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Third Link News

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Which way next?

During periods when the share market is volatile, I'm often asked whether I think the market is going up or down from here. My answer is always the same. Over the short term I have no idea but over the long term I take comfort from history that share markets usually provide attractive returns compared to other forms of investment.

I think it is fair to say that experienced and successful investors hold little faith in those that try to predict market movements. Consider these quotes from some of the world's well known investors…

'We do not have an opinion about where the stock market, interest rates, or business activity will be a year from now. We've long felt the only value of stock forecasts is to make fortune tellers look good. We believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.' (Warren Buffet)

'Sure it would be great to get out of the stock market at the high and back in at the low, but in 55 years in the business, I not only have never met anybody that knew how to do it, I've never met anybody who had met anybody that knew how to do it.' (John Bogle, founder of Vanguard)

'Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves.' (Peter Lynch, famed Fidelity manager)

'Here's the thing though: Bear markets are not predictable. No one on earth has consistently and repeatedly predicted bear markets. Remember, to exploit a bear market, you need to know when to get out, know when to get back in, and then do it again. I can't find the guy who's done that. You're not going to find him either. He's Santa Claus. You might want to think he exists, for a while you believe he exists, there comes a point where you know enough to know he doesn't exist but you can't admit it yourself, and then finally, maybe you will accept it. Also like Santa Claus, there are a lot of people running around pretending to be that guy you want to believe in so badly.' (Peter Mallouk, from his book *The 5 Mistakes Every Investor Makes and How to Avoid Them: Getting Investing Right*)

The evidence is strong that no one can time the market effectively and repeatedly over the short term. Peter Lynch also said "the key to making money in stocks is not to get scared out of them". So, with the current volatility being experienced in the Australian stock market (together with other stock markets around the world), as investors digest different views on the continuation of economic stimulus and its effect on interest rates, it is useful to reflect on these statements.

Thank you for your continuing investment in Third Link Growth Fund. It is heartening to see the fees you pay to us for having your money professionally managed continues to make a difference to others. Since the Fund began in mid 2008 around $2,750,000 has been donated to the charitable sector, with the donations now running at approximately $80,000 per month. If you have not done so already, have a look at the 'Our Charitable Partners' section of the website (**www.thirdlink.com.au**) to find out more about the charities we support.

Furthering financial literacy

Readers of this newsletter may also be interested to know that since February 2013 myself and three other colleagues have been producing a free weekly newsletter called Cuffelinks (**www.cuffelinks.com.au**). This is an independent, not-for-profit venture aimed at giving readers access to quality financial writing and to improve their financial literacy. It now has nearly 8,000 subscribers and continues to grow strongly. The newsletter is pitched at engaged investors and participants in the financial services industry. Each weekly newsletter usually has five articles of about 1,000 words each written by experts in their field (rather than professional journalists) and the full library of past articles can be found on the web site. Cuffelinks does not promote products and is not a short term stock picker or an economic commentator. Cuffelinks prefers to focus on investment strategies and useful information that can be practically applied, and within a medium to long term market horizon. We encourage readers to take a 'through the cycle', risk-aware perspective. I commend the newsletter to you.

Regards

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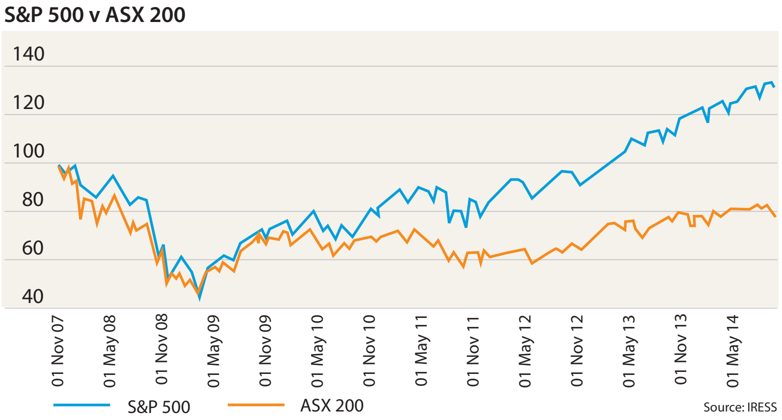
Australia's longest bear market?

