



The Leading Edge

QUARTERLY REPORT | **December 2008**

In this edition of "The Leading Edge" we want to provide an update on the outlook for equity markets in light of the deteriorating economic environment; consider a successful portfolio strategy for navigating through this bear market; and discuss some of the recent press on short selling and hedge funds.

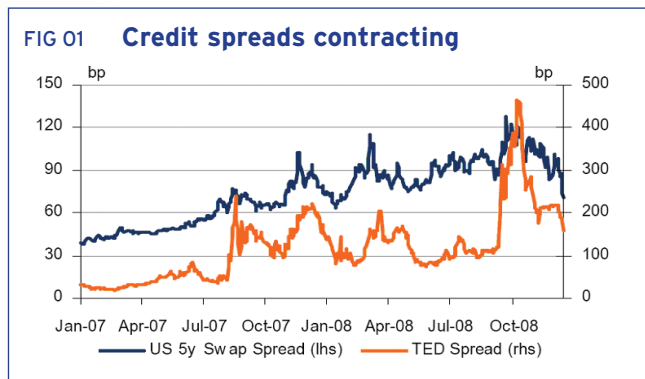
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Depth and duration of the global recession

The good news is, the worst of the credit crisis may have passed, indicators of financial stress are easing with credit spreads contracting and liquidity returning to credit markets (fig01). This is an important development for risk assets as a systemic failure of the banking system is a risk that cannot be easily quantified.

Following an unprecedented array of policy measures taken to shore up confidence in the banking system, credit markets seem to be showing early signs of recovery. As credit conditions ease asset markets can start to adjust and clear more readily, relieving some of the burden on equity to provide needed funding.



Source: Bloomberg, Merrill Lynch

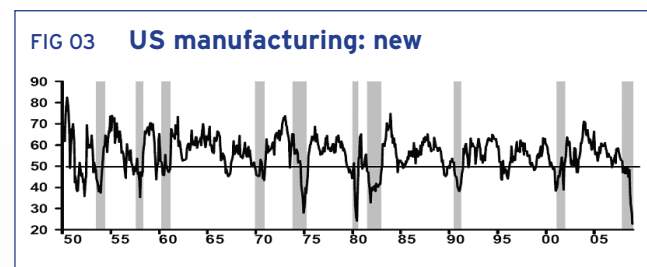
In fig (02) we have the reported losses to date for the major city centre banks around the world. In most instances the value of structured credits as reported in the Level 3 assets of these institutions have largely been written off, with \$1 trillion in losses incurred to date. Importantly the rate of losses reported each quarter are shrinking with worldwide losses in Q4 the lowest in 15 months, suggesting the worst is behind us.

The challenge for equity markets now is to grasp the depth and duration of the global downturn in the aftermath of the credit crisis. There is considerable

