thirdlink

Third Link News

Issue 4 : April 2010

'Neither a borrower nor a lender be, for loan oft loses both itself and friend…'

Though written around four centuries ago by William Shakespeare in *Hamlet*, this is perhaps a pretty relevant topic for the times we are in today.

The strong rise in world stock markets from the lows of March 2009 was the talking point six months ago, but since that time we have largely been tracking sideways. While many are waiting to see the extent and durability of recovery in company earnings before pushing equity markets higher, others are concerned about sovereign debt levels (primarily of developed countries) and whether country defaults are around the corner that may trigger another wave of severe loss of investor confidence and credit contraction.

As in previous recessions, governments made up for the collapse in private demand by increasing government spending, resulting in dramatically rising government debt levels. They transformed themselves into both lenders of last resort and spenders of last resort! When combined with weak debt positions to start with in the case of many countries, this has resulted in the rise in government debt defaults – causing the latest round of panic in some quarters.

Just like individuals and businesses, countries do default on their debts when they borrow more than they can afford to repay. In fact virtually every country has defaulted on its debts in the past. At any point in time an average of around 5% to 10% of all countries are in default on their external government debt. The problem is that we have recently been in a rare lull in government debt defaults, so the debt crises in Iceland and Dubai were seen as unusual and alarming – but this is merely a 'return to normal'. Already, Hungary, Latvia and Romania are in the hands of the International Monetary Fund. The next default candidate is Greece (who, by the way, has been in default on its external government debt for a total of 90 years out of the 181 years since its independence in 1829!), and may be followed by Spain, Italy and Portugal among others.

Government debt problems are often serious, but clearly not unusual throughout history. Although investors should be conscious of such events, it is unlikely to mean 'the end of the world' or anything like the scale of concern that existed in October 2008 when world credit markets virtually froze and the modern finance system as we know it was on the precipice of collapse.

During a recovery phase people are always worried about whether the recovery will last – hence the saying that 'the market climbs a wall of worry'. On this occasion, Europe and US do have much greater debt burdens than has been the case in the last 50 years – so for them this wall is that much higher! However, from an Australian point of view, Asian countries are now much more important (our top four trading partners are Asian, and even more importantly this is where 70% of our exports now go) so it may be that the fragility of the US and Europe is less of a concern.

Interestingly, there has been much discussion in Australia about our seemingly high government debt level, with some fairly alarming comments by certain politicians. Below is an article from a former colleague of mine from Colonial First State Investments, Hans Kunnen, which puts this in perspective.

The flip side of rising debt levels in the developed world is the increasing reserves of the creditor nations. China, for example, has an estimated US$2.4 trillion of foreign reserves, of which approximately US$1.7 trillion is invested in US Government treasury bills and bonds. That is becoming a very interesting dilemma given the poor state of the US finances – but is a story for another day!

The bias of the Third Link Growth Fund to the Australian share market continues to serve the Fund well. The recent company reporting season in Australia was stronger than predicted, though clearly more revenue growth is now needed to carry valuations further upwards.

Thank you for your continuing investment in Third Link Growth Fund. All the net management fees of the Fund 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

Chris Cuffe, Director
Third Link Investment Managers Pty Limited

Investment Manager
Third Link Investment Managers Pty Limited
Suite 1 Level 6, 6 – 10 O'Connell Street
Sydney NSW 2000
Phone: 1300 793 855
www.thirdlink.com.au

Responsible Entity
Treasury Group Investment Services Limited
Level 5, 50 Margaret Street
Sydney NSW 2000
Phone: (02) 8243 0400

Thinking about Debt

By Hans Kunnen, Economist

When the media latches onto stories dealing with debt, the tone tends to be alarmist. Such news lifts ratings but it doesn't always shed light on the issues at hand. Is the nation drowning in debt? How much is 'too much' debt?

First things first. We must always be mindful of which debts we are dealing with – the debt of the Federal Government; the nation's foreign debt or the debt of Australian households?

Headlines will often comment that debt has reached a certain 'critical' level of GDP and disaster looms. Debts have never been so high. But this is a rush to judgement.

GDP (gross domestic product) is a measure of the annual income of the nation, the value of the goods and services Australia produces each year. Consider it the personal equivalent to your annual salary.

Should we measure our debts as a proportion of our salary or as a percentage of our assets? More likely we tend to look at our ability to service our debts. What percentage of my salary are my loan repayments?

Debt to GDP ratios help us measure debt levels over time but they tell us little about the risks associated with those debts. Debt to GDP ratios tend to muddle accounting principles.