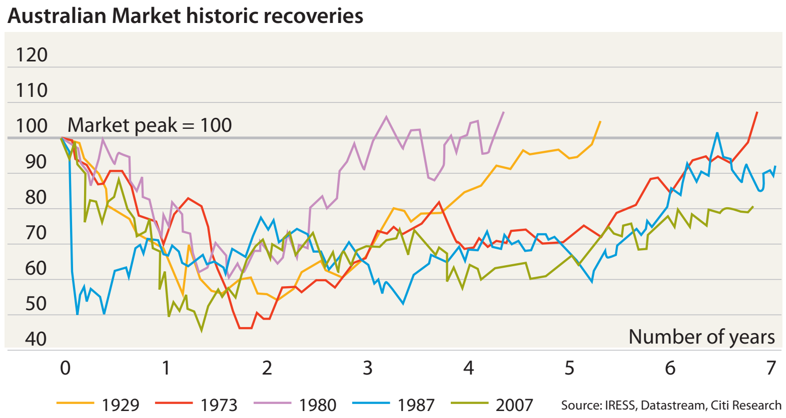
by Frank Macindoe

The performance of the Australian share market in recent years has surprised many, not just for how weak it has been relative to the US and other developed markets, but also relative to previous major bear markets in Australia.

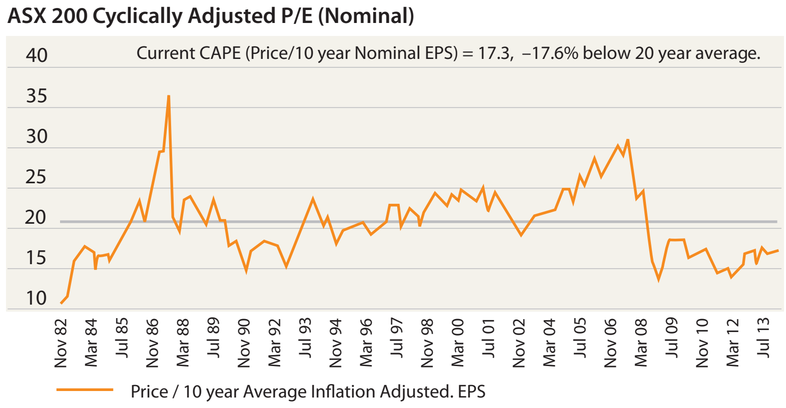
S&P 500 v ASX 200



Australian Market historic recoveries



ASX 200 Cyclically Adjusted P/E (Nominal)



Underperformance relative to the US market

The chart above left shows how closely correlated our market (orange) was with the S&P500 (blue) on the way down but how relatively tame our market's recovery has been.

So what might the explanation be? One possibility is simply the alternatives available to investors in each country. In the US interest rates available on cash and bank deposits have effectively been zero for 5 years. In Australia, on the other hand, deposit rates have been generous and even at their current lows of around 3.5% at least provide a positive return after inflation. So for those investors who have decided at least for the time being that the ups and downs of the share market are not for them, in Australia there has been a viable income-producing alternative.

It is also worth emphasising that although the correlation between our market and the US equity market can be very strong on a day-to-day basis, over longer periods the markets can behave very differently reflecting the differences in the two economies. So when the tech boom was in full swing around 2000 and Australia's economy was derided for being 'old economy' the US market was very much stronger, but the pecking order reversed with the tech wreck and the resources boom.

Underperformance relative to previous cycles

The performance of the Australian market relative to its own history also looks pretty grim. The chart top right (not taking into account the current correction) shows that seven years on we have still not nearly regained the previous market peak and the recovery looks markedly slower than bear markets that took place in the context of the Depression and the severe recessions of the 1970s and 1990s. While there are complaints about current low levels of growth and increased unemployment, relative to those earlier episodes recent years have been fairly benign.

A couple of major differences in the current cycle that may be relevant are the much higher levels of individual debt and the aging population.

To begin with, the extent that individual debt was used to fund investments it would have increased the effective losses. Secondly, the combination of a sudden reduction in net worth and impending retirement has no doubt persuaded many that they should save more for their retirement rather than rely on the growth of their investments. This is consistent with savings rates that are the highest in a generation.

Attractive valuations

One factor which would at least partially explain both aspects of the Australian market's disappointing performance is that Australian shares may simply be cheap. While the most commonly quoted metric is the price/earnings ratio, it does not take into account the fluctuations in profit margins at different points in the economic cycle. Accordingly, the 'cyclically-adjusted price/earnings' developed by Robert Shiller (winner of this year's Nobel Prize for economics) provides a more reliable guide to valuation by using 10 years of earnings rather than just one. The chart above uses that methodology and suggests that there is plenty of room for Australian equities to rise before they reach long term average levels.

