

building
shock resistant
portfolios

[Markets]

I've been thinking about...

**... avoiding avoidable
mistakes**

Tim Farrelly

Principal

farrelly's Investment Strategy



CONFERENCE

Avoiding avoidable mistakes

- Bubbles are big and compelling
- The damage is significant and long term
- But can they be identified in advance?
- Can we avoid them?

Bubbles – big and compelling

Asset	Year of peak	A good idea because...
Gold (US\$)	Jan 1980	The ultimate inflation hedge
Japanese equities (Yen)	Jan 1990	Japanese companies taking over the world
Japanese residential property (Yen)	1991	Rising demand, limited supply
US equities (US\$)	Mar 2000	The internet revolution
US REITs (US\$)	Mar 2007	Stable income, low risk, high returns

Avoiding avoidable mistakes

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Significant damage

Asset	Year of peak	Fall from peak to trough
Gold (US\$)	Jan 1980	-71%
Japanese equities (Yen)	Jan 1990	-82%
Japanese residential property ¹ (Yen)	1991	-65%
US equities (US\$)	Mar 2000	-56%
US REITs (US\$)	Mar 2007	-71%

Significant..... and permanent

Asset	Peak	10 years after peak Value of \$1000		20 years after peak Value of \$1000	
		Real value of asset	Real value of bonds	Real value of asset	Real value of bonds
Gold (US\$)	Jan 1980	\$297	\$1990	\$155	\$3458
Japanese equities (Yen)	Jan 1990	Y328	Y1977	Y496	Y2386
Japanese residential property (Yen)	1991	Y561	Y1962	Y689 ¹	Y2271 ¹
US equities (US\$)	Mar 2000	\$729	\$1819	na	na
US REITs (US\$)	Mar 2007	na	na	na	na

1. 19 years after peak

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Can your clients afford one or more of these experiences?

Asset	Year of peak	Fall from peak to trough	Time till trough
Gold (US\$)	Jan 1980	-71%	19 yrs
Japanese equities (Yen)	Jan 1990	-82%	19 yrs
Japanese residential property (Yen)	1991	-65%	14 yrs
US equities (US\$)	Mar 2000	-56%	9 yrs
US REITs (US\$)	Mar 2007	-71%	2 yrs

Avoiding avoidable mistakes

- Bubbles are big and compelling
- The damage is significant and long term
- Can bubbles be identified in advance?
- How can we avoid them?

The Occam's Razor approach to long term forecasting

Income

+

Growth in income

+ or -

Effect of change of PE Ratio

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Long run returns-an example

EPS

PE

Price

Contribution

\$1.00

10

\$10.00

5%pa

Income

+

Income
Growth

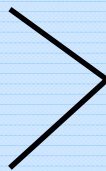
+

PE effect

5%pa

Total

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Long run returns-an example

EPS

PE

Price

Contribution

\$1.00

10

\$10.00

5%pa

Income

+

Income
Growth

\$2.00

10

\$20.00

+7%pa

+

PE effect

12%pa

Total

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Long run returns-an example

EPS	PE	Price	Contribution	
\$1.00	10	\$10.00	5%pa	Income +
\$2.00	10	\$20.00	+7%pa	
\$2.00	20	\$40.00	+7%pa	+
			<u>19%pa</u>	PE effect
				<u>Total</u>

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Long run returns-an example

EPS	PE	Price	Contribution	
\$1.00	10	\$10.00	5%pa	Income
				+
			+7%pa	Income
\$2.00	10	\$20.00		Growth
				+
			-7%pa	PE effect
\$2.00	5	\$10.00		
			<hr/>	<hr/>
			5%pa	Total

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Forecasting Australian equities returns

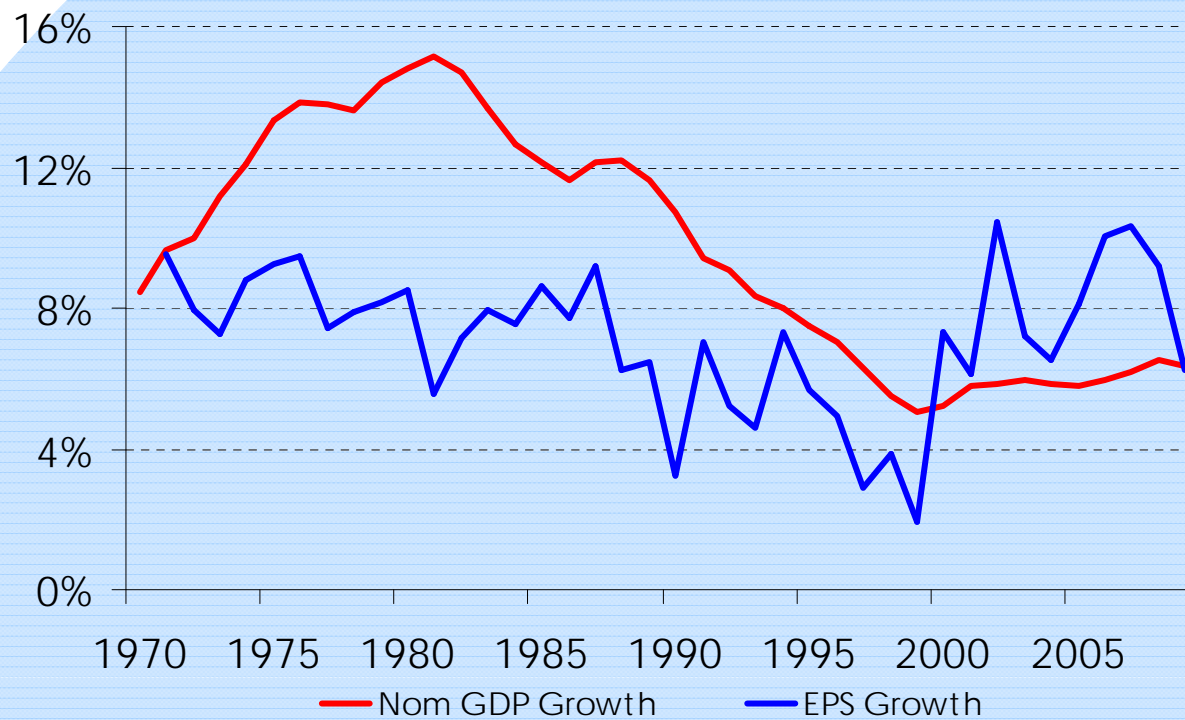
Return driver	Estimate	Notes
Yield	?	Includes imputation credits
Growth in EPS	?	
Change in PE	?	PE now : 14.7 PE 2020 : ?
Total		

Forecasting Australian equities returns

Return driver	Estimate	Notes
Yield	5.5%	Includes imputation credits
Growth in EPS		
Change in PE		PE now : 14.7 PE 2020 : ?
Total		

How fast can companies grow their earnings?

