thirdlink investment managers

Third Link News

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The unfolding Greek tragedy

The last 6 months have seen a period (yet again!) of very considerable share market volatility, and unfortunately in an overall downward direction.

From the end of March 2011 to the end of September 2011 the All Ordinaries Accumulation Index fell more than 15% – a very large decline in a relatively short period of time. As has been well reported in the press, there seems to be three key themes that have triggered such extreme financial market volatility:

- The ongoing likelihood of Greece defaulting on its sovereign debt (the tragedy of a country that has been living way beyond its means for far too long!) and the risk of contagion engulfing the southern states of the Eurozone leading to a European banking crisis and a cascading effect around the world;
- The fear of slowing growth turning into a recession in the US and Europe; and
- The apparent inability of US and European governments to respond effectively to ever increasing sovereign debt levels, debt limits and budget deficits (a good example of this was buried in some statistics I recently saw, which showed the US has run deficits almost every year since World War II, with prominent surpluses only 1998–2001).

In particular, the negative focus now on the Eurozone is reaching fever pitch. It seems obvious that the European banks (in particular) are holding a lot of bonds issued by European counties where the true value of these bonds is worth considerably less than their face value because of the fiscal mess these countries are in. This being the case, it seems obvious that what is needed is an immediate recapitalization of the banks that own the debt. So why is the Eurozone taking so long to decisively deal with this problem?

The Eurozone is a monetary union of 17 states that have adopted the Euro as their currency. The European Central Bank (ECB) is responsible for monetary policy for the Eurozone and is made up of a President and the head of each state central bank. The member states are: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain. The Eurozone has had trouble responding to the debt crisis because it has 17 separate states, which means 17 separate governments with their own budgets and parliaments. There are also 17 separate banking systems. Trying to get agreement within the Eurozone and the ECB is proving very difficult as the economic objectives and policies of each state and central bank differ to a degree. What a gridlock of a situation when difficult decisions are needed quickly!

Whichever way I look at it, I am convinced that the root cause of the problems seems to be growing government debt in most western countries caused by out of control social spending – a problem that has been progressively building through the past few decades. And attempting to reverse this is virtually impossible as there are ever-more elderly voters dependent upon ever-more social benefits.

I also continue to hold the view that the US consumer is the key to sustained and robust world economic recovery. Once we see a recovery in the US housing market (and it appears we are not at the bottom yet) then confidence will begin rebuilding, the US consumer will start spending again, the economy will grow again, jobs will be created… and on will go another upward cycle.

With all the current gloom, one thing is for certain. When the market gets over this phase it will rise rapidly and strongly…and probably at a time when people least expect it!

Thank you for your continuing investment in Third Link Growth Fund. All the net management fees of the Fund continue to support the non-profit sector through the inspirational work of Social Ventures Australia. To date, more than $1,200,000 has been donated.

Regards

Chris Cuffe,
Founding Director & Portfolio Manager
Third Link Investment Managers Pty Limited

Europe's forgotten lessons of history

By Oliver Marc Hartwich

The rise and fall of the Euro is just another chapter in the long history of monetary unions in Europe. The Euro was not the first attempt to unite different European economies and countries by a monetary framework. And it will not be the first such currency to fail.

If Europe's politicians had paid more attention to the continent's history lessons they would have been more careful with the design of the Euro. And if they had been aware of previous currency unions, they would have been particularly concerned about Greece.

In the 19th century, it was France that pushed for monetary union. After Napoleon, the French needed a strategy to bolster their influence in Europe. They tried it through monetary alliances. Belgium adopted the French franc after independence in 1830. Switzerland joined them in 1848. Italy followed in 1861, and finally in 1867 Greece and Bulgaria also linked their currencies to the franc.

The French monetary bloc then became the Latin Monetary Union (LMU). It was a union based on the same gold and silver content of coins in all its member countries. Several other European countries from Spain to Serbia joined this union in the following years.

LMU failed and was officially disbanded in 1927 for several reasons. It could not keep up the fixed relationship between gold and silver when more silver flooded the market. Second, there was no central authority to effectively control and coordinate monetary policy. And crucially, member states were cheating on the gold and silver content of their coins. One country was even formally expelled from monetary union in 1908 because of the grossly fraudulent gold content of its coins.

