thirdlink

Third Link News

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What an incredible period

the last six months has proven to be for the global financial system. Nothing exemplifies the fallout better than the purchase of ABN AMRO by Royal Bank of Scotland – finalised a little over a year ago with a payment of USD100bn, 80% in cash. For this same amount, RBS could recently have bought Citibank (USD18.9bn), Morgan Stanley (USD22.5bn), Goldman Sachs (USD41.8bn) and Deutsche Bank (USD15.2bn) – and still have $1.6bn in change. What a difference a year makes!

In managing the investments of the Third Link Growth Fund I see my job as listening to the opinions of other trusted and proven investment advisers (blocking out the daily 'noise' of the press and the many other self-proclaimed 'experts'), then to set and navigate a clear and decisive path, avoiding the shallows and keeping our ultimate destination front of mind. Right now, finding that clear path is difficult, with opinion varying considerably about the timing of the recovery of share markets. However, most agree that if a long term perspective is adopted then very attractive returns will be achieved from current levels. The dilemma is knowing what to do in the short term.

Although the performance of the Third Link Growth Fund is ultimately measured against the performance of the Australian share market, we have continued to have a relatively low exposure to shares over the last six months. While this has proved to be the right decision so far, I have been very conscious of the possibility of not fully participating in a market rally when it inevitably occurs. This 'risk' grows each day particularly given that statistically we are now at the outer edge of historic low market valuation levels (measured by standard deviations) and high dividend yields.

> *Life is simple:*
> *if you invest too much too soon you will regret it;*
> *'How could you have done this with the economy so bad, the market in free fall, and the history books screaming about overruns?'*
> *On the other hand, if you invest too little after talking about handsome potential returns and the market rallies, you deserve to be shot.*
>
> **Jeremy Grantham**, Co-founder and Chairman of GMO

My expectation is that in the short term the Fund's exposure to shares will start to increase as two key issues play out - the need for confidence to be restored in the global financial markets (and there is much happening at present to kick start credit markets and achieve this, though no single silver bullet has emerged) and the contraction in economic growth by nearly all countries of the world (which is not a new phenomenon in history).

Thank you for your continuing investment in the Third Link Growth Fund. The net management fees of the Fund, nearly $150,000 to date, continue to go to support the non-profit sector through the inspirational work of Social Ventures Australia. It is a valuable contribution, which is making a difference to the lives of some of Australia's most disadvantaged people.

Regards

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How dividend yields can help us to understand the share market cycle

By Don Stammer

There's a phrase I recall from my early days in investing: dividends are the ultimate source of value in shares. The expectation of rising dividends over time is what drives increases in the market value of shares. Even investors in newly established businesses, who might expect to receive no dividends for some years, are motivated by the appeal of dividends in the more distant future.

Nowhere in the world are dividends more important than in Australia. Dividends received from businesses that have paid Australian company tax carry tax credits that enhance the value of the dividends received. Australia's system of franked dividends – the world's best – works well for investors, who avoid the double taxation of dividends. And it imposes good discipline on companies, making them more accountable to shareholders.

Over much of 2008, share analysts were slow to reduce their forecasts for dividend payments when the global economy first slowed and then, after the Lehman Brothers debacle, hit an air pocket. Now, many share analysts are forecasting huge cuts in dividends. There's a risk they have now turned too pessimistic about reductions in dividends over the next year or two.

Given the uncertainty about future dividend payments, it's a good time to look instead at how, over the years, the share market has priced dividends recently paid to investors – in other words, to see what has happened to **trailing** dividends, for which there are hard numbers, rather than to **prospective** dividends, on which market views can change at short notice.