Debt is a 'stock' item and belongs in a balance sheet. It's a liability. GDP is a 'flow' item; it's what we earn each year. It belongs in the profit and loss statement.

To untangle these items we should look at the ratio of debt servicing costs to income – usually called the debt service ratio and later we can consider the debt to assets ratio.

> *National issues such as debt levels and current account deficits should not be treated lightly. But neither should they be demonised.*

The debt service ratio is easily calculated for most debts. We know what interest payments the Federal Government must make each year and we know its revenue.

What is the Government's debt to service ratio and has it been higher in the past? By 2013 the debt service ratio (interest payments to income) of the Federal Government will be 2%. It has been higher, 6.5% in mid-1990s and it has been lower. But it hardly constitutes a crisis. Again we can argue over alternative uses for the interest payments – which will be $7.6 billion, but interest payments have been as high as $9 billion per year in the not too distant past.

When it is breathlessly announced that the Federal Government will be in debt to the tune of $300 billion by 2013, it is conveniently forgotten that many people owe money to the Federal government. The government's net debt will be 'only' $188 billion in 2013. This is a large number – and we can argue about how we got there – but is it too much in a 'crisis' sense?

The Government's debt to assets ratio (if we use the Australian economy as our asset base) is close to 4% assuming that debt is $300 billion and the nation's assets are conservatively worth around $8.5 trillion or $8,500 billion. When someone says the Federal government has saddled each of us with $13,600 of debt ($300 billion divided by our population of 22 million) we can retort with the equally absurd statement that we each have at least $380,000 in assets.

Next question: Is our household sector sinking under unbearable debts?

Without doubt some people are deeply in debt and face financial trauma. But there are 8 million households in Australia and not all face crippling debts. Almost 30% of households have no debts at all. Around 60% of household debt is home mortgages, 25% is for investment housing and 15% is 'other personal borrowing' such as credit cards and car loans.

According to the Reserve Bank of Australia (RBA) and the Australian Bureau of Statistics (ABS), the indebtedness of Australian households has risen from $190 billion in 1990 to $1100 billion in 2008. Household debts as a proportion of household assets have risen from 9% to 19% over the same period.

The household debt service ratio tends to move with interest rates and debt levels. In the mid 1980s household interest payments as a percentage of household disposable income was only 5.5%. It rose to 9% in the late 1980s as interest rates rose and then fell back to 6% in the early 1990s. It peaked again at 15.4% in June 2008 before falling back to 10.3% in June 2009.

As a sector, Australian households are not stretched, but there are limits. Some households have already reached that limit. Some have surpassed it.

What about Australia's net foreign debt? As at June 2009 it stood at $633 billion – none of which was Government borrowing. Australia's foreign debts are private. They are the borrowings by banks, to lend for mortgages and other lending, plus offshore borrowings by other Australian companies. Annual payments on this debt amount to $28.8 billion or 2.4% of GDP.

New foreign debt is created each year if the demand for loans in the economy outstrips the nation's savings. The difference is made up by borrowing offshore and results in what is known as the current account deficit.

National issues such as debt levels and current account deficits should not be treated lightly. But neither should they be demonised. Public policy must encourage saving and we must retain the confidence of offshore capital markets. If the global financial crisis taught us anything it was that confidence and trust can evaporate overnight – leaving those with excessive debt badly exposed to financial trauma.

Recommended reading

Government debt – Commonwealth Treasury's Economic Roundup No1, 2009. *A history of public debt in Australia.*

Household Debt – ABS publication Australian Social Trends, March 2009, *Household Debt,* Catalogue number 4102.0.

Foreign Debt – Australian Parliamentary Library, Research Paper no 30. 2009-09, *Australia's foreign debt – data and trends.*

Mr Kunnen was formerly Head of Investor Markets Research at Colonial First State and Chief Economist at the State Bank of NSW.

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.

We are now some 22 months into managing your Fund with the portfolio positioned as follows:

		31 March 2010	30 Sept 2009
Growth-oriented investments			
Australian listed shares	– general	49.3%	52.3%
	– smaller companies	12.3%	12.7%
International listed shares	– general	8.4%	9.1%
	– emerging markets	8.9%	3.6%
Property (both domestic and international)		0.0%	0.0%
Alternative assets		3.2%	6.2%
		82.1%	84.1%
Fixed interest securities & cash			
Hybrid securities (Australian listed)		9.9%	3.3%
High yielding global fixed interest securities		0.0%	5.5%
Cash on deposit		8.0%	7.1%
		17.9%	15.9%
		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.

