalised advice, please make an appointment.** Please see the disclaimer below.

Are SMSFs heading for more restrictions?

The Cooper Review into the Australian superannuation system issued its “*Phase 3: Structure Issues paper*” on December 14, focussing on Self-Managed Super Funds (SMSFs).

My view is that the paper asks questions that can severely restrict the freedom of trustees. Since SMSFs are typically established to give the trustees the freedom they personally require, some of these points strike at the very heart of a person’s desire and ability to run an SMSF.

Below is a small summary of the questions posed in the paper:-

Trustee Issues : (i) What purpose does the current limit on fund members serve? Is four the right number? Why not seven or ten? Alternatively, should SMSFs be limited to one member?

(ii) Is there an age where the trustees of an SMSF need to be encouraged to move their retirement income arrangements out of their own hands or at least into simpler products needing less active management?

Trustee education: Given the obligations of being a trustee and the minimal barriers to entry, should there be some minimum level of financial and compliance knowledge/ongoing training required?

SMSF structure: An alternative model (to a trust structure) would be for SMSFs (and the rules that govern their operation) to be created by legislation, rather than by private instrument. A SMSF could then be created simply by completing an approved form and paying a prescribed fee to the ATO. Alternatively, a standard trust deed could be provided by the ATO at no cost. Would either of these approaches save costs and benefit new SMSF members?

Custody: (i) Could aspects of the Small APRA Funds (SAF) model be incorporated into SMSFs, such as a hybrid structure where trustees are comprised of both members and an independent external trustee? (*Ed note: More fees?*)

(ii) Would third party custody of fund assets have a role to play in removing the instances of illegal early release (and other breaches of the SIS Act) in the industry? (*Ed note: Still more fees?*)

Separately Managed Accounts (SMAs) and wraps: Could these be viable alternative structures to SMSFs? If so, what would need to be done? (*Ed note: And still more fees?*)

Asset allocation: SMSFs have been over-represented among the creditors to several high profile corporate failures such as Westpoint, while the balance of the superannuation industry had very little exposure. Does this reflect a particular vulnerability for SMSFs in the face of commission-driven marketing by financial advisers? (*Ed Note: None of my clients were placed into Westpoint, or Timbercorp, etc.*)

Investment Restrictions: (i) Should SMSF investments be restricted to what might be regarded as 'financial assets', such as listed equities and managed funds?

(ii) Should SMSFs be permitted to continue investing in artwork and collectibles or should they be phased out over time?

Compliance coverage: Given the community interest in the efficient operation of SMSFs, should the supervisory levy, currently set at \$150, be increased to, say \$500, to match the level applying to SAFs to fund higher levels of regulatory oversight? (*Ed note: Ouch??*)

Auditing SMSF establishment: Would the SMSF system benefit by having an approved auditor verify that a fund was appropriately established before it could be registered with the ATO? (*Ed note: Yet more fees?*)

(For a complete look at the paper, go to www.supersystemreview.gov.au/content/downloads/structure_issues_paper/Phase_3_Structure.pdf. The closing date for submissions is February 19th, 2010.)

May I take this opportunity to wish all readers a Happy and Prosperous New Year!

Disclaimer: This newsletter represents my current opinions, based on my available information and is a form of general advice that may not be suitable to your individual circumstances. As markets change, I will change my perception of them and their prospects and communicate these to my clients with the intention of helping them make more money than they would without this service. But some changes occur too suddenly and some are simply unforeseen. Your investment decisions are ultimately your own and should be based on as many opinions and sources of information as you can gather. This is generalised advice and may not apply to your specific circumstances. The writer and associated persons and companies may have interests in securities mentioned in this newsletter but these are unlikely to benefit from any recommendations made. Published by George Cochrane, Australian Financial Services License 237380. Tel 02 9363 2744. Mailing address PO Box 3001, Tamarama NSW 2026. Email: georgec@cochrane.net.au. Internet: <http://www.cochrane.net.au>. Annual subscription \$64.90 incl \$5.90 GST.