thirdlink

Third Link News

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Investment Manager
Third Link Investment Managers Pty Limited
PO Box 1087
Sydney NSW 2001
Phone: 1300 793 855
www.thirdlink.com.au

Responsible Entity
Treasury Group Investment Services Limited
Level 14, 39 Martin Place
Sydney NSW 2000
Phone: (02) 8243 0400

Remarkable

By the time you finish reading this newsletter, China will have produced the equivalent of a Sydney Harbour Bridge worth of steel.

China will produce and use 700 million tons of steel this year, which is the equivalent of building 18,500 Harbour Bridges in a year. China now builds the equivalent of a Harbour Bridge worth of steel every 15 minutes. That's four every hour, 12 hours a day, 365 days a year.

China's massive infrastructure construction boom has fuelled Australia's mining boom as most of the Chinese steel is made from iron ore and coking coal from Australia. Chinese steel production grew by an average of 7% pa during the 1980s and 1990s. It then surged to 20% growth pa between 2001-2007 and has now fallen to around 7% pa. Growth rates in the demand for steel are likely to flatten further in future as China's economy shifts away from being dominated by exports and construction, and more towards domestic consumption and services, which require fewer bulk raw commodities.

As I think about the 30 years I have spent hovering around investment markets in different capacities, I can't help pondering some of the remarkable statistics that exist at the moment that show we are in very unusual times. Not only is the China story remarkable, but consider the following:

- Sovereign bond yields around the world are at unprecedented levels. In Holland, 10 year yields hit their lowest in 496 years; 10 year US Treasury yields are their lowest since 1790; official base rates in the UK are at the lowest since the Bank of England's inception in 1695; Australia's are the lowest since the 1950s; and in June, Germany's two-year bond yield turned negative for the first time ever (you had to pay money to invest!).
- Over the past 3 years the Australian share market (including dividends) has increased only 1.7% pa and yet the US share market has increased 13.2% pa in value (in the last year this has been 14.5% in Australia and 30.2% in the US) – very unusual numbers for two markets that traditionally have a close correlation.
- China has had the fastest growing economy in the world throughout the sovereign debt crisis of the past three years but also the lowest stock market growth.
- Australia is now one of the few countries in the world with a AAA sovereign credit rating (we rank ahead of countries such as the US, Japan and most of Europe) attracting funds from the central banks of Germany and Switzerland – a long way from a 'Banana Republic'.
- Bank dividends in Australia are extraordinarily high right now and are nearly three times the cash rate.
- Thanks to China, Australia's terms of trade in the last few years have been the best since the 1890s.
- As a result of China's recent slowdown we have seen a dramatic fall in commodity prices and demand for our bulk raw commodities and yet the Australian dollar remains unusually high in value (the two normally have a very close correlation – falling commodity prices are usually immediately followed by a falling AUD).
- Household debt levels in Australia are three times those of the late 1980s, even though Australian household saving has increased to around 10% of disposable income (back to 1980 levels).
- Australia's current account has been negative since 1973 and interestingly this has remained so even as the export mining boom has accelerated in the last decade.

Since the previous newsletter much has happen at a fast pace. The Reserve Bank of Australia has continued to cut official interest rates (now at 3.25%), China's growth rate has slowed materially (resulting in our two speed economy starting to become one speed again), we saw another massive quantitative easing program (QE3) announced in the US, our terms of trade have fallen substantially. . . and on the list goes.

Below is a fascinating article by my fellow director of Third Link Investment Managers, Ashley Owen. With all the money that is being printed around the world now it is a timely reminder of the lessons of history and the role of inflation.

Thank you for your continuing investment in Third Link Growth Fund. The fees you pay to us for having your money professionally managed continue to make a difference to others. Since the Fund began in mid 2008, around $1,500,000 has been donated to the charitable sector, with the donations now running at approximately $50,000 per month.

Regards

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

Catapults and coin tricks

What US Federal Reserve Board Chairman, Ben Bernanke learned from the Greeks

By Ashley Owen

Many people regard inflation as a relatively recent phenomenon – it was a problem in the 1970s and it appeared to have been cured in the great 'disinflation' of the 1980s and 1990s. But inflation is not a recent phenomenon, and it certainly has not been 'cured'.

