Providence Wealth Advisory Group

Global Outlook & Strategy

3rd Quarter 2012

Investment Overview

The current investment climate remains particularly challenging with little historical precedent.

How will it resolve? We don't know. Politics are now the deciding factor in the fate of the global economy and sustainability of the financial system. At the core of the current issues is the well-publicised euro zone malaise, anemic growth in the US and concerns of a significant slowdown in China.

Global bonds in the "safe" havens namely the US, Germany, Switzerland and Japan are at levels that are indicating a deflationary environment with investors focusing on return OF capital rather than return ON capital. The current crucial issues facing the global economy cannot be simply plugged into a spreadsheet and solved.

Sovereign debt defaults are not new in history. In fact Greece has spent almost half of the past 210 years in default or rescheduling debt. It's the interconnectivity within the banking system that is causing the concern.

Combine the complexity of an interconnected banking system, the uncertain global political policy and leadership, excessive government debt levels and irrational human behavior and you have a situation where a high conviction stance is not defendable.

We can listen to the noise of the high conviction calls from Bull or Bear market commentators in the 24 hour news cycle but a more measured, cautions and humble stance is required in order to protect and preserve wealth.

A well-diversified investment portfolio focusing on sustainable income with plenty of patience is required in the current environment.

The near term outlook for risk assets however remain challenged with a disorderly breakup of the Euro a possibility. This is as hard as it gets from an investment management point of view.

Some of the statistics;

- US 10 year Treasuries (Government bonds) at 1.45%, lowest in 220 years
- US AAA corporate bond yields, the lowest in 50 years
- US real home prices 43% below 2006 peak, greatest bear market since 1921
- Japanese equity market cap of 8% of the global market is at an all time low vs. 44% in 1988
- The greatest Bull Run in US government bonds as yields fall from 15% in 1981 to 1.45% today
- German and Swiss Government bonds at negative nominal yields

Economic and Investment Market Overview

The risks to the global economy have skewed towards the downside over the past three months.

Poor income growth in the US, softening retail sales and lower consumer sentiment and weakening job growth numbers have placed pressure on GDP growth expectations with a 1.5%- 2% number looking more likely for the third quarter.

Europe is a genuine worry with most of Europe already in recession and Greece and Ireland more closely aligned to a depression.

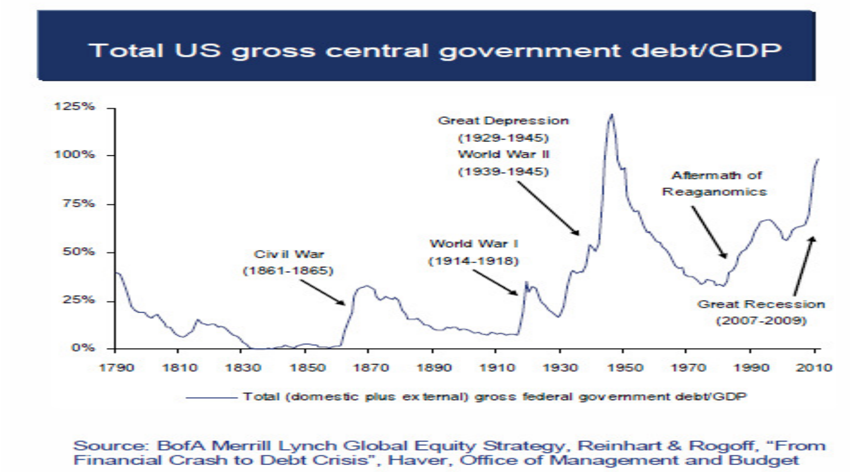
Japan posted strong Q1 growth as the recovery from the rebuilding related to the tsunami boosting growth to 3-4%. This is likely to trend back towards 2-3% by year's end.

Chinese GDP has slowed to 7.6% and has now seen four consecutive quarters of decline in growth momentum. We do not believe there will be a hard landing in China and think further monetary stimulus is likely.

The recent national accounts out of Australia seem too strong to be believed at an annualized pace of 4.3%. The structural changes within the economy with the heavy bias to mining, masks other parts of the economy that are close to recession. Conditions are expected to soften overall, due to the high cost structure, a higher than warranted AUD and still high household debt levels, leaving the economy vulnerable.

Given the likely slower growth momentum around the globe we are likely to see further stimulus from global central banks. The question remains how effective will this stimulus be? In the meantime structural debt issues remain.

