



## **Market Returns December 2010**

### **Balanced Investment Strategies**

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## Welcome to our Xmas addition of Market Returns.

At a time when we attend various social gatherings where we review what has happened over the year and set goals and make predictions for next year, we thought it appropriate to include the following articles this month about predicting the direction financial markets.

### Closed for Xmas

Our office will be closed from 4pm this Friday, 17 December, and we will be open again at 8am on Tuesday 4 January 2011.

From all of us at BIS Cosgrove we would like to wish you the very best for the festive season and hope to see you safe and well in the new year.

### Ghosts of Christmas Past

*An article by Jim Parker, Vice President, DFA Australia Limited*

Around Christmas, the northern hemisphere investment philosophers tend to hover around the fireplace. Down here in Australia, you find them grouped around the barbecue on the patio, flipping steaks and talking hot stocks.

One colleague has heard so many of these homespun wealth-building homilies around the hotplate that he has discerned an inverse relationship between the degree of sizzle in the meat and that of the investment strategies.

Let's go back in time, then, to the holiday season of 2006 when The Australian newspaper provided its readers with its 'Top 100 Tips' for 2007. In the fixed interest space, the top tips were 'collateralised debt obligations', offered through a then high-flying vehicle called the 'Basis Yield Fund'.

The paper quoted one analyst as describing the Basis Yield Fund as a "unique income offering which has delivered exceptional risk-adjusted returns of 15 percent a year over the past three years".

It was the sort of recommendation that heard over a few beers and the sizzle of hot dogs would have sounded hard to knock back. As it turned out, the only thing that would have gotten fried was your portfolio.

Investors in Australia lost an estimated \$320 million in the subsequent collapse of the Basis Yield Fund, leading to a host of law suits—including one by the founders of the fund against the marketers of the CDOs, Goldman Sachs.

Go forward a year, and the talk around Aussie barbecues just before Christmas was the great value evident in a couple of beaten down shares. The Australian Financial Review quoted brokers as recommending childcare provider ABC Learning Centres, which that week had hit a one-year low of \$5.10.

But this turned out to be less a hot dog than a cold fish, because within a few months, ABC's shares were worth 50 cents. The company then collapsed under the weight of \$1 billion in debt. Administrators were appointed in November, 2008.

Twelve months on, and the mood around the Christmas barbecue was sombre. The financial crisis was well underway and the burger-flipping investment impresarios were saying that maybe this was a good time to just stay out of the market. The Australian Financial Review quoted one major bank as saying the bear market was likely to last until September 2009.

Ok, they turned out to be only six months out. But those who acted on that piece of advice missed out on rallies of between 40 and 50 percent in the major world equity indices between March and September of that year.

By the end of 2009, a year in which the Australian market delivered its best calendar year performance in 16 years, the end-of-year barbecue was a little more buoyant, but still cautious. After a 37 percent market gain in 12 months, the "smart" money was saying it was time to be selective. That's right—a climate for stock pickers.

Stocks recommended by the Financial Review's panel of experts included the banks, Telstra, Tabcorp, Woolworths, Resmed, Primary Health Care, Qantas, Asciano, Toll Holdings, News Corp, Ten Network, Downer EDI and Seek.

But maybe the analysts' pencils weren't sharp enough, because as of December 2010, the best performing sector in the Australian market has been resources—with Fortescue Metals, Rio Tinto, Oil Search and Newcrest Mining among the top blue chip performers year-to-date. None of those were on the AFR's list. In fact, Toll Holdings, Telstra, Asciano, News Corp, Woolworths and three of the four major banks were all in negative territory for the year as of December 10.

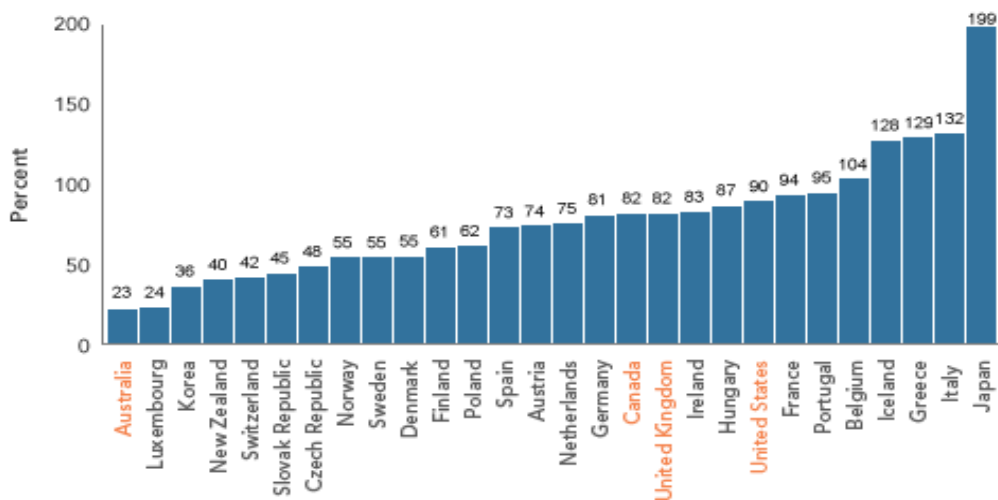
Who knows what will be on the menu at the Christmas barbecue this year. But it should be evident from all this that if forecasting is a fool's game, festive season forecasting can be even more dangerous to your wealth.