The key adjustments to the portfolio over the last six months have been:

- To significantly increase the exposure to emerging markets (from 3.6% of the portfolio to 8.9%) given our belief in the stronger growth potential of these regions compared to more mature economies. To achieve this we allocated money to the RARE Infrastructure Group to access the *RARE Series Emerging Markets Fund* (this fund comprises 25-60 listed emerging market infrastructure securities, diversified across a range of sub-sectors such as gas, electricity and water utilities, toll-roads, airports, rail and communication infrastructure) and Aberdeen Asset Management for its emerging markets expertise via the *Aberdeen Emerging Opportunities Fund*;
- To significantly increase the exposure to Australian listed hybrid securities (from 3.3% of the portfolio to 9.9%) given the very attractive floating rate yield spreads being offered relative to the risk profile of the securities; and
- To sell out of our exposure to high yielding global fixed interest securities (from 5.6% of the portfolio to 0.0%) as a we felt the large gains enjoyed from the material tightening in global credit spreads over the last 12 months had largely run its course.

We did not materially change the overall exposure to growth-oriented investments, which now sits at 82.1% of the portfolio. We believe that most equity markets are within their fair value range (being neither cheap nor expensive) while at the same time corporate fixed interest markets continue to provide relatively attractive value from a risk/ return tradeoff.

Net inflows to the Third Link Growth Fund over the past six months totalled $3.3 million, with the overall Fund size now at $37.8 million.

As can be seen from the above table, we continue to have a strong exposure to Australian equities given the very favourable outlook for Australia, including:

- Strong and stable banking system;
- Rising corporate profits and strong corporate balance sheets;
- Relatively low unemployment;
- Relative lack of problems in its housing market;
- Relatively manageable government debt, even post the stimulus packages; and
- Strong resources demand, particularly from China.

We are not yet comfortable enough with the outlook for the listed property sector (compared to equities and fixed interest markets) and hence have no exposure to this asset class.

The key portfolio changes that occurred over the last six months (since our last newsletter) in addition to those already mentioned were as follows:

- A takeover occurred for one of the Fund's two direct equity investments, Challenger Kenedix Japan Trust. A healthy gain of over 25% (including distributions received) was achieved during the 18 month holding period;
- We redeemed our 'Alternative assets' investments with Select Asset Management and Ellerstone Capital due to the relative small size of these holdings;
- We redeemed our 'International listed shares' investment with Taube Hodson Stonex Partners to increase our exposure to Australian listed shares given the increasingly favourable outlook for Australia; and
- A new directly held infrastructure security was purchased.

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

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

International equities
– Intrinsic Value Investments
– Magellan Financial Group
– Arkx Investment Management (global clean energy)
– Aberdeen Asset Management (emerging markets)
– RARE Infrastructure (emerging markets infrastructure)
– Schroders Group (emerging markets)

Alternative assets
– Technical Investing

Fixed interest & cash
– Colonial First State Investments

Fund Performance

We aim to outperform the returns of the Morningstar Multi-Sector Growth Market Index after fees over rolling five year periods.

	Since inception (June'08) (per annum)	1 year	6 months	3 months
Third Link Growth Fund	+5.5%	+38.3%	+5.7%	+1.4%
Morningstar Multi Sector Growth Market Index	–2.6%	+23.7%	+3.3%	+1.4%
Fund relative performance	+8.1%	+14.6%	+2.4%	+0.0%

Returns are calculated after fees have been deducted and assuming reinvestment of distributions. No allowance is made for tax.

The adjacent table shows the Fund's performance after fees, relative to the Morningstar Multi-Sector Growth Market Index, as at the end of March 2010.