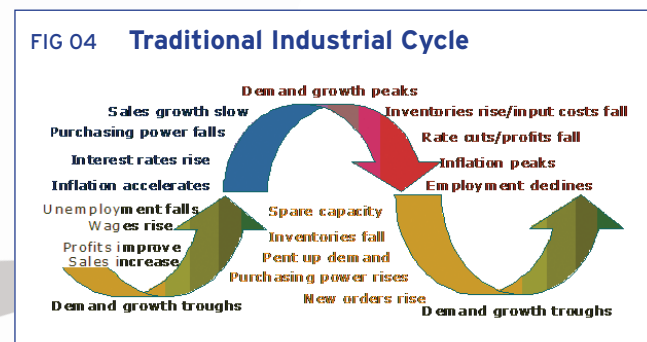
Base Currency: Billions		USD		4Q08		3Q08		2Q08		1Q08		4Q07	
	Total	Loss	Capital	Loss	Capital	Loss	Capital	Loss	Capital	Loss	Capital	Loss	Capital
6) All Financial													
7) Worldwide	1005.3	926.9	78.9	462.3	250.2	99.7	167.1	195.7	223.7	89.3	217.6	64.0	
8) Americas	678.3	554.6	76.6	292.5	190.8	44.1	108.4	103.4	129.5	62.6	124.3	47.1	
9) Europe	296.4	318.3	2.3	141.9	56.5	46.8	54.7	78.7	83.1	22.8	81.5	16.8	
10) Asia	30.6	54.1	.0	27.9	3.0	8.7	3.9	13.6	11.2	3.8	11.9	.0	
11) Banks/Brokers													
12) Worldwide	744.8	795.9	77.9	395.7	175.1	98.1	124.4	161.0	156.7	86.1	163.5	45.9	
13) Wachovia Corporation	96.5	11.0	44.9	.0	29.1	.0	13.0	7.5	4.4	3.5	3.2	.0	
14) Citigroup Inc.	67.2	113.8	.0	64.8	12.3	4.0	12.0	13.9	19.0	19.4	18.2	11.8	
15) Merrill Lynch & Co.	55.9	29.9	.0	.0	12.0	11.7	8.9	4.3	7.6	7.2	18.0	5.9	
16) UBS AG	48.6	34.1	.0	5.6	4.4	.0	6.0	16.4	19.2	.0	14.4	12.1	
17) Washington Mutual Inc.	45.6	12.1	.0	.0	30.9	.0	5.5	.0	4.1	8.1	3.5	4.0	
18) HSBC Holdings Plc	33.1	4.9	.0	.0	5.7	.9	9.5	3.9	4.2	.0	10.0	.0	
19) Insurers													
20) Worldwide	146.0	94.6	1.0	52.8	36.7	1.6	13.7	27.7	42.4	3.2	42.8	4.6	
21) American Internatio...	60.9	65.8	.0	40.7	12.7	.0	8.7	25.1	19.9	.0	19.3	.0	
22) Amfac Financial Gro...	10.6	1.4	.0	.0	2.2	.0	-6	.0	2.7	1.4	5.6	.0	
23) Hartford Financial S...	7.9	3.0	1.0	2.5	3.1	.0	3	5	1.9	.0	8	.0	
24) MetLife Inc	7.2	2.3	.0	2.3	3.3	.0	1.0	.0	2.1	.0	2	.0	
25) Allianz SE	4.5	2.0	.0	.0	.7	.0	.9	2.0	1.3	.0	1.0	.0	
GSE													
26) Freddie Mac	58.4	20.8	.0	13.8	17.8	.0	12.7	.0	15.1	.0	6.1	6.0	
27) Fannie Mae	56.0	15.6	.0	.0	20.5	.0	16.3	7.1	9.5	.0	5.2	7.5	

evidence to suggest we are in for the worst recession since 1982. A combination of a very sharp contraction in activity in advanced countries and modest growth in the developing world, lead by China.

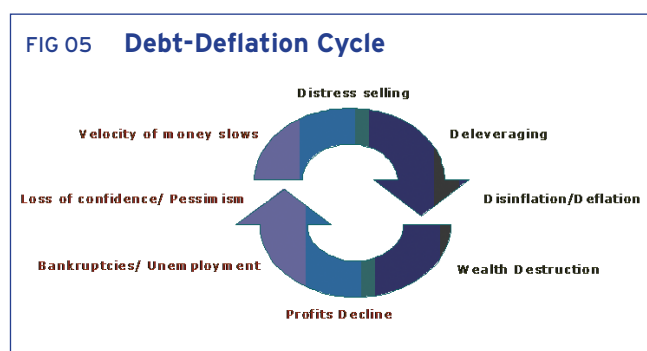
In the final quarter of 2008 the US economy contracted by 6% and Japan shrank by 7% on an annualised basis. The latest US manufacturing data (fig 03) provides some historic perspective on how bad the situation is with manufacturing orders falling the most in 50 years.



It is important to recognise this recession is unlike a traditional industrial cycle. In a normal downturn the economy overheats and slows in response to policy tightening before recovering again (fig 04).



