

# MyConsultant

Newsletter October 2008

## Bonfires of the vanities



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Senior Asset Consultant

**Fires during the dry season of the Cape region of South Africa are an intimidating spectacle. Walls of flames, fanned by the strong, dry winds of summer, spread rapidly through the parched vegetation.**

I particularly remember watching firefighters and helicopters battling blazes in Cape Town at night, where the red rings of destruction shot fiery plumes high into the air as a tree or house fell victim.

Scanning the ashen scars on the mountainsides in the hazy morning light, it was difficult to imagine anything growing again. Yet, as with the legendary Phoenix, the renewal of life after fire is essential to the ecology of the Cape. In fact, some species of *fynbos*, or fine-leaved plants, rely on fire to germinate their seeds, as is the case with some Australian species.

The firestorm currently raging in financial markets, partly fanned by the media and fought by governments and central banks, flickered into life in the American housing market and quickly jumped oceans to ignite other continents. It resulted from a long, hot summer of benign economic conditions and an excessive thirst for borrowing and risk.

be considered pre-requisites for earning risk premiums on more volatile investments, even if these periods have sometimes been extensive. Long term investors can therefore exploit their most precious asset, their *long term investment time horizon*. It can help them ride out the downturns and reap their reward in the form of long term returns fattened by risk premiums.

**A hundred years of financial history teaches us that no matter how bleak the circumstances, or unique the causes, every market downturn has eventually been followed by recovery ...**

Investors might find it difficult to focus on the potential benefits of the current maelstrom when confronted by the heat and smoke. My purpose here is to highlight how you, as a long term investor, stand to reap rewards when markets eventually recover. What is required is to stand firm with your long term investment objectives, and to remain true to the carefully considered, well-diversified strategy designed to meet them, provided your circumstances have not changed significantly.

Let's focus first on recovery. A hundred years of financial history teaches us that no matter how bleak the circumstances, or unique the causes, every market downturn has eventually been followed by recovery; this was the case even when modern central bank and government interventions did not exist. Indeed, negative periods of the market cycle can

But how long will it be until recovery? **Table 1** shows the period from boom to bust and the extent of the drop in the MSCI World Index for a number of historical scenarios, compared to the current crisis to date. The conclusion is that there is no way to predict when markets bottom; if this were the case I would most likely already be retired to a mansion on the slopes of the Cape mountains (with suitable firebreaks), instead of typing this article. Rather, we need to focus on how we can best take advantage of unpredictable cycles and avoid getting burnt.

For clients of MLC, preparation for their journey through uncertainty began with the strategic design of their investment portfolios. Detailed scenario analysis 'stress tested' the level of diversification in their portfolios in the face of a wide range of possible economic environments.

# Bonfires of the vanities

## As long as our clients hold onto their well-diversified units in their investment trusts, they retain the potential to recover unrealised capital losses.

Working hand in hand with this are our high conviction mandates, giving our managers maximum scope to use their skills to mitigate the potential impact of overheated markets. The current crisis has flung sub-prime mortgages, Collateralised Debt Obligations, hedge funds and a number of 'iconic' firms into the flames; our strategy design has either ducked these potential fireballs completely, or their effect has been dissipated through our optimised diversification.

Of course, successfully avoiding the third degree burns suffered by many others does not mean our clients' portfolios are immune to the indirect or contagion effects of a market downturn. As long as our clients hold onto their well-diversified units in their investment trusts, they retain the potential to recover unrealised capital losses. The danger is the urge to de-risk or sell units for reasons of panic rather than long term strategy; this would mean crystallising losses that cannot be recovered. Members of super funds, in the absence of sound financial advice, can be particularly vulnerable to this impulse, fuelled by the incendiary rhetoric of the media. And when markets recover, they often move quickly and sharply ahead of the more ponderous economic data. Thus selling out can translate into losing out even further.

When the 'living was easy', and complacency grew in tandem with

bull market returns, MLC's disciplined rebalancing of our clients' portfolios realised some of the gains in the growth strategies and reinvested them defensively. Now that the debt strategy continues to post positive returns whilst equity values contract, the role of rebalancing is reversed: money feeds our equity managers' who hunger to exploit the cheaper buying opportunities presented by the bear market.

The Warren Buffets of the world are currently circling above the carnage to pick off deals which rarely become available in less testing conditions. Having avoided the major blow-ups, we also have the dry powder to take advantage of distressed assets and forced sales in the market.

The potential benefit of the current market downturn goes further than buying opportunities. The bonfires are consuming the deadwood of excessive debt in balance sheets, charring greed, complacency and hubris, and jolting governments and regulators out of their slumber to properly man their posts.

There is also critical re-evaluation of accounting standards that have been sprouting densely over recent years. In particular, there is global concern about the impact of mark-to-market valuations. This practice stands accused of adding fuel to the current crisis by forcing banks to recognise assets at firesale prices, thereby driving collapses which further weaken asset prices and so on in a vicious cycle. We are aware that our clients are not immune to the pressure of ever-increasing accounting legislation, and sometimes this can impinge on the way investments are viewed. We cannot overstate the importance of setting long term investment strategy separately from

**Table 1:**  
**Current global downturn compared to previous falls**

Bull market top	Bear market bottom	Length of decline (days)	% decline in MSCI World Index	Length of recovery (days)
15/03/1973	4/10/1974	568	-43.86	1015
15/06/1981	12/08/1982	423	-19.23	110
2/05/1984	31/07/1984	90	-11.50	94
4/09/1986	28/10/1986	54	-7.73	66
27/08/1987	26/10/1987	60	-21.38	382
4/01/1990	28/09/1990	267	-26.31	913
7/10/1997	12/01/1998	97	-10.23	25
20/07/1998	5/10/1998	77	-20.70	85
27/03/2000	9/10/2002	926	-49.16	1063
31/10/2007	?	356 days to 21/10/08	-36.91 to 21/10/08	?

# My Team

short term accounting considerations. Where there is a perceived conflict, we recommend steps are taken to explain and resolve any issues with auditors so that the investment strategy is not compromised by reporting constraints designed for a completely different purpose.

I recently returned from a visit to South Africa, where the Cape of Storms had lived up to its name throughout winter, with massive swells and ferocious winds damaging property. However, the driving rain had also irrigated the earth scorched by last summer's fires, and the *fynbos* is reasserting itself, growing fresh shoots and transforming buds into magnificent blooms like the protea.

The season of recovery and renewal will eventually arrive for investment markets. In the interim our managers continue to sow the seeds of future returns. By standing firm, long term investors will ultimately benefit from healthier global financial systems where risk is better assessed and rewarded by markets and returns are generated on a more realistic and sound footing.

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long term investors  
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## Susan Groenen

### Asset Consulting Analyst

**Our Asset Consulting Analyst, Miss Susan Stubbs, is now Mrs Susan Groenen after marrying Mark, her partner of nine years, on May 17th.**

While Susan and Mark had attended school together since kindergarten, it wasn't until their HSC year that they decided to take more interest in each other. In July 2006, Mark produced a sparkling diamond ring in a very romantic proposal overlooking the Sydney skyline.

Susan and Mark wed in a church ceremony in front of 80 guests before continuing their celebrations with family and friends at a reception in Castle Hill. For their honeymoon, they spent two weeks in New York City.

**We wish them all the best for their future as a married couple.**

**If there are any topics you would like us to cover or if you have comments or questions about any of the articles, please contact us on (02) 9936 4520 or email [myconsultant@mlc.com.au](mailto:myconsultant@mlc.com.au)**

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