Aus GDP v EPS Growth
10 year rolling returns



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Forecasting Australian equities returns

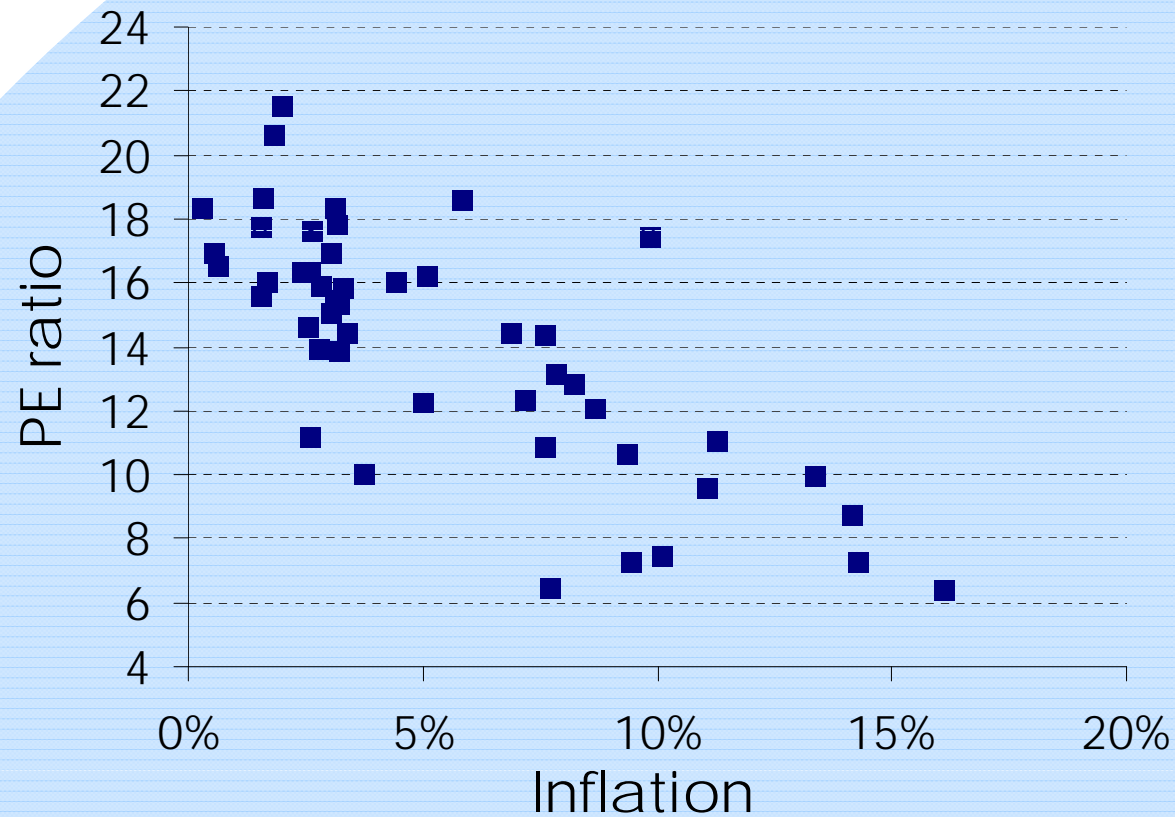
Return driver	Estimate	Notes
Yield	5.5	Includes imputation credits
Growth in EPS	3.6	
Change in PE	?	PE now : 14.7 PE 2020 : ?
Total		

Forecasting Australian equities returns

Return driver	Estimate	Notes
Yield	5.5	Includes imputation credits
Growth in EPS	3.6	
Change in PE	?	PE now : 14.7 PE 2020 : ?
Total		

Where will PE's be in 2020?

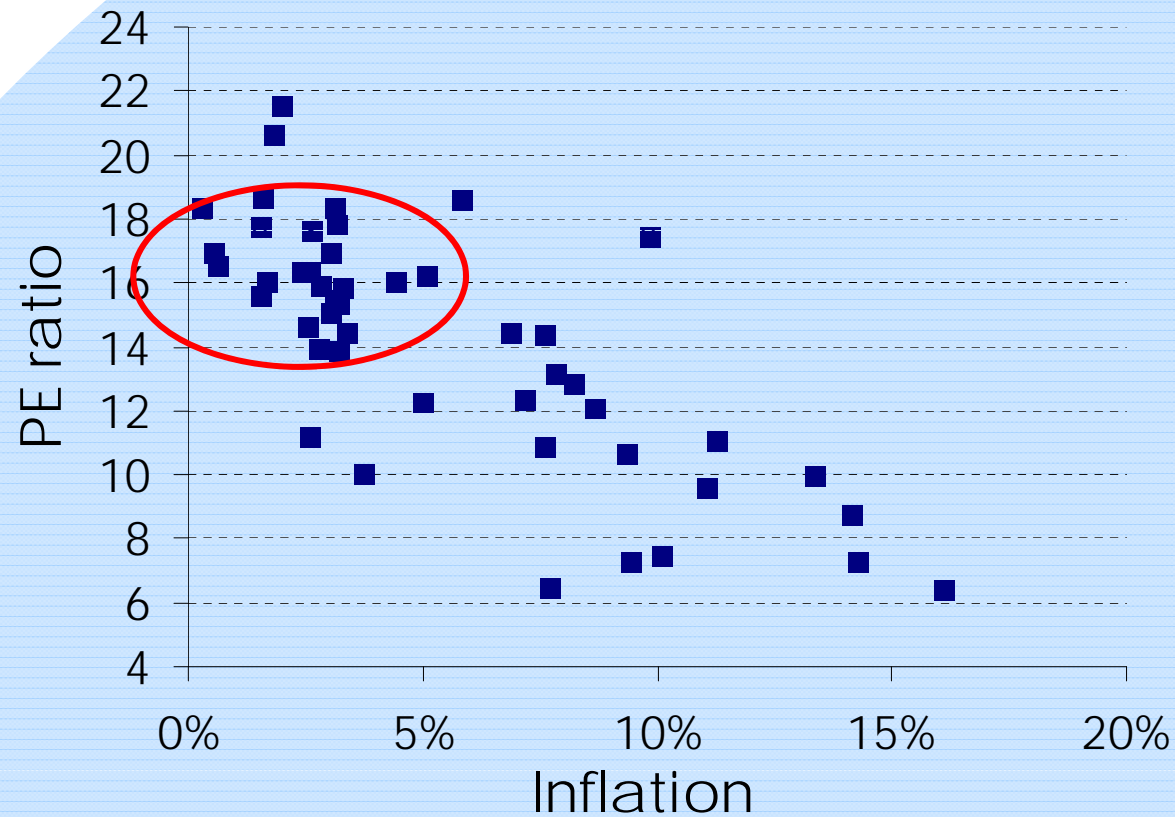
Australian PE's vs. Inflation
1961-2009



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Where will PE's be in 2020?

Australian PE's vs. Inflation
1961-2009



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Forecasting Australian equities returns

Return driver	Estimate	Notes
Yield	5.5	Includes imputation credits
Growth in EPS	3.6	
Change in PE	0.8	PE now : 14.7 PE 2020 : 16.0
Total		

Forecasting Australian equities returns

Return driver	Estimate	Notes
Yield	5.5	Includes imputation credits
Growth in EPS	3.6	
Change in PE	0.8	PE now : 14.7 PE 2020 : 16.0
Total	9.9%pa	

Forecasting Australian equities returns & bonds

Return driver	Estimate	Notes
Yield	5.5	Includes imputation credits
Growth in EPS	3.6	
Change in PE	0.8	PE now : 14.7 PE 2020 : 16.0
Total	9.9%pa	
10 year Govt bonds	5.2%pa	

What did this framework indicate about bubbles?