But while valuations are critical when it comes to long term returns, in the short run (say less than 3 years) other factors including investor attitudes to different asset classes are often more important, so there is no guarantee that our market's underperformance will end overnight. ■

Frank Macindoe is an Executive Director at JBWere and a responsible manager of Third Link Growth Fund. The views expressed are his own.

Portfolio Update

The objective of the Third Link Growth Fund is to provide an investment in Australian listed shares. To achieve this, the Fund extensively invests in other managed investment funds run by professional third party investment managers.

As at the end of September 2014 the portfolio was invested as shown in the table opposite.

Over the last six months the changes to the portfolio, excluding movements in our cash investments (which increased over the period from 1.1% to 4.7%), have been as follows:

- we added to our investment in the Goldman Sachs Premier Australian Equities Fund;
- we added to our investment in the Cooper Investors Australian Equities Fund;
- we added to our investment in the Paradice Mid Cap Fund;
- we added to our investment in the Aberdeen Australian Small Companies Fund;
- we added to our investment in the Montgomery [Private] Fund; and
- the Fund paid a distribution of income to investors in respect of the six months ended 30 June 2014.

No new managers were added to the Fund during the six months ended 30 September 2014.

AUSTRALIAN EQUITIES		
General:		
JBWere Individually Managed Account	19.4%	
Bennelong Ex-20 Australian Equities Fund	8.7%	
Cooper Investors Australian Equities Fund	11.0%	
Greencape Wholesale High Conviction Fund	6.6%	
Goldman Sachs Premier Australian Equities Fund	8.6%	
Montgomery [Private] Fund	8.2%	
Paradice Mid Cap Fund	10.2%	72.7%
Small Caps:		
Aberdeen Australian Small Companies Fund	6.4%	
Eley Griffiths Group Small Companies Fund	3.2%	
Ophir Opportunities Fund	3.4%	
Pengana Emerging Companies Fund	9.6%	22.6%
		95.3%
CASH & CASH EQUIVALENTS		
Colonial First State Premium Cash Enhanced Fund		3.9%
Custody Account & Other		0.8%
		4.7%
TOTAL		100.0%

The figures shown against each Australian equities fund listed above do not 'look through' each fund and strip out any cash component.

As at the end of September 2014 the Third Link Growth Fund stood at $72.9m in size ($67.2m at the end of March 2014). During the last six months we received $7.9m in new applications and processed redemptions totalling $0.6m.

A description of each of the fund managers we invest with, including their funds listed in the table above, can be found on our website at **www.thirdlink.com.au** (see the section 'Fund Managers We Invest With').

Each of these managers rebates their management fees and performance fees which apply to the investment of Third Link Growth Fund in their respective fund, effectively meaning they are managing the assets of Third Link Growth Fund for free. It is through this extraordinary generosity, together with that of other service providers (all listed on the Fund website), that Third Link is able to make sizeable donations to the charitable sector without diluting the returns to investors from the Fund.

Fund Performance

	three months	six months	one year	two years	three years	five years	Since inception (June 2008)
Third Link Growth Fund	+1.9%	+1.4%	+8.1%	+17.8%pa	+16.4%pa	+10.2%pa	+8.7% pa
Fund performance relative to its benchmark [1]	+2.5%	+1.1%	+2.4%	+3.5%pa	+2.7%pa	+2.2%pa	+3.8% pa

Returns are calculated after fees have been deducted and assuming reinvestment of distributions. No allowance is made for tax. The benefits of franking credits from dividends received have been ignored.

1 Up until the end of January 2012 the benchmark was the Morningstar Multi-Sector Growth Market Index and from February 2012 onwards the benchmark was the S&P/ASX 300 Accumulation Index. The S&P/ASX 300 Accumulation Index covers the largest 300 shares listed on the Australian market. Being an accumulation index, it measures changes in both the value and income of the shares.

Third Link Growth Fund aims to outperform the S&P/ASX 300 Accumulation Index after fees over rolling five year periods. This objective is being achieved very satisfactorily. As at the end of September 2014, the Fund performance relative to the Fund benchmark was as shown in the table above.