The country in question was none other than Greece.

In watching the current Greek tragedy we are witnessing history repeating. Once again a French initiated monetary union is on the verge of collapse. And once more, this collapse was brought about by a lack of political coordination, cheating member states and ineffective sanction mechanism.

Where the French of the 19th century aimed to increase their geopolitical standing through monetary union, in the late 20th century France made another attempt at European monetary union in order to prevent Germany from becoming the dominant force on the continent.

There is mounting evidence that the introduction of a European currency was President Mitterrand's condition for France agreeing to Germany's unification in 1990. Such a deal was recently confirmed by World Bank President Robert Zoellick, who at the time headed the US delegation in the negotiations about Germany's unification.

> *'Europe will pay a high price for ignoring the lessons of history.'*

France was afraid of an economic powerhouse of 82 million people as its neighbour. Previous experiences of devaluation against the German mark were a source of constant embarrassment to the French. With the Euro, so Mitterrand believed, such German dominance would be a thing of the past.

In forming the Euro, politicians of the 1990s repeated the mistakes of their predecessors a century earlier. In binding together various European countries, they failed to establish an institutional framework to make this monetary union work. They overlooked the structural differences between European economies. Rules for fiscal and monetary stability were insufficient and systematically violated right from the start.

Greece was able to join the Euro although everyone knew that Athens had fiddled its fiscal statistics. France and Germany ignored deficit rules without being held to account. The 60% debt-to-GDP limit set by the EU's Stability and Growth Pact has been contravened so regularly that it is not even clear why it was legislated in the first place.

The political independence of the European Central Bank was damaged right from the start. Its first president, Dutchman Wim Duisenberg, had been elected for a full eight-year term. However, political pressure ensured that he resigned his position after four years to allow his colleague Jean-Claude Trichet to take over, just as the French government had demanded.

With such 'independence' of the ECB, it should not have surprised anyone that in the European debt crisis the bank did not play the role of an impartial arbiter but became deeply involved in fiscal matters. No central bank should ever find itself in such a position.

The loss of good central banking practice started with the acceptance of low-grade collateral. It continued with ultra-loose monetary policy. And it culminated in the large scale purchase of government debt on the secondary market.

The parallels between the decline of LMU and the Euro today are stunning. Despite decades of European integration through the framework of the European Economic Community and later the European Union, Europe has remained a continent of nation states. These nation states continue to have their own national interests, which they are not prepared to compromise for any greater European good. They are still unwilling to delegate decision-making to common institutions or even play by previously agreed rules.

Then and now this lack of political integration is resulting in the collapse of monetary union. Today, however, it is going to be much more costly than in the 19th and 20th centuries.

Back then monetary union was at least still based on commodities – gold and silver. In addition, national currencies continued to exist nominally even though their gold and silver values were harmonised. Today, in comparison, there had never been anything backing the Euro currency but trust. Now that trust in Europe's political and financial institutions has all but evaporated, it will be even harder to move on to an alternative monetary framework.

LMU existed while Europe was rapidly growing; today it is in decline. Europe is an old and ageing continent. Its governments are heavily indebted; taxes are high; and there is no realistic prospect of Europe growing out of its debt.

Monetary union in Europe was a grand, utopian project. This made it a political dream that has caused an economic nightmare. Europe will pay a high price for ignoring the lessons of history. ■

Dr Oliver Marc Hartwich is a Research Fellow at the Centre for Independent Studies.

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.

The portfolio of your Fund is currently positioned as follows:

		30 September 2011	31 March 2011
Growth-oriented investments			
Australian listed shares	– general	32.2%	39.0%
	– smaller companies	9.9%	10.8%
International listed shares	– general	11.1%	15.1%
	– emerging markets	6.5%	6.5%
Property (Australian listed)		–	–
Alternative assets		11.8%	7.5%
		71.5%	78.9%
Income-oriented investments			
Property/infrastructure trusts (Australian listed)		7.7%	4.3%
Hybrid securities (Australian listed)		8.0%	9.4%
High yielding global fixed interest securities		7.4%	6.1%
Cash on deposit		5.4%	1.3%
		28.5%	21.1%
		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.