- US REITs
- The internet revolution
- Japanese equities
- Gold

As at March 2007

REITs yields are historically low

US Equity REIT Yields

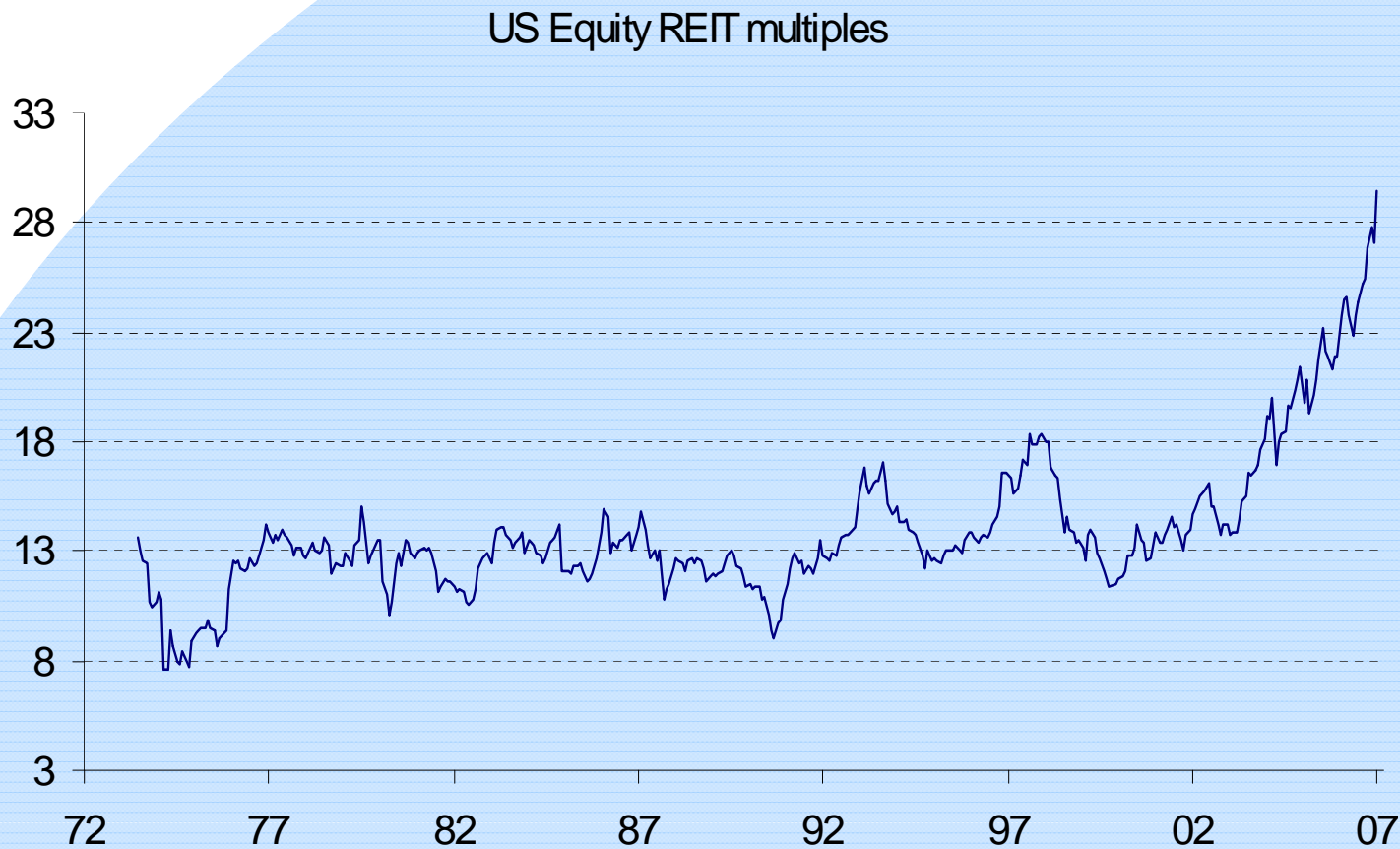


Source Nareit

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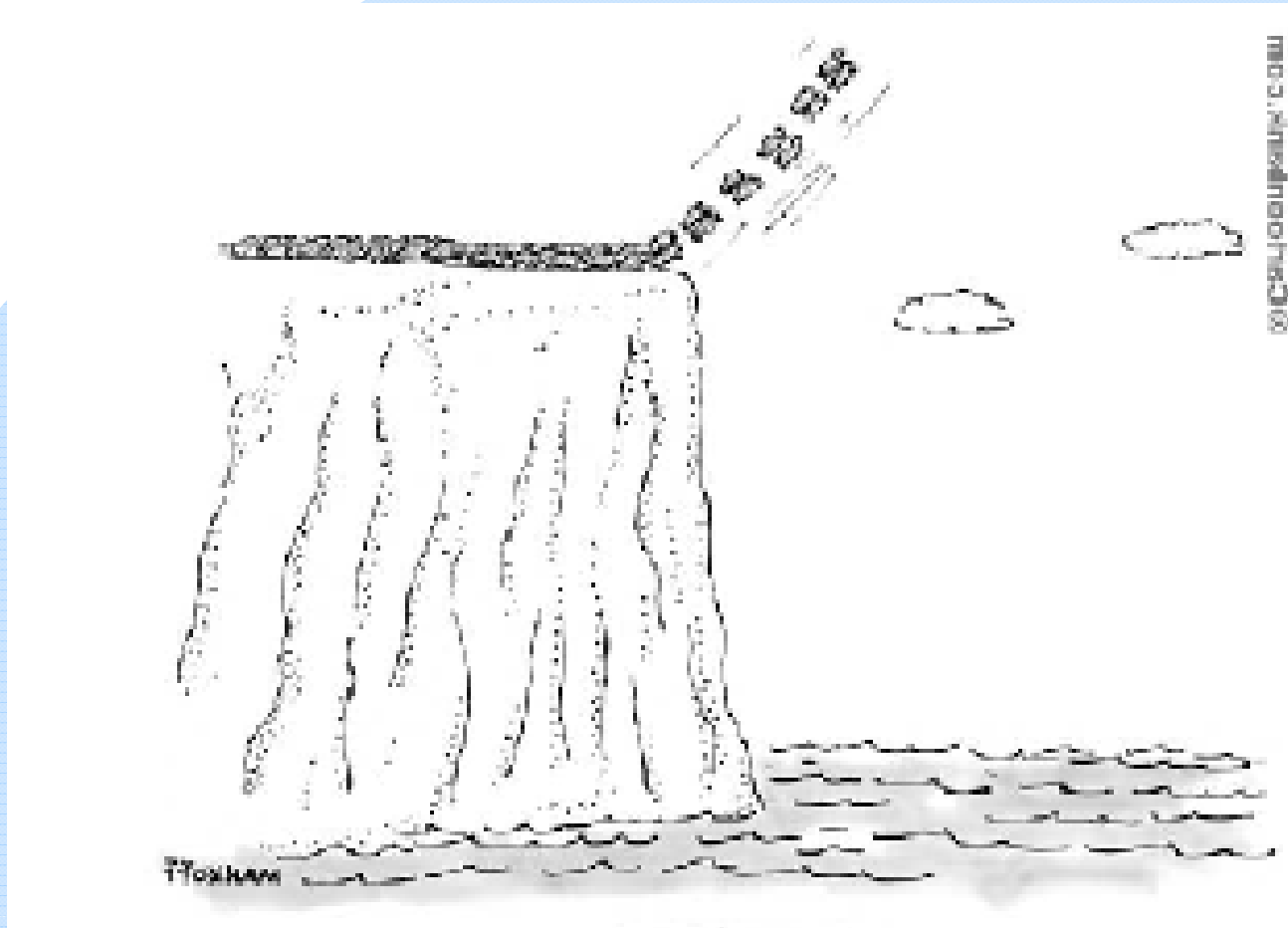
As at March 2007

Price/Distribution makes US REITs look extremely overstretched



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What lemmings believe...