At 99% of GDP, US Government debt has only ever been higher following WWII…



Opportunities

Income

- Australian REIT's and selected commercial property syndicates - good yield, distribution growth, discounts to NTA, conservatively geared, lower interest rates, inflation protected
- Corporate bonds and syndicated loans - strong balance sheets, low default rates
- Selected equity hybrids – good margins above cash rate

Income and Growth

- Fully franked dividends within Australian equities, particularly banks with a 9.5% gross yield
- Large cap multi national companies with scale and brand leveraged to developing economies - conservative balance sheets, growth opportunities, low PE's, low Price to Book ratios
- Utilities, toll roads, telecoms paying high dividend yields with growth

Security

- Australian term deposits - security with reasonable yield
- Equity market protection through put options

Risks

- Long term fiscal profile of the US/Europe combined with ongoing political gridlock
- Unravelling of the Euro zone and subsequent financial crisis
- A significant slowdown in China
- Policy uncertainty
- Potential for a deflationary environment short term
- Conflict with Iran

Implications

- Retain high cash buffer and then look for opportunities
- Focus on income producing investments
- A flexible stance will be required for asset allocation

- Credit, AUD cash is preferred over Government bonds
- Ongoing volatility and uncertainty remain in investment markets
- A lower long term real return from portfolios than was the case in the 80's and 90's
- Potential for upside surprise given all the bad news in markets and high cash weightings

Asset Class Review

Equities

Indices are not relevant in today's "manipulated" stock exchange environment. However, valuations of individual companies are attractive on an historical basis. The current equity risk premium (dividend premium over bond rates), forward PE's and lower price to book values are as attractive as they have been in over 35 years. A contrarian with a long-term time horizon who is able to withstand volatility would be compelled to accumulate companies at these levels.

Despite the universally negative investor sentiment, deflation is certainly not built into share prices. Although we believe this is an unlikely outcome, bond markets have a seemingly different view.

Earnings expectations are likely to remain under pressure in the current slow growth environment and we feel it unlikely to see any PE re-rating to the upside given current concerns therefore returns in general are likely to be high single digits at best.

We prefer companies and managers that focus on high return on capital, are not index aware, provide a sustainable income yield, are not reliant on short term financing and have a conservative balance sheets.

Domestic Equities

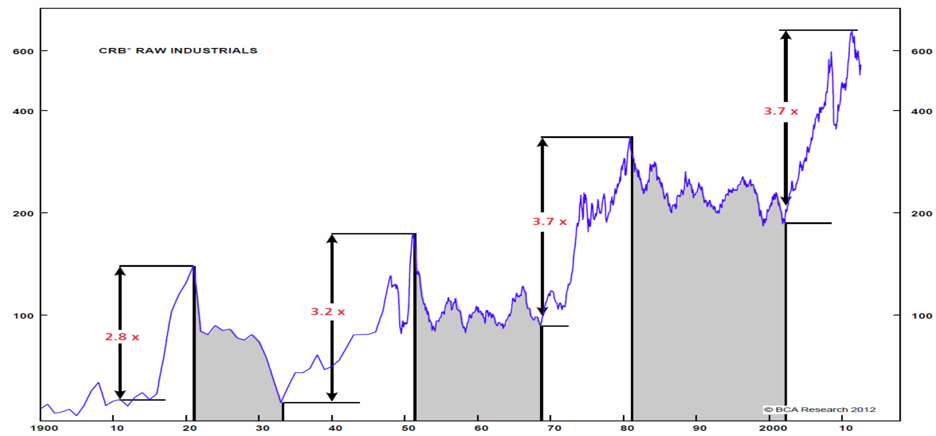
It is hard to be positive on Australian equities given the current high cost structure within the economy and the high AUD which is negatively impacting company profits.

Resource stocks are also under pressure due to higher labor and capex costs along with concerns of a slowdown in China and global growth. Although we are not forecasting a significant pullback in commodity prices from these levels it is important to keep the rise over the past decade in context.

Commodity Prices and 20 Year Cycles

As can be seen for the chart below commodity cycles tend to have periods of strength over 20 years followed by 20 years of decline.

We are perhaps in the last stages of the current bull cycle…?



The supply side of the equation, new production and expansion, is likely to be constrained somewhat given the current environment which may support prices at current levels.

Banks are unlikely to see much profit growth in the current economic environment. Cost of funding and low credit growth is likely to see profits under pressure. However we believe dividends are sustainable and, on a grossed up basis, provide attractive income returns. Income yield is likely to make up over 70% of total returns in the Australian market.