During the six month period to 30 September 2011 you can see that the percentage of growth oriented assets decreased from 78.9% to 71.5% with a corresponding increase in income oriented assets from 21.1% to 28.5%. This has been partly caused by a decrease in the value of many of the growth assets in the portfolio, but also a deliberate move given concerns about fear gripping equity markets.

Within the two broad categories of growth oriented assets and income oriented assets, the following key changes have occurred during this period:

- We redeemed our holding in the *Platypus Australian Equities Trust*;
- We decreased our allocation to international shares by redeeming our holdings in *Arkx Clean Energy Fund*;
- We increased our allocation to Alternative Assets, making a new investment into the *Swita International Asset Allocation Fund* (managed by the Swita Investment Management group), which specialises in global asset allocation;
- We increased our allocation to listed property/infrastructure investments (classified as income oriented investments) by:
  - adding to our positions in the *Australian Infrastructure Fund*, given the attractive and diverse nature of its portfolio of primarily airport assets, its discount to net tangible asset backing, and because we believe there will soon be a partial return of capital from asset sales;
  - adding to our holding in *Westfield Retail Trust* and taking an initial position in *CFS Retail Property Trust* given their significant discount to its asset backing, low gearing, and high quality portfolios of shopping centres;
- We altered our exposure to listed hybrid securities by:
  - selling out of the Southern Cross Airports Corporation interest bearing securities, which we regarded as fully valued;
  - adding to our position in the listed *Adelaide Managed Funds Asset Backed Yield Trust* given its attractive discount to net tangible asset backing and wind up in progress; and
  - taking a position in the newly listed ANZ convertible preference share offering; and
- We added to and diversified our exposure to high yielding global fixed interest securities through an initial investment in the *Bentham Global Income Fund* (managed by Bentham Asset Management) utilising funds partially redeemed from the *Colonial First State Wholesale Global Credit Income Fund*.

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

- We completely sold out of our small direct holding in the *Dexus Rents Trust* as we were not able to accumulate a significant enough holding at an attractive price;
- We sold out of our direct holding in the listed *Commonwealth Office Property Fund*, bought a month earlier to take advantage of its steep discount to net asset backing, booking a handy 6% profit for this short holding period.

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.

We believe that the economic outlook for Australia (where we continue to have a strong bias, with Australian equities representing around half of the portfolio) remains positive and that equity markets currently represent very good value. ■

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) (pa)	3 years (pa)	2 years (pa)	1 year	6 mths	3 mths
Third Link Growth Fund	+2.1%	+3.9%	+1.4%	–2.2%	–9.9%	–7.3%
Morningstar Multi Sector Growth Market Index	–2.6%	–0.2%	–0.2%	–2.4%	–7.5%	–6.2%
Fund relative performance	+4.7%	+4.1%	+1.6%	+0.2%	–2.4%	–1.1%
Australian Share Market	–5.9%	+0.0%	–3.5%	–8.4%	–15.5%	–11.3%
Cash	+4.9%	+4.5%	+4.7%	+5.0%	+2.5%	+1.2%

Returns are calculated after fees have been deducted and assuming reinvestment of distributions. No allowance is made for tax. The figures for the 'Australian share market' and 'cash' are measured by reference to the All Ordinaries Accumulation Index and UBS Bank Bill Index respectively.

This index is constructed by the Morningstar group from reviewing the asset allocation of Australian fund managers who operate multi-sector funds and have between 61% and 80% of their assets in growth sectors (typically defined as shares and property asset classes) with the balance in cash and fixed income securities. In order to achieve this objective, we have considerable flexibility in the type of investments and exposure to each that the Fund may hold.

The above table shows Fund performance after fees relative to the Morningstar Multi-Sector Growth Market Index as at the end of September 2011. To provide useful points of comparison, the table also shows the returns from the Australian share market and from cash on deposit over the same period.