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As at March 2007

US Equity REITs forecast

Yield		3.4%
Earnings Growth	Inflation + reinvestment- depreciation - leakage	1.9%
Valuation Effect	Yield rises to 5.6% from 3.4%	-5.4%
Currency	Aussie bonds less US bonds; 5.8%-4.8%	1.0%
Total		0.9%pa

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10 Year Forecasts as at October 2000

Asset	Dividend Yield	EPS Growth	PE Effect	Central Forecast
Australian Equities	4.5%	5.0%	-1%	8.5%
US Equities	1.0%	6.0%	-1%	6.0%
LPTs	8.5%	1.0%	0%	9.5%
Bonds	6.0%	0%	0%	6.0%

Realistic 10 Year Forecasts as at October 2000

Asset	Dividend Yield	EPS Growth	PE Effect	Central Forecast
Australian Equities	4.5%	5.0%	-1%	8.5%
US Equities	1.0%	4.0%	-3.5%	1.5%
LPTs	8.5%	1.0%	0%	9.5%
Bonds	6.0%	0%	0%	6.0%

Based on 2010 PE of 21

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As at December 1988

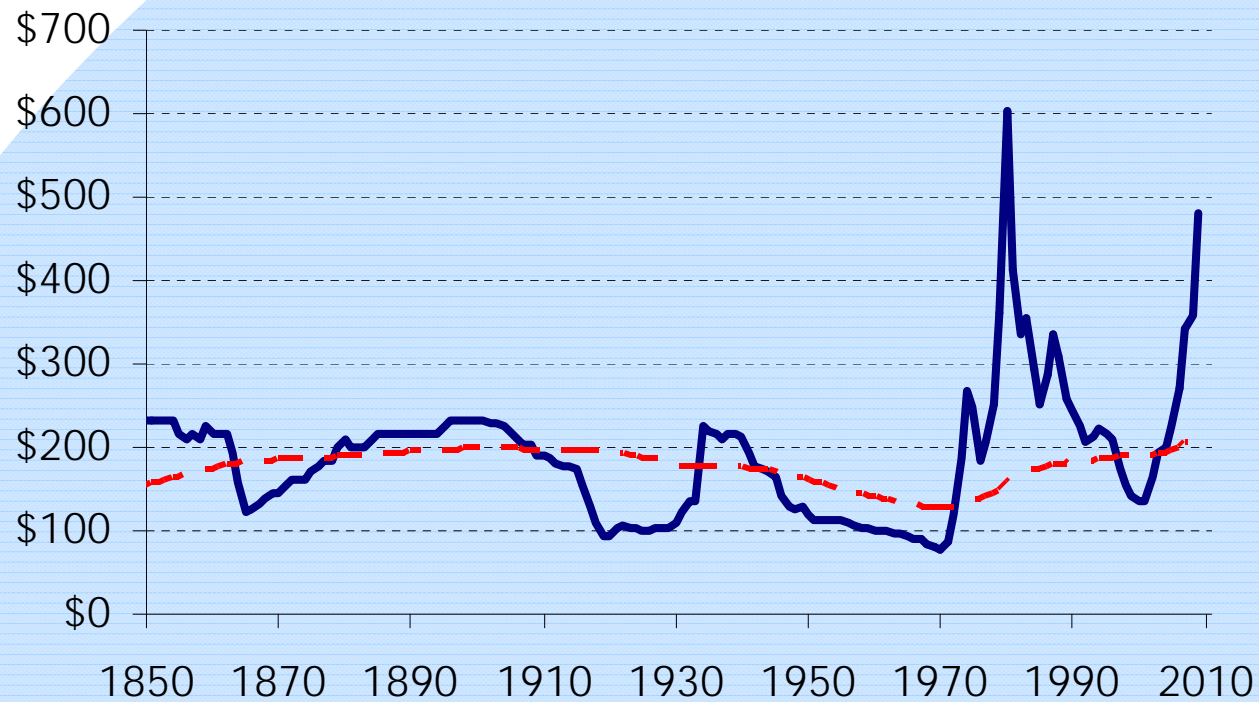
Japanese equity forecast

Yield		0.8%
Earnings Growth	Inflation + reinvestment- depreciation - leakage	6.0%
Valuation Effect	PE falls from 58.4 to 20	-10.1%
Total (Yen terms)		-3.3%pa
Japanese Bonds		4.5%

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Gold really is an inflation hedge.

Gold price in 1980 US dollars



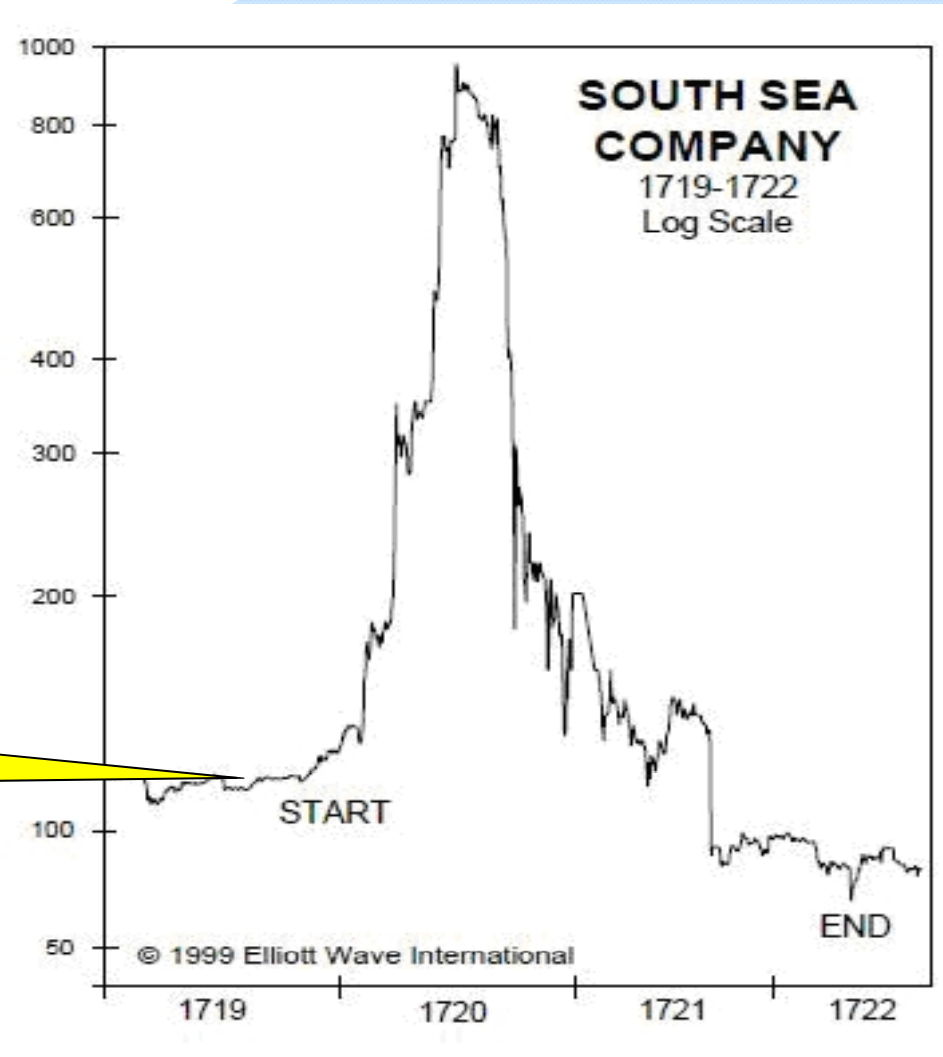
— Actual — 50 year average

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Avoiding avoidable mistakes

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- The damage is significant and long term
- But can they be identified in advance?
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Avoiding bubbles : even smart investors are at risk