The central banks in the US, Japan, Europe, UK and Switzerland are all doing their best to fuel inflation using the oldest monetary trick in the book – printing money to repay debts with debased currencies, and inflate away the real value of the debts. There is no other hope of repaying the mountains of government debt – with ageing populations, pensioner numbers growing more quickly than the workforce, unaffordable welfare commitments, and politicians promising even more tax cuts.

History is littered with episodes where governments abandoned fixed currency systems to print excess amounts of money (usually to finance wars or repay debts). The resulting inflation led to civil unrest, often involving the violent overthrow of governments. Peace and prosperity is generally only restored with a 'hard money' system, where a government's ability to create money is restricted by the supply of a limited hard currency, usually silver, gold or a common currency like the euro. This has been the pattern ever since Ancient Greece, where it all began.

Two destructive inventions

Dionysius (405 - 367 BC) was the despotic tyrant of Syracuse in Sicily during the wars between the Corinthians, Athenians and Carthaginians for control of Syracuse. Dionysius invented two great weapons of mass destruction – the catapult and money debasement. The catapult was effective in destroying the Athenians, but Dionysius' debasement of money in his own city resulted in inflation, unrest and rebellion.

Dionysius had run up huge debts to the public and he wanted an easy way to repay the debts without raising taxes. He recalled all the one drachma coins in Syracuse (on penalty of death), and then over-stamped each coin with a 2 and used these newly minted '2 drachma' coins to repay his debts. The people were not happy! Doubling the total face value of money in circulation just doubled the money price of everything. A bag of grain was still a bag of grain, but its price in drachma was now effectively inflated by 100%. The money the people received in repayment of their debts only bought half as much as it did before the debasement.

> *'History is littered with episodes where governments abandoned fixed currency systems to print excess amounts of money.'*

Plato's tin pot scheme

The philosopher Plato was also a soft currency man. Under his guidance, Dionysius introduced coins made from tin in 388 BC but the plan failed. The people knew the value of the tin in the coins was only a fraction of the artificial value stamped on them, so they had no trust in the coins and the experiment failed. The coins soon fell to the value of the tin: virtually worthless. Plato was sold as a slave as punishment. In the ensuing economic and social turmoil, the rule of Dionysius and his son Dionysius II collapsed. The Corinthians finally restored order and democracy, and made peace with Carthage in 343 BC.

Fortunately Plato's student, Aristotle learned the lesson and became a hard currency man. He introduced a common silver-backed currency across Greek states and territories. Governments were restricted from creating money by the supply of silver. Confidence was restored, prices were stabilised, trade and commerce flourished, the citizens became wealthy. Alexander the Great, Aristotle's own student maintained the hard currency stance, but after his death in 323 BC, the currency was debased repeatedly and the economy declined along with the empire.

History repeats itself

Almost every country in every era, from Syracuse to the US, has succumbed to the temptation to create money at a rate higher than the rate of growth in output in the economy. The outcomes have been remarkably consistent: economic disruption, price inflation and social and political unrest. Inflation often provided the catalyst for violent rebellion and revolution. Individuals and businesses want a system of money they can trust, where the money has real value and substance and where prices remain stable and predictable.

These episodes often take many years to unfold. Japan has been printing money furiously since the 1990s. The US, UK and Europe joined in during the GFC with Switzerland more recently, in spectacular fashion. Bernanke added 100% to the monetary base in 'QE-1', added another 100% in 'QE-2' and is now embarking on a potentially unlimited 'QE-3'. To date, investors have not been concerned about inflation. Unemployment rates are high and yields on long term government bonds are at multi-century lows – investors globally are not assuming any risk of inflation or default for many years. Five countries actually pay negative yields on their short term government debt so investors are paying governments to take their money!

Although the crisis has taken many years to build, perceptions can change quickly. Once inflation is out of the bag it is devilishly difficult to contain. Un-printing money is much more difficult than printing it.