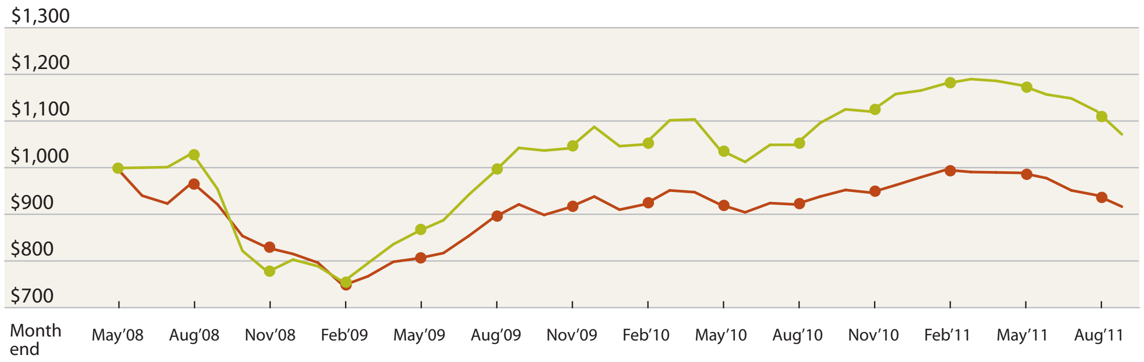
During this period the Australian share market fell by 15.5% and global share markets were similarly heavily negatively impacted. Apart from cash, nothing escaped the malaise of this extremely difficult investment period, with valuations of nearly all asset classes materially negatively affected by concerns of credit issues in Europe, a possibility of another recession in the US, and slowing growth in China.

This flight to risk-free assets resulted in a sharp sell-off in asset classes that the Fund had relatively large exposure to – international equities, emerging markets and global fixed interest securities. The result was a disappointing investment performance for the Fund over the six month period of -9.9%

More positively, in May 2011 the Third Link Growth Fund passed its three year anniversary, which is an important milestone for any investment fund in terms of meaningful performance measurement against other managers. Compared to its peer universe, being the Mercer Investment Performance Survey of Wholesale Balanced Growth Funds (that have a similar asset allocation to Third Link Growth Fund), the last available measurement period, being to the end of July 2011, positioned the Fund as 1st over one and two year periods and 2nd over three years.

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 quarterly 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 Market 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.

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

Social Ventures Australia
Activity Update

Paul Bridge, Principal Derby District High School is changing expectations.

The kids at Derby District High School in Western Australia know exactly what it means to be 'Black and Deadly'. According to Principal Paul Bridge, to 468 Aboriginal students 'Black and Deadly' means being 'top notch'; 'being in charge of your life'; 'being proud'.

Located, just about as far away from the main population centres of Brisbane, Sydney and Melbourne as you can get while remaining on mainland Australia, Derby District High School is the only secondary school in the Kimberley region.

When Paul arrived at the school, it had been going through a tough time. Paul was the fourth principal in five years and while the previous principal had put a great deal of work into refocusing the school policies and procedures and laying foundations for change, education outcomes for many students were still poor.

'It was clear from feedback from staff that there were inconsistencies in the way we were catering for students' needs. The ability ranges within each class were diverse which was challenging for teachers. I also believe there were inconsistencies in expectations in students' abilities to learn. It quickly became very clear that a lot of that was caused by the high staff turnover and the staff supply problems,' Paul explains.

Paul had met Dr Chris Sarra, Executive Director of SVA's venture partner the *Stronger Smarter Institute* some four or five years earlier and the two had formed a strong friendship. Paul reconnected with Chris and decided to attend the leadership program offered by the Institute.

'The focus of the professional learning was to deliver leadership development to school leaders in Aboriginal education, in changing the tide of expectations that Aboriginal students cannot achieve. We could no longer collude with the notion that underachievement is alright if you are Aboriginal and that it was alright for Aboriginal children to be disrespectful, and not be responsible for their behaviour', reflects Paul.

'The message was that we need to set high expectations and standards for students, and at the same time instil in students pride and respect for self, their own cultural identity, the school community and others. We needed to change expectations and ensure parents, teachers and students were all working collectively.'

Paul is leading a change process in the school and although it is too early to gauge changes in academic results, Paul has already noticed behavioural changes.

'There is still a way to go as some of the kids still believe that to be Aboriginal is to be second rate. We need to instil in them greater pride in who they are,' concludes Paul.

Your investment commitment to the Third Link Growth Fund, the management fee of which contributes to SVA's work, enables SVA to support organisations like the *Stronger Smarter Institute* – and in turn support principals like Paul in their efforts to transform the lives of disadvantaged Australians.

SVA thanks you for your support. ■

www.socialventures.com.au

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