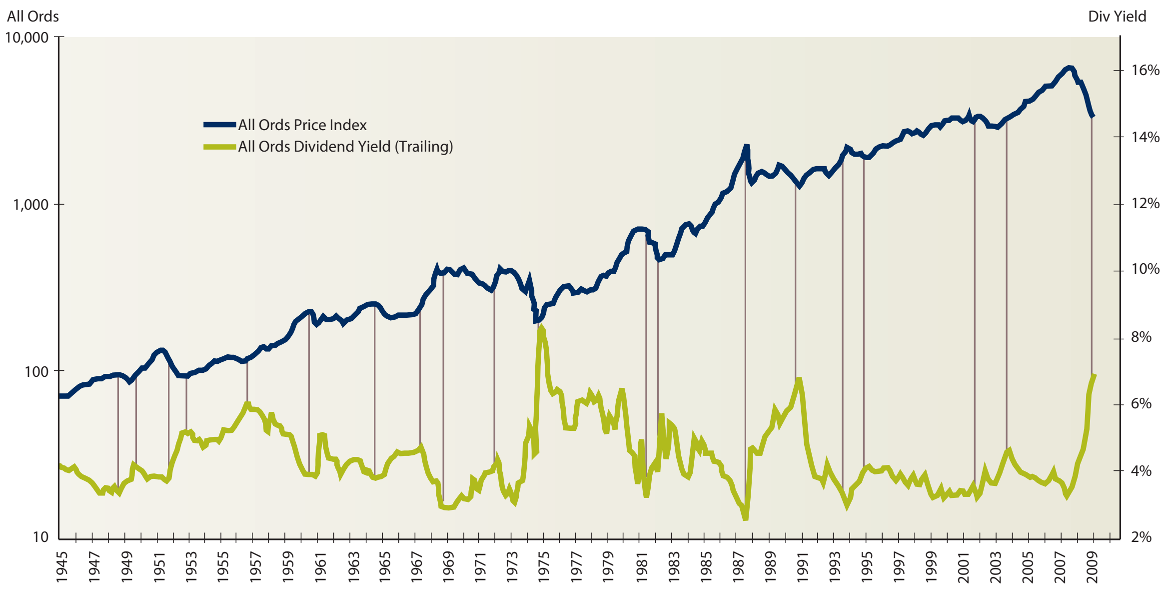
The chart displays the trailing dividend yield for the All Ordinaries Index of Australian shares since 1945. It is plotted monthly. Each point on that line shows total dividends over the preceding twelve months as a per cent of share prices at the end of the month for which the data are plotted.

Since 1945, the trailing dividend yield has averaged 4.1%. This excludes the benefits of dividend imputation introduced in the 1980s.

There have been five major cycles and three smaller cycles in the trailing dividend yield over 53 years. The chart also shows the performance of the share market over this period – and the eye can tell that there is a close relationship between the cycle in dividend yields and the cycle in share prices.

At time of writing, the trailing dividend yield was above 7%, its second highest level since 1945. In 1974, the trailing dividend yield spiked to 8.2% – a reflection of the intense gloom priced into shares from investors' concern about the deep recession and about the Whitlam government's problems in handling it. More modest peaks were recorded in 1956, 1967, 1979 1982, 1990 and 2003.

All Ords Trailing Dividend Yields – 1945 to 2009



The chart shows very clearly that the trailing dividend yield does not remain at peak levels for long. Instead, the trailing dividend yield fell away sharply as dividends were cut and, more importantly, as share prices recovered.

The low point for the trailing dividend yield was 2.5% in 1987, reflecting the extreme optimism priced into share prices during that frantic boom. It also was well below its trend level in 1969, 1973, 1981, 1993, 1999 and 2007.

These low levels of the trailing dividend yield were not maintained for long. Instead, the trailing dividend yield soon rose as dividends were increased and, more importantly, share prices fell.

The trailing dividend yield at the time of writing was a little over 7%, it's clear that the share market is priced for substantial cuts in dividends.

Let's say that, on average, listed companies reduce their average dividends per share by 25% – and that's quite a big hit. In that event, the dividend yield would still be 5.6%, which is well above its long term average (and, to repeat, this figure doesn't include the tax benefits from franked dividends). By comparison, yields on other asset classes, which are taxed, have fallen to unusually low levels: cash trusts at about 3%, long-term government bonds at 4.3% and residential real estate at an average net rental yield of perhaps 4%.

Looking at the history of trailing dividend yields, it's necessary to ask whether the gloom now priced into shares is – or soon will be – overdone. Sure, there are problems aplenty for governments and banks in meeting the challenges of the global financial crisis. But the trailing dividend yield is so high as to suggest that a lot of gloom has recently been priced into the share markets. The bear market in shares may not be dead … but it appears, at last, to be tiring.

Dr Stammer is an adviser to Chris Cuffe in relation to the Third Link Growth Fund and has a long experience in funds management and investment banking. The views expressed are his alone.

Portfolio Update

The objective of the Third Link Growth Fund is to provide a diversified growth-oriented investment with a bias at most times to Australian listed shares.

Although we aim to outperform the returns of the All Ordinaries Accumulation Index over time, we have considerable flexibility in the type of investments the Fund may hold outside of Australian listed shares. This sets us apart from most other 'Australian Equity' funds.