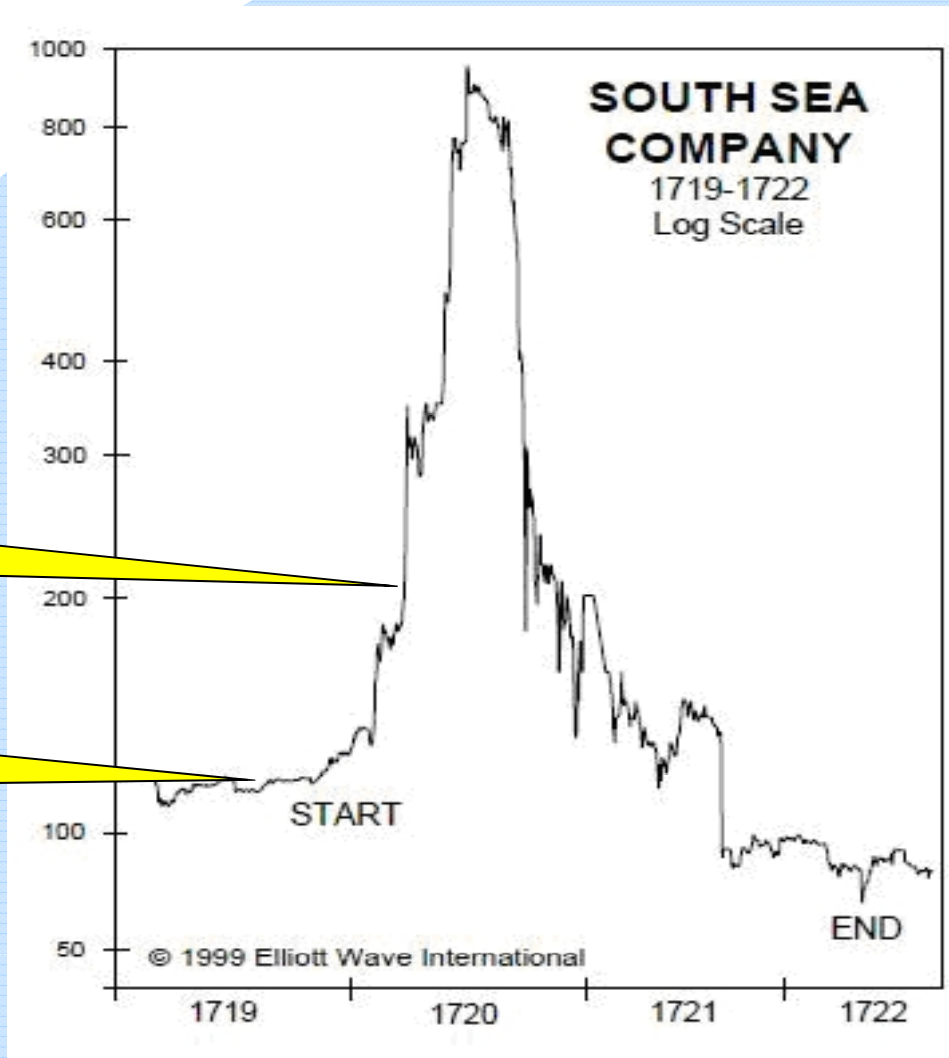


Newton invests a bit

From GMO: Isaac Newton's Nightmare

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Avoiding bubbles : even smart investors are at risk