The Fund has produced a modest return of +1.4% over the last six months after fees, albeit in excess of the S&P/ASX 300 Accumulation Index which increased by only +0.3%. Over the same period, cash on deposit yielded just +1.3%. The last six months was characterised by significant volatility, with the Index producing monthly results which ranged from a high of +4.4% in July to a low of -5.4% in September.

Despite the short term gyrations, the longer term performance of the Fund, as shown in the table above, continues to be very pleasing. As an example, the five year return of 10.2% pa compound after fees (which excludes the positive impact of franking credits) has been particularly good for our investors, especially considering cash on deposit over the same period yielded just +3.9% pa. Such returns show, yet again, the importance of having a long term time horizon when investing in shares.

The performance of Third Link Growth Fund has been above its benchmark over all time periods shown in the table above. This has been achieved because of solid long-term investment results by the fund managers utilised by the Fund, validating their continuing inclusion. This result also continues to demonstrate that our active approach to adding value for investors is proving to be rewarding.

Helping young people discover their potential

Outward Bound Australia (OBA) provides challenging outdoor experiences that help people to discover, develop and achieve their full potential. By developing the potential of individuals, teams, leaders, organisations, communities and the broader Australian society, it aims to create outstanding leaders who are actively engaged in service in their schools, organisations and communities.

Experiential education

Outward Bound is the leading not-for-profit outdoor experiential education organisation in the world, with over 40 Outward Bound schools internationally. OBA has been delivering life-changing educational programs since 1956 with over 300,000 participants. OBA is committed to making courses available to a wide range of Australians. At the forefront of this drive for open accessibility is the Australian Outward Bound Development Fund (AOBDF) – a private company and public benevolent institution established in 1999 that offers financial assistance to disadvantaged young people to participate in an Outward Bound course.

OBA focuses on serving young people aged from 13 to 25 years, with approximately 5,000 participants each year. However it also remains dedicated to providing opportunities for people from communities of all ethnicities, socio-economic backgrounds and abilities. In addition to supporting the many young people who just need a small 'hand up' with their fundraising, OBA works with schools and community partners to provide opportunities for their young people to participate in Outward Bound who are unable to afford an Outward Bound experience.

Stretching participants

In the 1980s OBA developed the Life Effectiveness Questionnaire (LEQ) to measure growth and outcomes in outdoor education programs. Data received from the LEQs consistently demonstrates that personal development in the areas of fitness, initiative and enterprise, skill and care, self-discipline, memory and imagination and compassion is achieved through appropriate outdoor programs.

OBA's courses are conducted in all weather conditions in national parks around Australia and involve working at heights with ropes, navigating and trekking, overnight bivouacs, abseiling, white-water rafting and caving. These activities stretch participants well beyond their comfort zone; they learn to endure, to work with others, to think about others, to lead and to reflect on their own journey, personal capabilities and potential. Importantly they learn through personal experience that they can achieve more than they initially believed, and that this experience is transferable to life.

Increasing opportunities

With the support of funders like Third Link, OBA hopes to expand its Outward Bound course opportunities for less advantaged young people. The long term objective is to increase the opportunity for participation in Outward Bound courses by regionally, financially and physically less advantaged young people, including Indigenous Australians.

'We remain firmly focused on what we are both best at and passionate about: developing human potential.'

BENJAMIN FARINAZZO – OUTWARD BOUND AUSTRALIA

Other charities we support

In addition to OBA, Third Link also supports the following organisations.

AIME – The Australian Indigenous Mentoring Experience works towards education equality, where Indigenous students perform and finish school at the same rate as every Australian child.

Batyr – bringing young people's social and mental health issues out in the open. Using peer success stories to engage, educate and empower young people Batyr also advocates the many support services available.

Beacon Foundation – influencing the attitudes and culture of Australians to prevent young Australians leaving secondary school from moving into unproductive or insecure pathways, becoming marginalised or dropping out.

Children's Ground – starting from the ambition of Aboriginal people to change their future and helping their kids to be 'strong both ways': strong in the oldest living culture in the world and fully engaged in the Western world.

National Centre for Childhood Grief – professional support and guidance in a safe place where children grieving a death can share their experience as they learn to live with the impact on their lives.

REAPing Rewards Program – The Rural Education Australia Program (REAPing Rewards) responds to the ongoing need for an independent and flexible source of funding for community based early childhood and education service providers in Australia's rural and remote communities.

Uplifting Australia – a charity that improves the emotional wellbeing and resilience of children and families across Australia.

Design: Eyconology.com (at a reduced rate)