We are now some 10 months into managing your Fund with the portfolio positioned as follows:

	31 March 2009	30 Sept 2008
Growth-oriented investments		
Australian listed shares	45.1%	38.2%
International listed shares	11.3%	16.8%
Property (both domestic and international)	0.0%	6.7%
Alternative assets	3.0%	2.8%
	59.4%	**64.5%**
Fixed interest securities & cash		
Hybrid securities	21.2%	20.5%
High yielding global fixed interest securities	11.9%	12.3%
Cash on deposit	7.6%	2.7%
	40.6%	**35.5%**
	100.0%	**100.0%**

The majority of the Fund's assets are invested in other managed funds run by third party investment managers. The above figures do not 'look through' each underlying fund, but are based on the overall classification of each fund.

As can be seen from the above table, we continue to deviate significantly from only holding Australian shares. Our rationale is as follows:

- The continuing very uncertain investment climate since the Fund commenced has meant that we have resisted being fully invested in growth-oriented investments.
- We believe exposure to international shares is warranted at present given:
  - diversification benefits; and
  - some international markets, particularly emerging markets, appear to have good long term growth prospects compared to Australia and appear to have been significantly oversold.
- Successful government guaranteed debt issuance by major banks, aggressive fiscal policies from advanced economies and lowering of interest rates by central banks around the world are all encouraging signs for credit markets that have already priced in an extremely weak economic outlook and extreme default rates. Hence we took the view that credit exposure, via high yielding global fixed interest securities, would provide a good medium term alternative to equities. In hindsight we have been too quick off the mark in obtaining such exposure (given the traumatic financial events of last October) but are confident that this position will be well rewarded in the near term.
- We were of the view that some well rated hybrid securities with short to medium term redemption dates were a useful alternative to holding cash, particularly in a falling interest rate environment.

The key portfolio changes that occurred over the last six months (since our last newsletter) were as follows:

- We completely sold out of global property securities. We originally invested in this sector because it had been very heavily sold off and, from a quantitative standpoint, was starting to represent very good value compared to a pure exposure to Australian shares only. However, this view proved to be premature as there continues to be significant negative factors influencing this sector including valuation downgrades, deleveraging required for borrowing covenants, tight credit, difficulty with capital raisings and very few sales transactions.
- We completely sold out of specialised global resources and global infrastructure funds having formed the view that this specific exposure is too niche for Third Link Growth Fund. We have decided the underlying Australian and international funds we invest in are better placed to decide whether to have resources and/or infrastructure exposure as part of their portfolios.
- We switched out of our specific Asian equities exposure into the more broadly diversified emerging markets exposure (via the Schroders Group) which we believe offers a better long term risk/return trade-off.
- Two of the hybrid securities we owned were redeemed (being those issued by Commonwealth Bank and St George) and we sold out of the Suncorp Metway hybrid security we owned given concerns over that group's financial strength post the government guarantee and our desire to switch into fixed rate securities during a falling interest rate environment.
- We significantly increased our exposure to a highly rated and well diversified fixed rate hybrid security on a very attractive yield and maturing in the short term.

The combination of the above actions, together with further falls in equity markets over the last six months caused our exposure to growth-oriented investments to decrease during the period from 64.5% to 59.4%.

As stated above, the majority of the Fund's assets are invested in other managed funds run by third party investment managers. A description of each of these managers/funds can be found on the website at **www.thirdlink.com.au**. In summary, the managers being used are as follows:

Australian equities
– Cooper Investors
– Solaris Investment Management
– Platypus Asset Management
– Orion Asset Management
– Paradice Investment Management
– Goldman Sachs JBWere/Frank Macindoe
– Eley Griffiths Group (smaller companies)
– Pengana Capital (smaller companies)

International equities
– Intrinsic Value Investments
– Taube Hodson Stonex Partners
– Magellan Financial Group
– Schroders Group (emerging markets)
– Arkx Investment Management (global carbon reduction)

Property
– Perennial Investment Partners

Alternative assets
– Ellerstone Capital
– Select Asset Management

Fixed interest & cash
– Colonial First State Investments

Fund Performance

We aim to outperform after fees the returns of the All Ordinaries Accumulation Index over rolling five year periods. The Fund performance is calculated by comparing unit prices over the relevant measurement period and also taking into account income distributions made during the period.