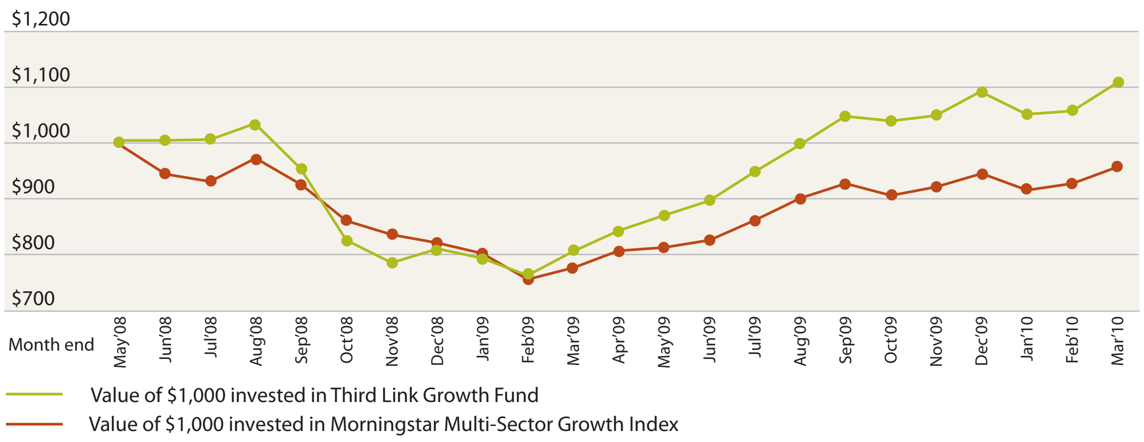
The last six months (being when we wrote the last newsletter) has certainly seen a significant moderation of investment performance compared to the previous six month period from April 2009 to September 2009 (+5.7% vs 32.6%), albeit the return of +5.7% is still very healthy in a low inflation environment where relatively low interest rates still prevail.

On an annualised compound basis, the Fund's return of +5.5% pa since inception is now slightly above returns from 'cash in the bank' over the same period. This is an encouraging result for investors though hardly sufficient reward for the volatility endured! Interestingly, the All Ordinaries index (a common barometer used to measure the performance of the Australian share market) is now up 57% to the end of March 2010 from the 6th March 2009 bottom, but is still 29% below the peak level reached on 1 November 2007. There is still a long way to go yet!

Over the last six month period, the key contributors to the Fund's performance relative to the benchmark were: having a higher exposure to growth-oriented investments given such markets performed better than cash and most fixed interest markets; holding some hedged international equities during a period when the $A continued to materially appreciate against the $US; having an overweight exposure to Australian smaller companies; the good overall performance of our main-stream Australian equity managers; and the takeover of one of the Fund's direct investments. However, the Fund's relative performance was hampered by the exposure to emerging markets funds because of their unhedged currency positions.

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 Morningstar Multi-Sector Growth Market Index over the same period.

Performance of Third Link Growth Fund vs Morningstar Multi-Sector Growth Index



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

When Terry White is asked what he was doing before he started work at Fair Repairs, he explains with a self-deprecating grin: 'Looking after the kids and pretty much being a dole bludger.'

Terry is typical of the workers at the repairs and maintenance business, Fair Repairs – one of the enterprises established by Social Ventures Australia (SVA) venture partner Fair Business to provide jobs for the long-term unemployed. At 31, married with four kids and living in public housing in the outer south-western suburbs of Sydney, Terry had been out of work for over two years before he joined the Fair Repairs team.

Terry had been in and out of employment since leaving school but after losing his last job in 2007, with no qualifications and an inconsistent employment record, Terry struggled to find an employer willing to give him a chance. And as the unsuccessful applications mounted, Terry began to lose confidence in both himself and the system.

'For young fellows like me it's hard to get a job. I was looking for work but had no success as no one would give me a go because of my recent history. But Fair Repairs put all of that aside and checked us out and found we're all good and healthy and willing to work. They gave us all a go and that's all we needed.'

Fair Business buys and grows existing businesses, creating new jobs in the process and proactively recruiting long-term unemployed to fill roles. There are currently four different enterprises across various industries in the Fair Business portfolio.

In the case of Fair Repairs, the business model is based on matching the skills of unemployed public housing residents with repair and maintenance jobs in their local area. And for young unemployed people with limited skills, Fair Repairs creates trade based traineeships to help improve their skills and employability.

Research shows that individuals facing long-term unemployment experience social isolation, low self esteem, poorer physical and mental well-being and the increased risk of economic hardship. But for people like Terry who are given the chance to successfully integrate back into the workforce, life can pretty quickly turn around.

'It's made everything a whole lot better. I can actually do things now without having to look in my pocket every time. I've actually got a career coming, that's the way I see it. I'm willing to do anything for Fair Repairs and work hard to keep my new role.'

Your investment commitment to the Third Link Growth Fund, the management fee of which contributes to SVA's work, has been an important component of SVA's growing funding base. And through growing its funding base, SVA can continue to support organisations like Fair Business – and more importantly, help transform the lives of young Australians like Terry and his family. SVA thanks you for your support.

www.socialventures.com.au

Design: **Eyconology**.com (at a reduced rate)