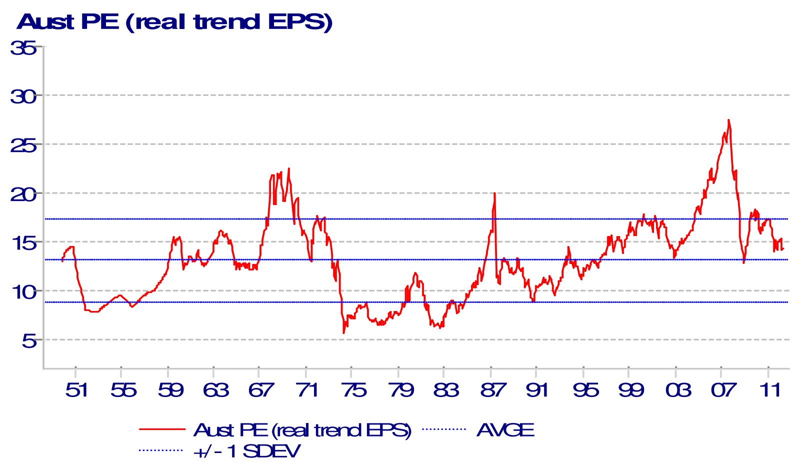
Smaller, ignored industrial companies with high cash weightings may provide an opportunity. Many small caps with good growth prospects are trading at large discounts to the value of their underlying assets and a small number are trading at a discount to cash backing. Amongst small cap resource stocks valuations suggest not only the end of the resource boom but that no new mines are going to be developed.

The current environment makes it extremely difficult to raise capital and companies that need to tap equity markets for funds can experience dramatic share price falls. However, the baby has gone out with the bathwater and companies that have very robust projects and ample ability to fund them, without tapping equity markets, have been tarred with the same brush and sold down with the rest of the market.

Share price falls have been on very low volumes and the conditions are in place for a rally in these stocks should commodity prices stabilize at these levels. Many companies have made substantial progress on exploration and progress toward development while the market has been taking no notice and have a lot of catching up to do when investors start to focus on this area again.

There are significant and profound changes occurring in the economy due to technological advances. It is imperative to look for companies that may be beneficiaries or those that suffer and are unable to adapt. Sectors of interest are Tourism, Healthcare, Technology and Agriculture.

For the market as a whole we have calculated a long term real trend EPS number since 1950 and subsequent PE. The average PE on this basis is 13.1 times as opposed to the current 14.2 times. Allowing for this adjustment back to average and adding dividends of 5% plus real trend EPS growth of 1.5%, the expected return for 12 months would be flat at an index level.



Source:,IBES, RBA, ABS, using proxy updates

International Equities

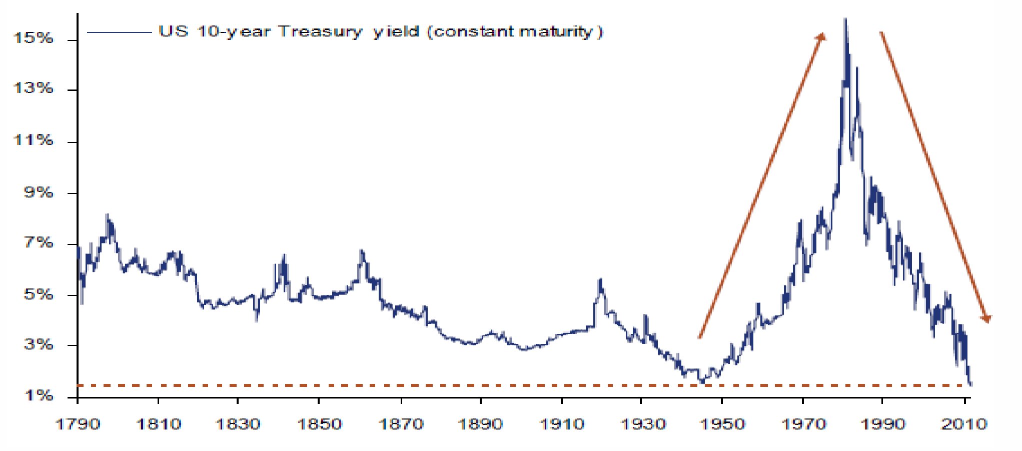
Given the high AUD we favour international equities (unhedged) over Australian equities. We prefer managers who focus on company specific fundamentals rather than an index based approach. Given the global and interconnected village we now live in opportunities can be found in unloved markets.
The premium received over bonds for owning equities is at extreme levels indicating significant value. In a deflationary environment however equities would suffer. Our feeling is a lot of the bad news is factored into share prices with the current Euro crisis the most widely analyzed, commented on and known crisis in history. The world still needs to eat, travel, learn, have shelter, be clothed and consume.