Bond yields are very low now, but a sudden catalyst can change sentiment 'on a dime'. In our opinion, yields will start to jump, probably in the US first, as the drivers of economic growth are stronger there than in Europe, UK or Japan. Investors everywhere will suddenly realise that it is crazy to lend their hard earned money to profligate governments for 10 years for a lousy 1 or 2% with no inflation hedge. The stampede to get out of bonds will be on and the next inflationary spiral will have begun. ■

Ashley Owen is a director of Third Link Investment Managers and joint CEO of Philo Capital Advisers.

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 2012 the portfolio was invested as shown in the table opposite.

Over the last six months the only changes to the portfolio have been as follows:

- we sold our remaining direct holding in Australian Infrastructure Fund, at a significant profit over the original cost price; and
- the Fund paid a distribution of income to investors in early August in respect of the six months ended 30 June 2012.

No new managers (or funds of existing managers used) were added to the portfolio in the last six months.

As at the end of September 2012 the Third Link Growth Fund stood at $45.1m in size. During the last six months we received $0.4m in new applications and processed redemptions totalling $2.3m.

AUSTRALIAN EQUITIES			
General:			
JBWere Individually Managed Account	20.3%		
Bennelong Ex-20 Australian Equities Fund	7.7%		
Cooper Investors Australian Equities Fund	11.5%		
Montgomery [Private] Fund	9.3%		
Paradice Mid Cap Fund	10.9%		
Solaris High Alpha Fund	11.1%	70.8%	
Small Caps:			
Aberdeen Classic Series Australian Small Companies Fund	2.3%		
Eley Griffiths Group Small Companies Fund	2.6%		
Pengana Emerging Companies Fund	12.5%	17.4%	
Other:			
Tasman Market Neutral Fund (managed by Regal Funds Management)	9.7%	9.7%	
			97.9%
CASH & CASH EQUIVALENTS			
Colonial First State Wholesale Premium Cash Enhanced Fund		1.9%	
Custody Account & Other		0.3%	
			2.1%
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.

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 rebate their management fees and performance fees which apply to the investment of Third Link Growth 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

The objective of the Third Link Growth Fund is to provide an investment in Australian listed shares, with the aim of outperforming the S&P/ASX 300 Accumulation Index[1] after fees over rolling five year periods.

As at the end of September 2012, the Fund performance relative to the Fund benchmark was as shown in the table opposite.

Before February 2012 the objective of the Fund was to provide a diversified growth-oriented investment with a bias at most times to Australian listed shares, with the aim of outperforming the returns of the Morningstar Multi-Sector Growth Market Index[2] after fees over rolling five year periods. As such, the performance of the S&P/ASX 300 Accumulation Index in the table above for one year and longer has been shown for illustrative purposes only.

The Fund has produced a roller coaster performance ride over the last six months, finishing the period slightly in the black with a six month performance of +3.0% after fees. Individual monthly performances ranged from -5.3% in May to +4.6% in August.

However, more pleasing is the one year performance of +13.8%, particularly in the context of cash on deposit over the same period yielding +4.4%. This one year result has occurred against a backdrop of lower global growth expectations and seemingly endless amounts of bad news from Europe, making this strong return paradoxical. Such an outcome should serve as a good investment lesson. The correlation between economic growth and asset

	three months	six months	one year	two years	three years	Since inception (June 2008)[4]
Third Link Growth Fund	+8.1%	+3.0%	+13.8%	+5.5% pa	+5.4% pa	+4.7% pa
Fund performance relative to its benchmark[3]	-0.6%	-0.3%	+1.1%	+0.6% pa	+1.5% pa	+3.9% pa
S&P/ASX 300 Accumulation Index[1]	+8.7%	+3.3%	+14.5%	+2.2% pa	+1.7% pa	−1.4% 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.

prices is often non-existent in the short term, and often tenuous even in the long term. Hence the reason why successful investors don't just look at the *economic* fundamentals – they look at the *financial* fundamentals, which is basically the difference between value and price. Indeed, the famous investment veteran, Warren Buffet, insists that rather than looking at macroeconomic forecasts when deciding on what stocks to buy, he focuses on the fundamentals of the company and whether or not those fundamentals are properly reflected in the share price. Accordingly, one can infer that the markets have managed to rally over the past year against poor economic data, because the market was previously factoring in *even worse* economic data and financial conditions.

