Volume 1, Issue 5

July 2006

SIRA VIEWS

Where To From Here?

The general consensus among other fund managers and stock broking market analysts I speak to is that the recent fall in the market is just a correction.

The problem with this is that the consensus is often wrong!

Why do we have doubts?

Firstly, the Australian bull market has run long and hard. From its low point in March 2003, it doubled to the peak in May this year. The US S&P500 index has risen 2/3 during the same period. Now the balance of probability is that after a run this big and this long (three years) the market needs to catch its breath before it moves up again. In the very long term (20+ year timetables), the share market has risen steadily, generating (since 1950 and 1970) total returns of 14.8% per annum. This *includes* previous bear markets, corrections, etc. This rate means that an investment will double every 5 years. Over 26 years, again at this rate, the initial amount will multiply 36 times. These are amazing numbers, and emphasize the long-term benefits of being invested in shares.

However, within that longer-term upward trend there are spells when markets go sideways, and sometimes fall. Since in the long term the risk lies in being *out of* the market rather than *in it*, the best strategy if you think a downturn is coming is usually not to liquidate holdings and go into cash, but to choose less 'risky' shares, though some cash is also useful. This way, if the market does go up, your portfolio will too, even if it's less than the 'market'.

This is particularly important when central banks move from adding liquidity to the system to removing it. Across the world, central banks have raised interest rates steadily. At first it was just the US, because there they had fallen the most as Alan Greenspan slashed the Fed Funds rate to stave off recession and deflation. But now the other central banks have joined the party. The European Central Bank has raised the discount rate from 2% to 2.75% over the last six months. Japan is about to move from a zero discount rate for the first time in several years. The Bank of China has tightened reserve requirements at commercial banks. And as we have discussed before, inflation is trending up, so the risk is pretty high that they will continue to tighten. This is a good reason to be cautious.

But there are other reasons. Government bond yields are rising. All investments are valued relative to all other investments, taking into account different risks and expectations. So if bond yields rise, then the earnings yield should too (the earnings yield is the inverse of the p/e ratio). As the attached chart shows, this is what happens.

In This Issue

Is the big bull run over?

Special points of interest:

- *Market likely to travel sideways*
- *Inflation in US remains key risk*
- *Long-term equity returns excellent*

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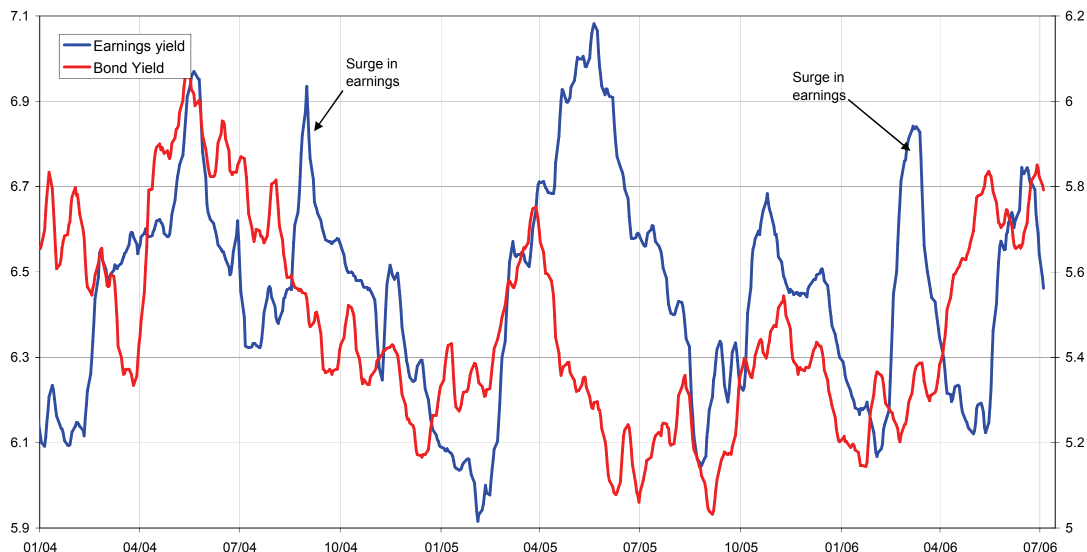
Market Update:
Nigel Purchase

Now bond yields are rising in part because – you guessed it – inflation is rising. They have been abnormally low in the US despite a switch in Government accounts from big surplus to even bigger deficit. This has been partly because of very low cash rates, but partly because China and other Asian boom economies have been investing their current account surplus in US Treasuries – the widest, deepest and most liquid securities market in the world. If the surplus in these countries goes down, they'll buy fewer US government bonds. And, it seems very likely that their combined surplus will go down over the next year or so.

We believe that we must remain cautious about market prospects. *However, we don't believe that there will be a bear market.* The market appears more likely to trend sideways from here, though there will be the usual up and down shorter term moves. Earnings rises will help mute the effects of higher short- and long-term interest rates. But just in case there is a bear market, we need to remain vigilant and continue to both spread our investments to maintain diversification as well as maintain our bias towards defensive stocks. Even if the market drifts sideways, our typical portfolio will earn around 7% in dividend income after adding back franking credits. This is a respectable return. Moreover, our portfolio structure leaves us positioned for both bear markets as well as moderate increases in the market. Only in the extreme cases of another huge run in the market or a major economic recession, will your portfolios be inappropriately structured, in the first case because we will not be holding enough 'aggressive' stocks, and in the second because many of the classic defensive stocks (banks, for example) will be hit by poor earnings. However we believe that there is a small probability of either of these possibilities occurring.

THE EARNINGS YIELD AND BONDS



As always, if you have any questions or concerns, please do not hesitate to contact us.

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