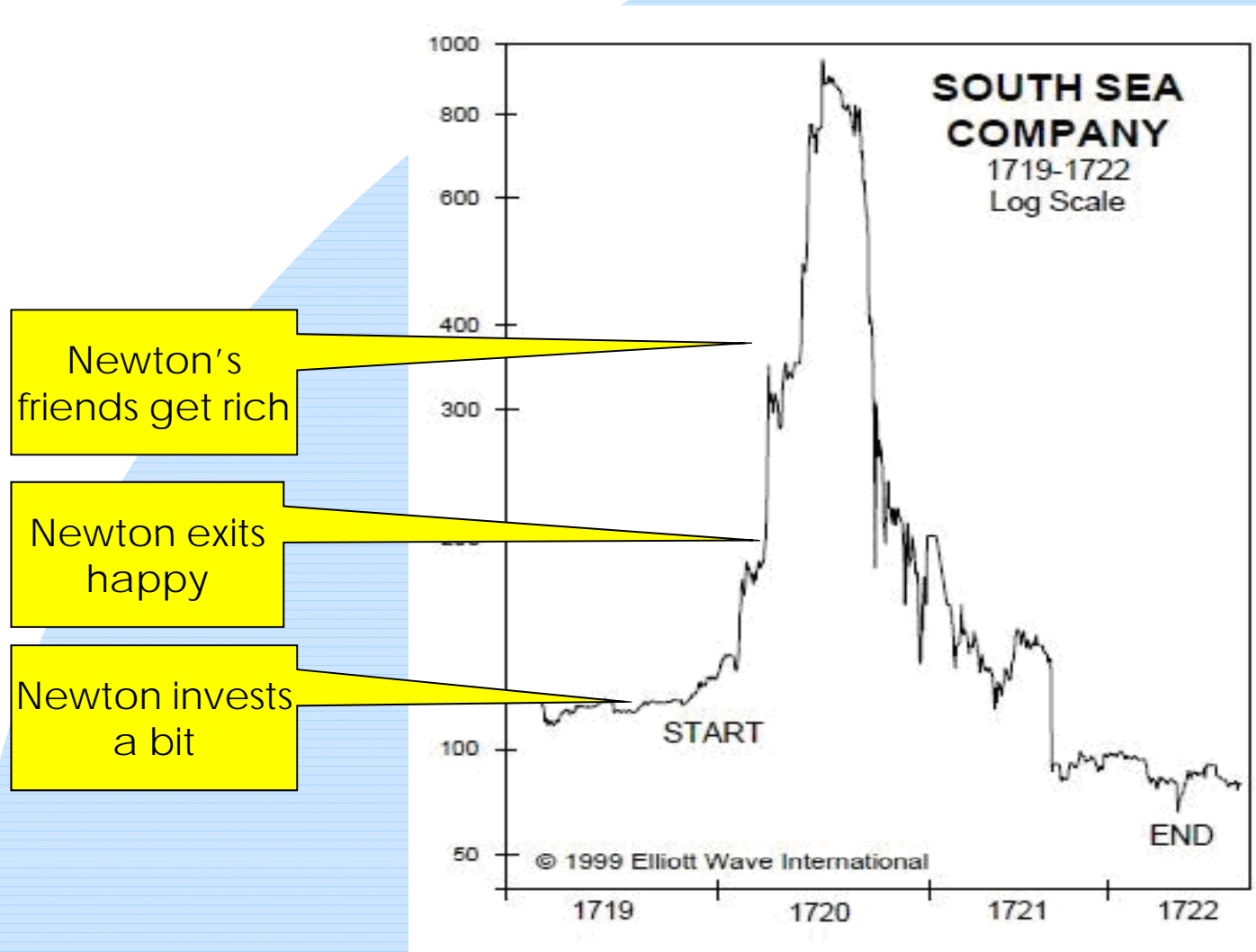
Newton exits happy

Newton invests a bit

From GMO: Isaac Newton's Nightmare

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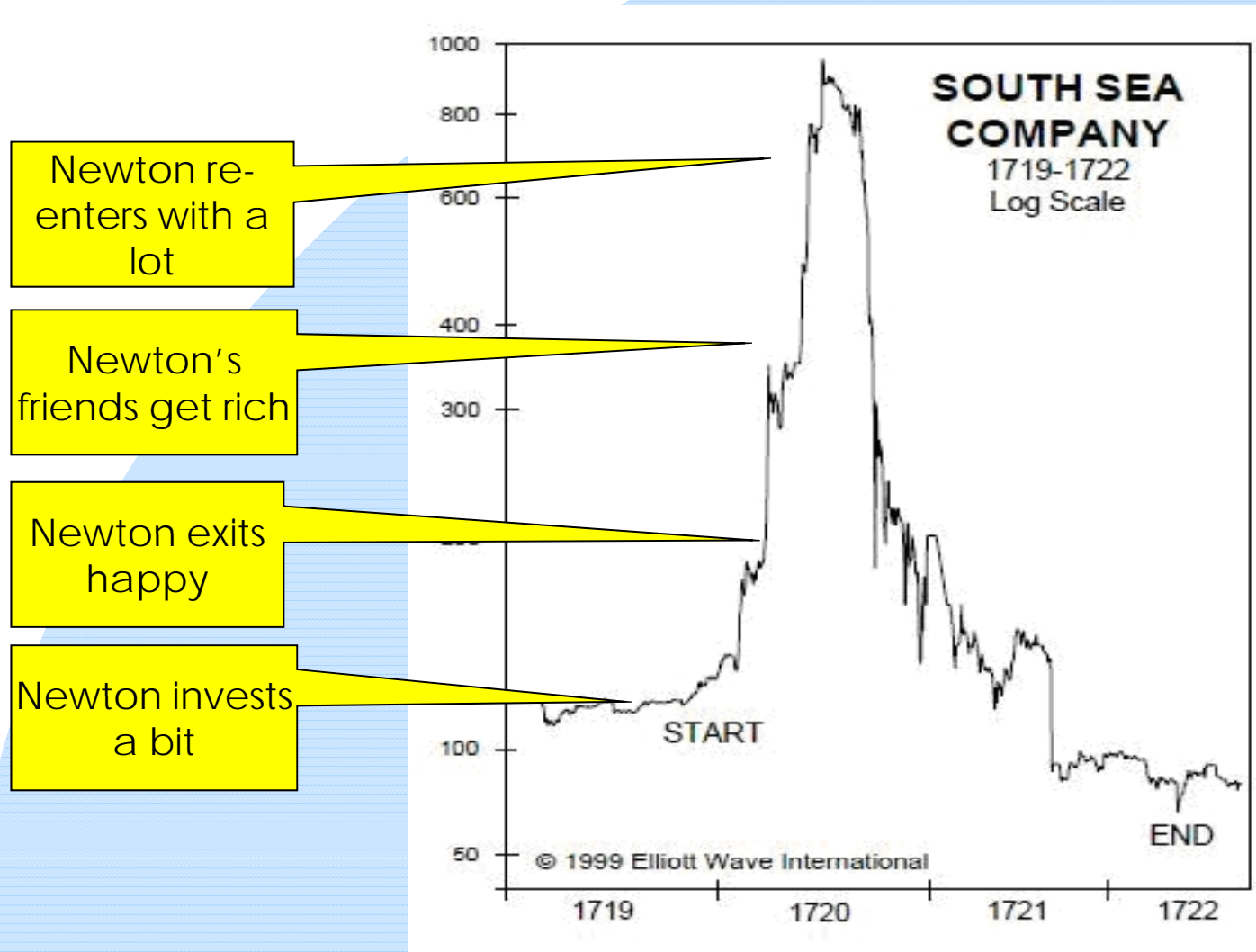
Avoiding bubbles : even smart investors are at risk



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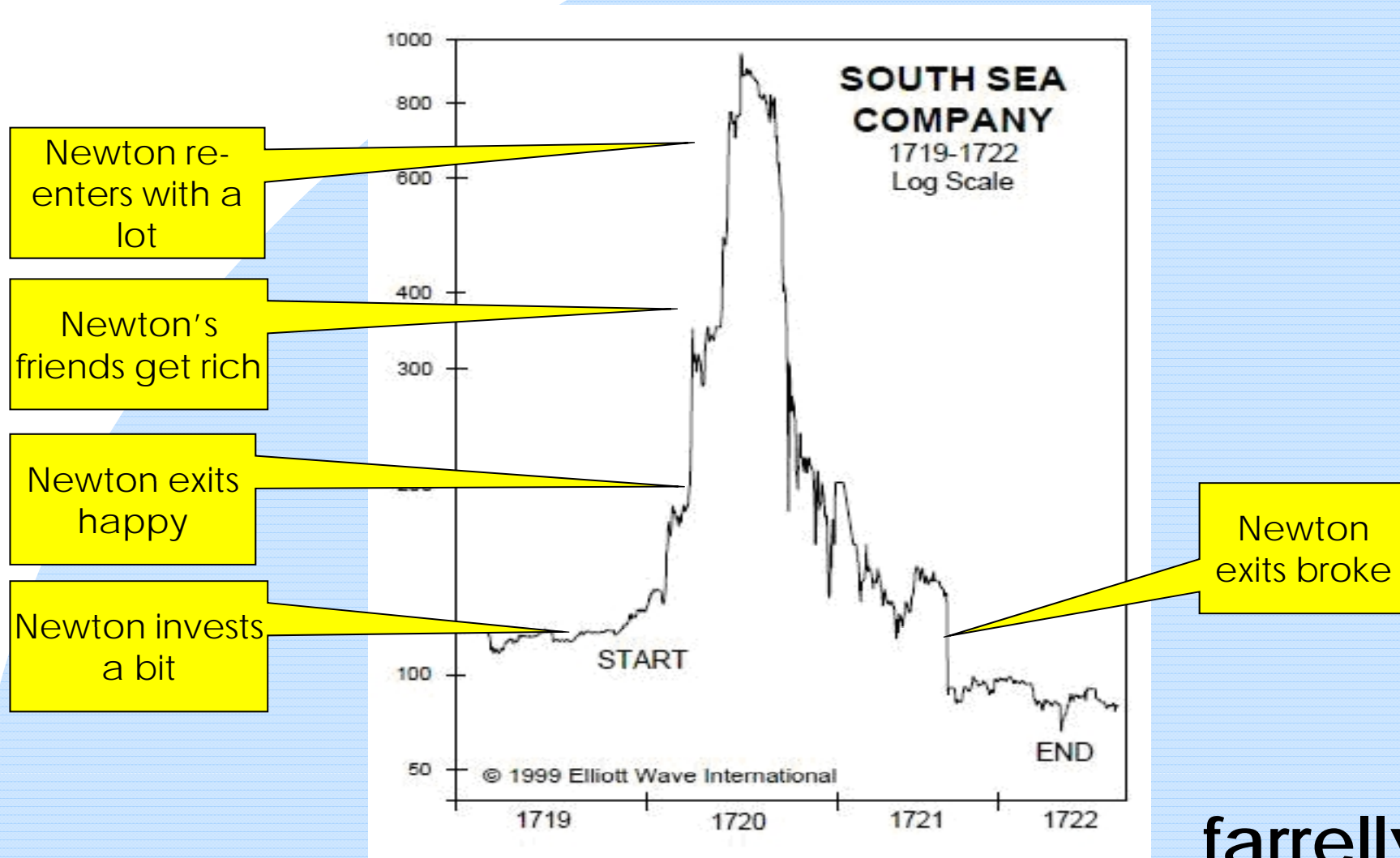
Avoiding bubbles : even smart investors are at risk