As we observed in our last newsletter six months ago, we believe the Australian share market still appears to have favourable winds that are likely to provide attractive returns over the near term for the following reasons:

- Australian interest rates appear likely to fall further because large parts of the economy are suffering under the weight of a stubbornly high Australian dollar (a fall in interest rates would also benefit Australian consumers and the housing market);
- Corporates continue to have strong balance sheets;
- Stock market valuations are not stretched (and still below their long term trend);
- Dividends are attractive (particularly compared to bond yields); and
- Australia's sovereign debt levels are not excessive.

The key wildcard though still appears to be the possibility of a further softening in China's growth which we are so reliant on now for our own flow-on prosperity. ■

1 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.

2 The Morningstar Multi-Sector Growth Market Index is compiled by Morningstar Australasia Pty Ltd (Morningstar), a unit of Morningstar, Inc. Morningstar construct this index by reviewing the asset allocation of Australian fund managers who operate multi-sector funds and have between 61 per cent and 80 per cent of their assets in growth sectors (typically defined as equity and property asset classes) with the balance in cash and fixed income securities.

3 As mentioned above, the benchmark up until the end of January 2012 was the Morningstar Multi-Sector Growth Market Index and from February 2012 onwards the benchmark was the S&P/ASX 300 Accumulation Index.

4 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. The performance figures shown in this column are expressed as annual compound returns.

Support, guidance and a safe place

The National Centre for Childhood Grief

Third Link currently has six partner charities that help children to thrive, not just survive. One of them, the National Centre for Childhood Grief (NCCG) provides a vital service for children grieving a death.

As well as counselling and support, NCCG provides a safe place where children can share their experiences as they learn to live with the impact of a death on their lives.

The centre also provides support for care givers of bereaved children along with education and training for individual, school and other organisations handling the grief of children and young people.

The centre was founded in 1994 by clinical directors, Dianne and Mal McKissock to provide specialist bereavement counselling free of charge to children between the ages of 3 and 18. The Centre's ethos was, and remains, that no child should miss out on grief counselling due to financial circumstances. These can change dramatically when families lose one or both income earners.

Over 2,700 families directly supported

Over the last 18 years NCCG has provided counselling to around 400 families every year. That's a total of 2,700 families who have benefited directly from their pro bono services. Because Dianne and Mal have also taught and mentored many school and community counsellors, the number of children that have been helped indirectly is even greater. They also regularly run programs in bereavement counselling for other counsellors, psychologists and GPs.

The centre's core programs consist of group and individual counselling sessions along with email support for families who can't access face-to-face sessions. Additional programs include Girls and Boys Adventure Weekends where children and young people learn resilience and have experiences they might otherwise have had with the parent they are grieving for.

A common occurrence

While many people may think that children losing their parents is a relatively rare occurrence, the 2006 census showed that 9% of people in NSW had lost either one or both parents before the age of 18. The impact of such a loss cannot be underestimated. Bereaved children's short and long term outcomes tend to be polarised – they are more likely to under or over achieve rather than gravitate to the middle. Adolescents, in particular, are at an increased risk of falling behind at school and have an increased potential to adopt negative coping strategies. Through counselling and support NCCG gives bereaved children a higher than average chance of being in the 'over achiever' group in the longer term.

Mending broken hearts

Despite the importance of its work, NCCG receives no government support and is funded entirely by individual and corporate donations and grants. Childhood grief is little understood and almost never acknowledged or discussed in our community. We would consider it outrageous if we did not have hospitals to take our children to, when they have broken limbs. When a child grieves, they have a broken heart. We need to ensure the sustainability of NCCG so we can assist children to mend their broken hearts and become well-functioning adults. ■

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