Fixed Income

Government Bonds

After the greatest bull market in history we feel that global government bonds are now risky. Swiss and German bonds are now NEGATIVE with Japanese government and US bonds at negative REAL (after inflation) rates. The bond market is indicating a severe deflationary environment with investors focusing on return OF capital rather than return ON capital.

US 10-Year Treasury Yield since 1790



Credit

Credit quality of US corporates has been improving steadily since 2009. Given cheap funding corporates have extended the maturity of their debt, increased cash on the balance sheet and reduced leverage and reduced reliance on short term commercial paper for liquidity. Therefore default rates are expected to remain low whilst the yields above Treasuries look attractive.

Risks to the credit portfolios would be a period of deflation. Current yield to maturity of 9.65% with short-term interest rate duration can be found. An attractive return over equities on a risk adjusted basis.

Hybrids

There has been an increase in the issuance of Australian Hybrid securities. Although many appear to be the same and investors tend to only look at yield and get an opinion on the likelihood of default, all are not structured the same and it is important to understand the finer details regarding conversion and ranking in the debt structure of a company. We are attracted to offshore Australian Bank hybrids, which can attract an additional 1% interest to local issues.

Property

Barring a deflationary/recession in Australia this asset class looks attractive. Within the Australian REIT's (listed property sector) gearing is a low 28.6%, interest cover is 3.7x, price to Net Asset Value is an 8% discount and the dividend yield is 6.3%. Although the sector has delivered an 11% return for the past 12 months, we are content to retain a holding here.

Direct property syndicates also attract our interest despite their illiquidity. Depending on the risk of the individual property opportunity, WALE (weighted average lease expiry), quality of tenants, development risk, demographic drivers and gearing levels, income returns of 8-10% are available. This combined with minimum rental increases of circa 3.5% provide an attractive return at a nominal level. Target annual returns of 13-20% are sought with quality managers. Lower funding costs are also providing support to valuations.

Given the illiquidity of these investments care must be taken to invest over a cycle and ensure that any liquidity requirements over the investment period can be met from other assets.

Hedge Funds/Absolute Return Funds/Alternatives etc

We have recently invested for first time in this asset class. The low correlation with equity markets and the ability for specific strategies to generate positive returns in both up and down markets are attractive at this point in the cycle. We have been following a number of managers for a couple of years and are now comfortable with their process and consistent return profile. Whilst the remuneration structure of some of these managers can be high we believe the additional alpha generated and the portfolio diversification benefits outweigh this.

Private Equity

We have little exposure at this stage, although there may be some attractive opportunities arising in the future as available credit will be scarce for those companies looking to expand. There may be a case for switching some funds from equities to private equity managers over the coming 18 months.

Summary

A very difficult investment climate expected to continue with noise out of Europe and slowing US growth to undermine confidence. The great deleveraging decade is set to continue placing pressure on world growth and company earnings. However a lot of bad news is factored into risk assets besides a global deflationary scenario. Any form of decisive, strong policy action in Europe, confidence that Chinese growth has stabilised and some evidence of a pick up in US growth will see equities rally strongly.

Our stance is to protect portfolios (cash) from short-term volatility and look for longer-term investment opportunities (equities, credit and property) whilst avoiding the current bubble (Government Bonds).

Conclusion

- Preferred assets; credit (corporate bonds), commercial property/REIT's, high yielding domestic equities, global equities leveraged to emerging economies and cash
- We expect long term returns from a balanced portfolio to be in the order of 8% pa amongst a "Wall of Worry" backdrop
- Income generation will constitute a higher percentage of total returns
- Our approach is to remain defensive over the longer term with higher cash levels and a focus on yield/income in other assets

Asset Class	Strategic	Range	Tactical	Overweight/ Underweight
Australian Shares	35%	25% - 50%	22%	Underweight
International Shares	25%	10% - 35%	22%	Underweight
Property	10%	0% - 15%	13%	Market weight
Infrastructure	n/a	0% - 20%	0%	Not applicable
Govt Bonds	25%	0% - 50%	0%	Underweight
Corporate Bonds	0%	0% - 50%	21%	Overweight
Cash(term deposits)	5%	2% - 50%	18%	Overweight
Hedge Funds	n/a	n/a	4%	Not applicable
	100%		100%	

The above table illustrates the Strategic Asset Allocation of a balanced portfolio (Van Eyk, 2012) against an active Providence Tactical Asset Allocation. The objective of tactical asset allocation is to move among various asset classes within a risk-controlled framework to create an additional source of return. An attempt is made to take advantage of short and intermediate term market inefficiencies as a means of managing investors' exposure to market risk.

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