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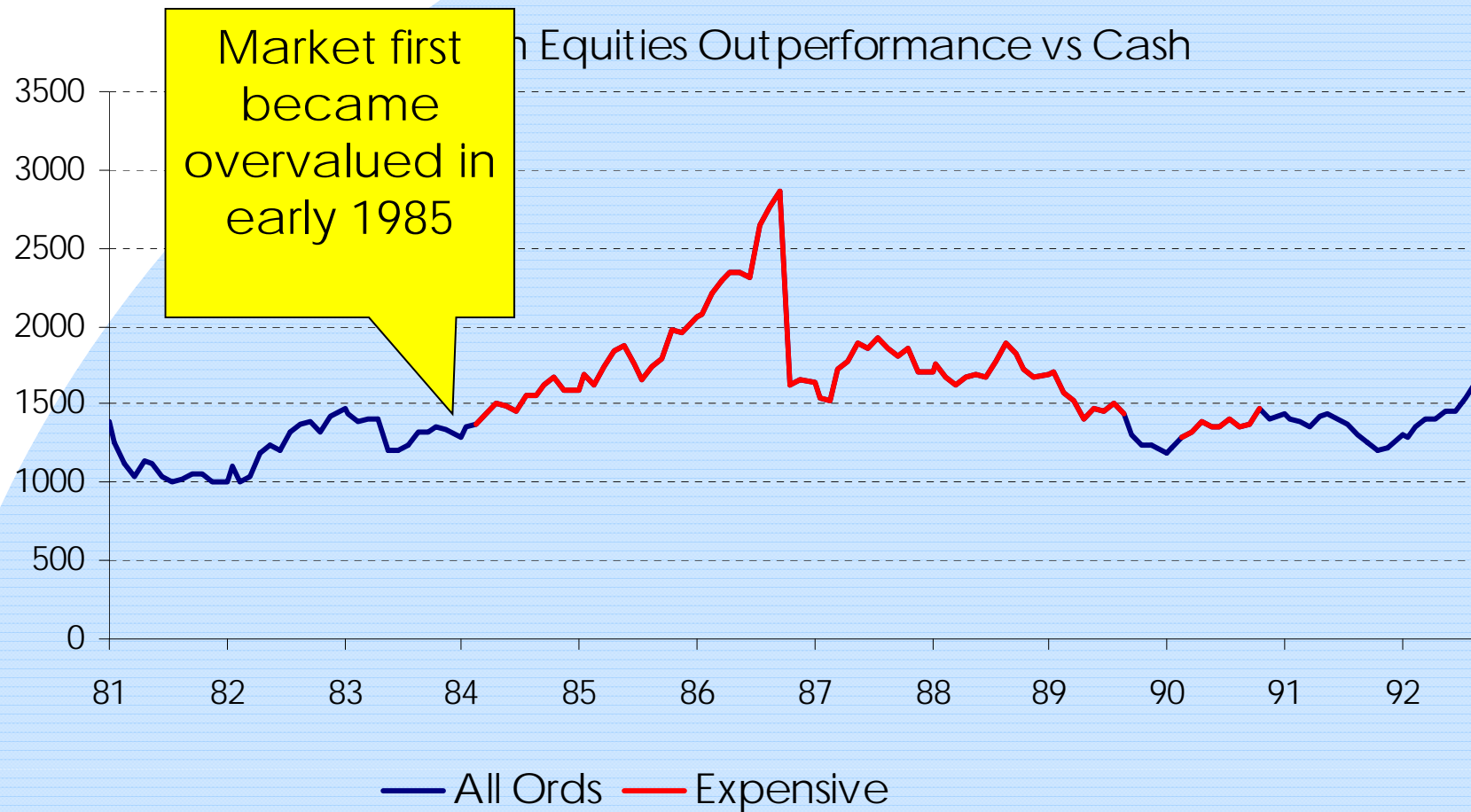
Avoiding bubbles : even smart investors are at risk



From GMO: Isaac Newton's Nightmare

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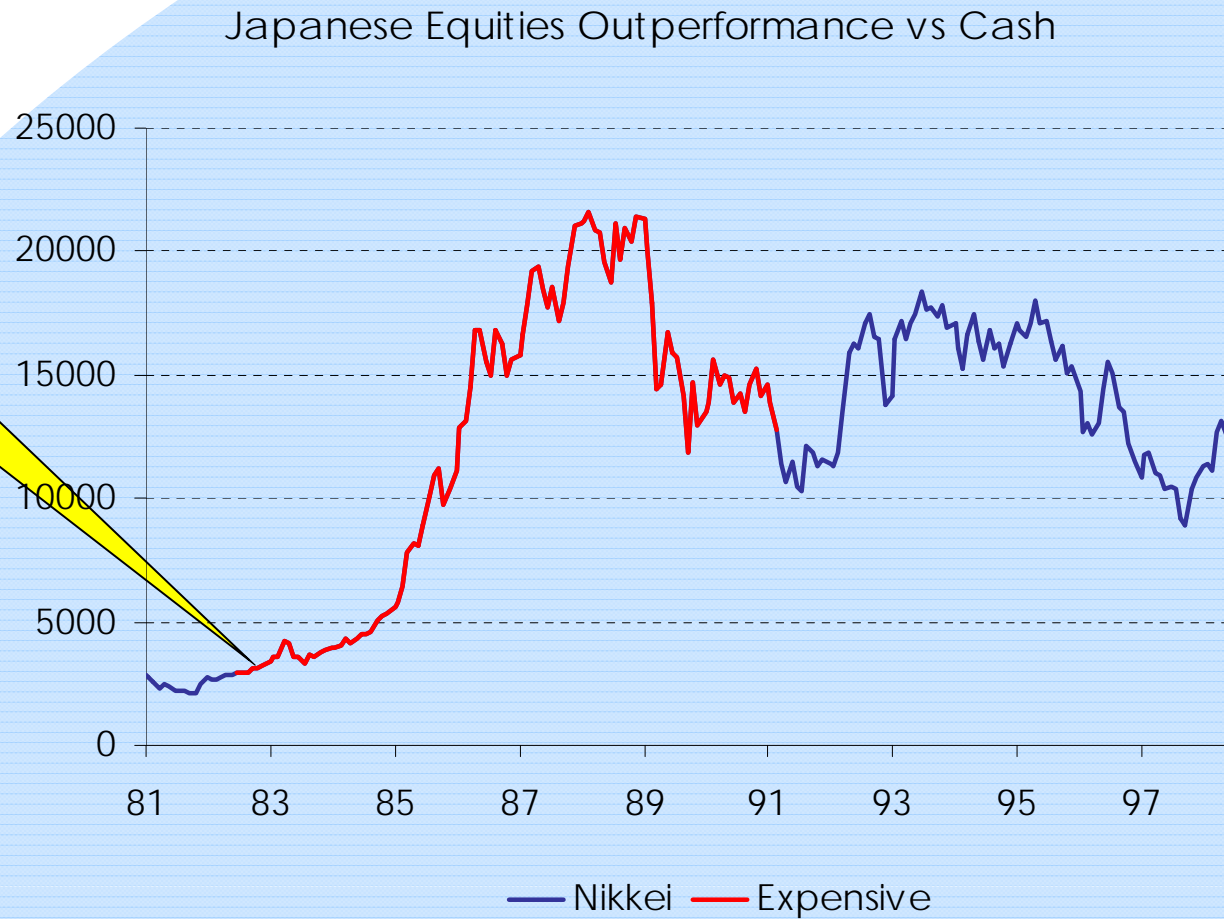
Markets can stay irrational longer than you can stay solvent