## Deficits, Debt, and Markets

As government spending hits record levels around the globe, some politicians, economists, and pundits are warning that rising indebtedness may drag down economies and financial markets. This issue has raised concern among investors who assume that a government's fiscal policy is closely linked to the country's economic growth and market returns.

The graph below shows the projected state of indebtedness around the world. Over half the Organization of Economic Co-operation and Development (OECD) member countries expect to have debt-to-GDP levels above 70%—and the US, Canada, and the UK project debt levels exceeding 80% of their economic output.

**Government Debt as a Percent of GDP**  
2010 Projections in OECD Countries



Source: OECD

Government efforts to stimulate these economies out of recession may partly explain this level of borrowing, which is high compared to historical levels. But longer-term trends such as aging populations, expanding public pensions, and rising health care obligations are compounding the fiscal challenges of these countries.

So how does public debt affect economic growth and market returns? Here are a few popular questions about sovereign debt:

### **Do rising deficits drive up interest rates?**

Yes. As borrowing increases, a government must offer higher interest rates on its debt to compete for capital. The public sector consumes savings and investment that may have otherwise fueled private sector growth—a displacement of resources known as the “crowding out effect” in economic theory. Additionally, as debt levels rise, market concerns about higher default and inflation risks put additional upward pressure on interest rates.

### **Do higher deficits hamper economic growth?**

It depends on a country’s debt level. World Bank data from 1991 to 2008, comparing current deficits to future GDP growth in sixty-seven countries found an increasing interactive effect between deficits, debt, and economic growth. High-debt countries that run deficits are more likely to experience lower economic growth over the next three years. But numerous forces may affect a country’s economic direction, and deficits explain only a small fraction of the variation in future GDP growth. The combination of high debt and deficits can create headwinds for economic expansion, but slower growth is not guaranteed.

### **Does low economic growth result in diminished equity returns?**

No. This relationship can be tested by comparing a country’s GDP growth to its equity market performance in subsequent years. Looking at analysis using all the developed countries in the MSCI universe, divided each year into high-growth and low-growth “portfolios” based on growth in real GDP - there was no statistical difference between the annual returns of equity markets in high-growth versus low-growth countries. In fact, low-growth countries had slightly higher average returns than high-growth countries.

Other research has confirmed a weak relationship between a country’s economic growth and its stock market returns. Several factors may contribute to this decoupling effect. For one, with globalization, a multinational company’s stock price in its home market may not reflect economic conditions in other countries.

Also risk, not economic growth, determines a stock’s expected return. Research indicates that this principle also applies to a country’s stock market. Similar to value and growth stocks, markets with a low aggregate price (relative to aggregate earnings or book value) have high expected returns, and markets with a higher relative price have lower expected returns. Consequently, while holding a “growth market” may be a rational investment approach, investors should not expect to earn higher returns by tilting their portfolios toward countries with high expected GDP growth.

## **Do fiscal deficits lead to currency depreciation?**

No. It is commonly believed that large fiscal deficits and high debt cause a currency to depreciate as the government borrows more from foreign sources, and investors who are concerned about inflation and default risk flee the currency. Although recent developments in the US would seem to support this relationship, there is less convincing long-term evidence that deficits affect currency rates. During the 1970s and 1980s, the US dollar strengthened while the government increased deficit spending. This observation is consistent with academic studies concluding that exchange rates appear to move randomly, and there are no models to date that can reliably forecast currency returns.

## **Conclusions**

Some economists claim that developed market countries are moving into an era of high government deficits and lower market returns. While higher deficits and debt may impact a nation's interest rates and economic growth to some extent, the investment implications are not easily discerned. History does not offer strong evidence that current deficits predict future bond or equity returns in a country's financial markets, or anticipate short-term currency movements.

Investors should assume that stock and bond prices reflect all that is currently known and expected about government spending and debt, economic growth, risk, and other issues affecting performance.

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