	One month	Three months	Six months	Since inception (June'08)
Third Link Growth Fund	+5.4%	-0.9%	-16.5%	-20.3%
All Ordinaries Accumulation Index	+8.1%	-1.7%	-21.5%	-35.9%
Fund Outperformance	-2.7%	+0.8%	+5.0%	+15.6%

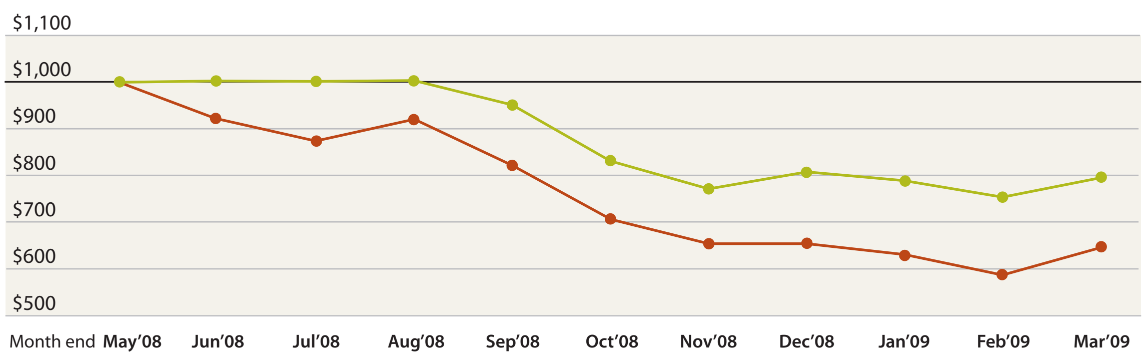
As at the end of March 2009, the Fund performance after fees relative to the All Ordinaries Accumulation Index[1] was as shown in the table above.

While this relative outperformance shown above is pleasing, we can assure you we take no comfort in losing value for investors.

The key contributors to the Fund outperformance were: our low relative exposure to growth-oriented investments; the above index returns achieved by a number of the Australian equity managers we use; and the exposure to general international equities. The key detractors were: the early exposure to high yielding global credit securities; the specific exposure to global resources and global property securities (subsequently sold); our ownership of a Suncorp Metway hybrid security (subsequently sold) and early exposure to various smaller company funds.

The graph below shows the value of $1,000 invested in the Third Link Growth Fund since the start of June 2008, tracked on a month by month basis and assuming income distributions were reinvested. This is compared to the value of $1,000 invested in the All Ordinaries Accumulation Index over the same period.

Performance of Third Link Growth Fund vs All Ordinaries Accumulation Index[1]



Value of $1,000 invested in Third Link Growth Fund
Value of $1,000 invested in All Ordinaries Accumulation Index[1]

[1] The All Ordinaries Accumulation Index is Australia's premier market indicator and represents the 500 largest companies listed on the Australian Securities Exchange measured by market capitalisation and with dividends reinvested. The Third Link Growth Fund was established on 12 March 2008 (though it was not open for investment until 10 April 2008, being the date of the first PDS). Up until the end of May 2008 it was a requirement that application monies received into the Fund were kept on deposit as the unit price was held at $1.00. This restriction was removed from the beginning of June 2008, at which time the Fund was free to invest in accordance with its objective.

Social Ventures Australia
Activity Update

Three years ago Kate Maguire's life was changed forever by a simple request from her dying father. He wanted to die at home, just as he had lived, surrounded by life and all that he had loved.

'When Dad finally began to lose his puff,' Kate recalls, 'I expected my father's GP to be my guide, but hospital and nursing homes were the only options she offered. And that was that. I went home and cried, wondering if dying at home was actually an option after all.'

Kate would later discover that for many people this is where the story of caring for their loved one at home ends.

'With the help of HOME Hospice, my father had a death that was as filled with meaning and love as his lifetime had been.'

Fortunately, Kate found another GP who arranged nursing and other services and she gradually gathered together all the equipment her father would have had in a hospital.

But the relentless effort took its toll on Kate and by the time she heard about HOME Hospice, a venture partner supported by Social Ventures Australia (SVA), and met her HOME Hospice mentor Julie, she was exhausted. Julie helped Kate to bring her personal community and family around her in a supportive and practical way to help ease the burden and to share the joys of caring for her father.

'HOME Hospice enabled my family and my community to come together to share the last days of my father's life. This experience has changed our perspectives of death forever.'

> *'With the help of HOME Hospice, my father had a death that was as filled with meaning and love as his lifetime had been.'*
>
> **Kate Maguire**

HOME Hospice exemplifies all that SVA is trying to achieve in driving transformative social change in Australia. Find organisations that have developed new ways of addressing old problems, conduct due diligence to test the model and make sure it has the potential to succeed and scale, provide multi-year funding, business, governance and strategic consulting and introduce the organisation to a broad and well connected network of people to further complement the in-house skills that SVA offers. It's a well-refined brand of venture philanthropy that works.

Your investment commitment to the Third Link Growth Fund, the management fee of which contributes to SVA's work and that of its venture partners, helped to positively impact the lives of 50,000 people around Australia in 2008.

SVA thanks you for your support, as do they.

www.socialventures.com.au