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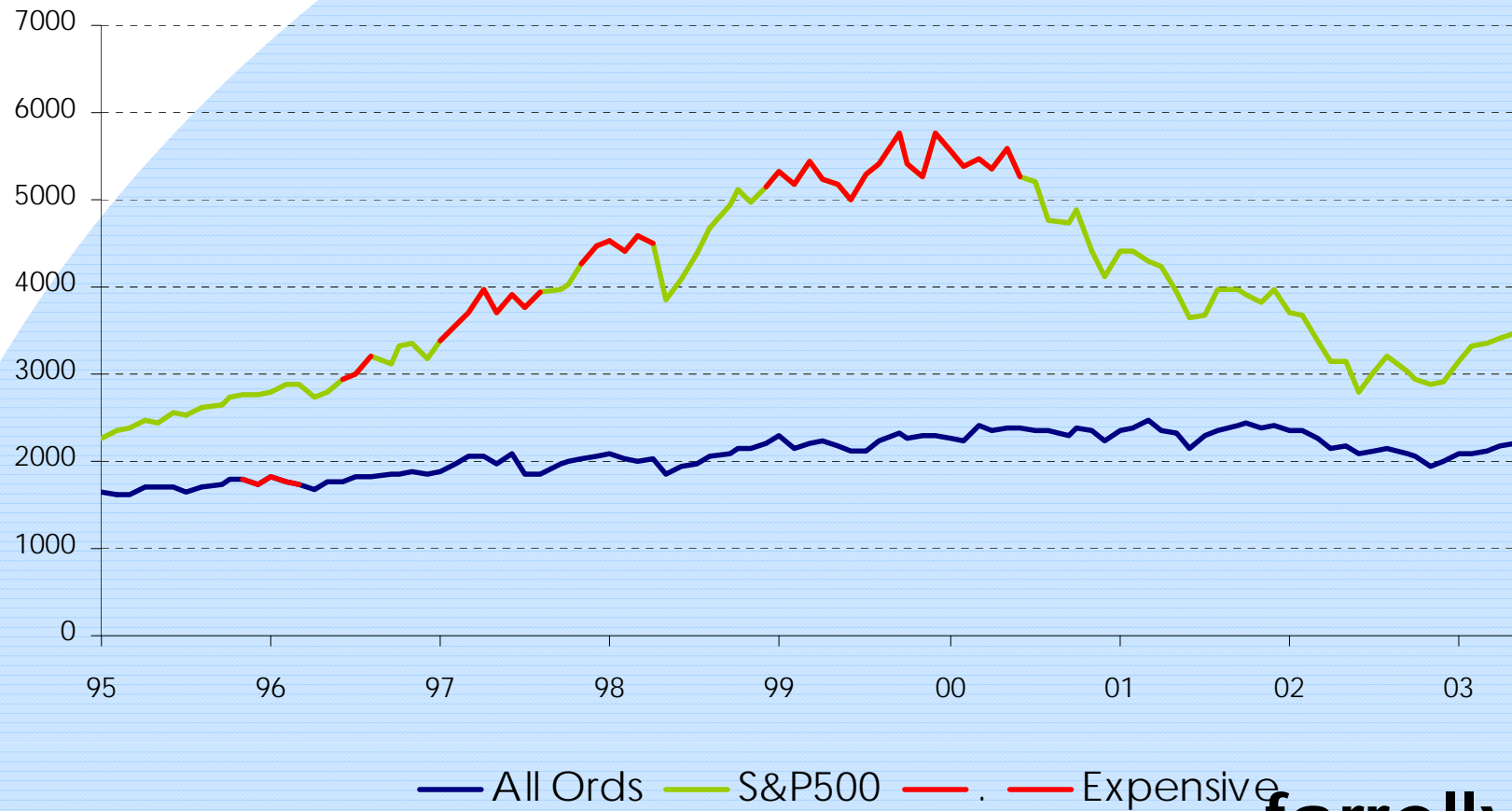
Japan was much worse...

Market first became overvalued in mid 1983



Again in the late 90's

Equities Outperformance vs Cash



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US REITS first became expensive in 2004

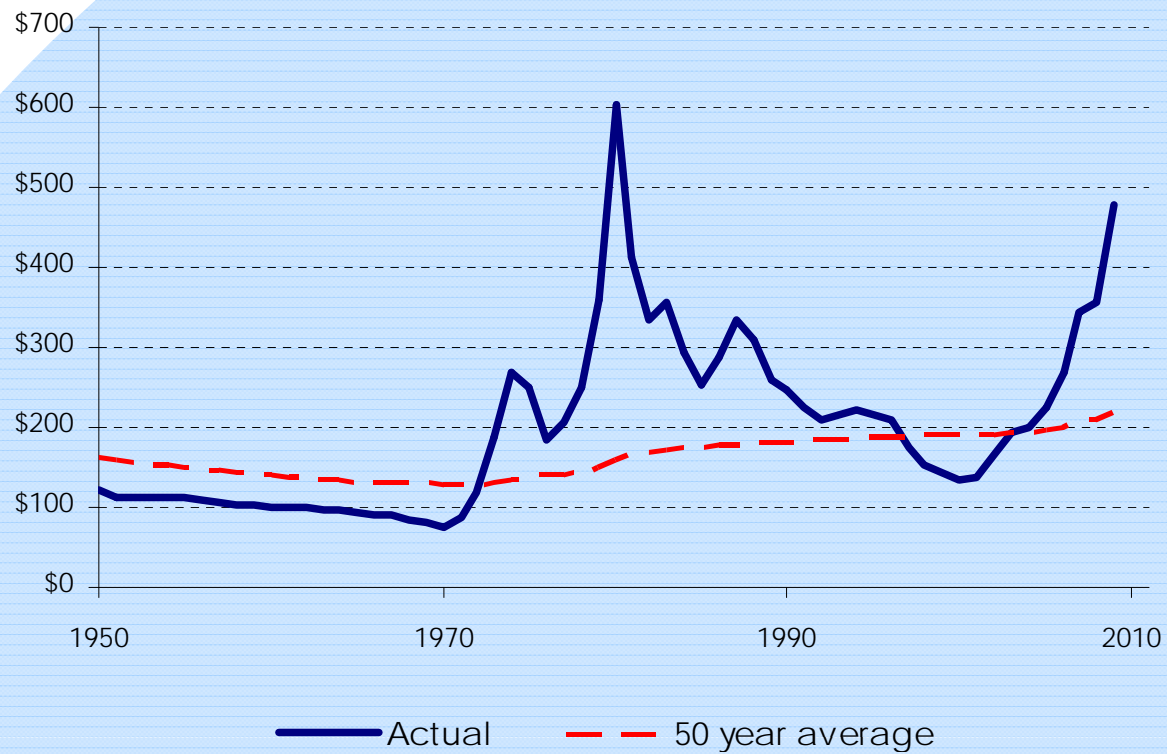
US Equity REIT multiples



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Gold a very long time in the expensive range...

Gold Price in 1980 US\$



Don't want to sell too early...

	Date first expensive	Peak	Time to peak
Gold	Apr 1973	Jan 1980	6 years, 9 months
Japanese equities	Sep 1983	Jan 1990	6 years, 4 months
Australian equities	Feb 1985	Oct 1987	2 years, 8 months
Japanese residential property	1985	1991	6 years
US equities	Sep 1987	Oct 1987	2 months
US equities	Apr 1986	Aug 2000	4 years, 4 months
US REITs	Mar 2005	Jan 2007	1 year, 10 months
Chinese Equities	Jan 2007	Oct 2007	9 months
Australian equities	Dec 2007	Jan 2008	1 month

Because we don't know how long
or how high...

- Just don't buy expensive assets
- Sellers can take their time

The new imperative in asset allocation

- Bubbles are a recurring theme
- The damage caused is significant and permanent
- No one is immune from their charms
- They can be clearly identified in advance
- They are an avoidable mistake

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