Following decades of credit fuelled growth and the near collapse in the Global Financial System we are now faced with a far more pernicious debt deflation cycle (fig 05). As consumers and companies deleverage balance sheets and curtail spending, prices start to fall and real interest rates rise potentially bringing a cycle of prolonged asset price weakness. You need look no further for evidence of this trend then the latest US CPI data which saw the biggest drop in consumer prices since April 1938. The race is on to cut spending, sell assets and reduce leverage.



Past examples of a deflation cycle can be found in the Great Depression and the post bubble recession in Japan. In both cases, slow policy response ensured the downturn was far more destructive resulting in a prolonged period of asset price weakness and economic stagnation.

The good news is unlike these two previous episodes, policy makers have recognised this risk and acted decisively to reflate the global economy. The Federal Reserve and Bank of Japan have both moved to “zero rate” policies and embraced qualitative easing (printing money) recognising the precipitous risks with a deflation cycle.

The new Obama administration is already putting the finishing touches on the biggest public works program in the post war era, with \$750 billion of new government programs to be legislated soon after his inauguration.

While we may be able to avoid the worst of a prolonged downturn, the recovery is likely to be muted with tight credit conditions continuing for some time as the financial system recovers. The most likely outcome is a protracted period of suboptimal growth

in Western countries, supported by continuing growth in emerging markets.

Implications for Australia

Australia is most likely in recession already. Softer global growth, restrictive credit conditions and deleveraging are playing a similar role in Australia as elsewhere in the world. Thankfully, we are in better shape than most countries to weather the storm.

Growth this year will slow to just under 1%, still well ahead of the experience offshore with the US and Europe both expected to contract by about 1.5% in 2009. Unemployment should peak in the US at around 8.5% versus 6.5% in Australia.

If you consider the key fundamental pillars buttressing any economy: The strength of financial institutions, private and public sector indebtedness and the health of capital markets, Australia finds itself in an envious position for a number of important reasons:

1/ The Australian banks have avoided the large losses that have overwhelmed the banking industry with \$US 1 trillion lost so far. Having recently raised additional capital and with the benefit of the Commonwealth Government Guarantee, our banks are in a relatively sound position when compared with their international peers. This is clearly evident in their credit ratings with 4 of the world’s 20 AA rated banks based in Australia.

2/ The Australian Commonwealth is in a strong fiscal position with little debt to speak of, providing enormous scope to stimulate the economy. The net value of Commonwealth and State government debt on issue is insignificant at \$50 billion or 5% of GDP, unchanged in 25 years. In sharp contrast, Japan in its attempts to pump prime its economy out of recession now has public sector net debt at 100% of GDP. While the soon to be elected Obama administration is showing leadership in targeting the largest post war stimulus program on record, in truth the country has limited capacity with net debt already at 50% of GDP following years of excessive budget deficits.

Governments around the world would love to have entered the crisis with no debt as has Australia. Our position looks great when you consider that (according to the Financial Times) sales of government debt will reach US\$2 trillion this year - led by the United States and Britain, each borrowing about 10% of GDP. For France, new borrowing will reach 8.6% of GDP.

In addition to the strong financial standing of banking institutions and the Government, there is considerable scope for financial conditions to ease further. While the RBA target cash rate has come down by 3% already to 4.5%, we still have plenty of ammunition, unlike the US Fed and Bank of Japan who have moved to "Zero Rate" policies.

Finally, the Australian dollar has fallen 30% providing relief to the domestic economy and alleviating some of the deflationary pressures at play. Partly offsetting this benefit will be a decline in Australia's terms of trade or purchasing power as commodity prices fall.

While our base case is for modest growth in 2009, the depth of the downturn will hinge on the outlook for commodity prices and the strength of demand for resources from China and emerging Asia. Business investment in Australia has doubled since 2001 and is running at a very high level with \$600 billion of projects in the pipeline. The government's "Build Australia" program is unlikely to kick in until 2010 as approvals and tenders are sort. This pipeline is heavily weighted to resource and infrastructure projects that will only proceed if Chinese demand recovers. If it doesn't and these projects are cancelled the drag on the economy will be significant.

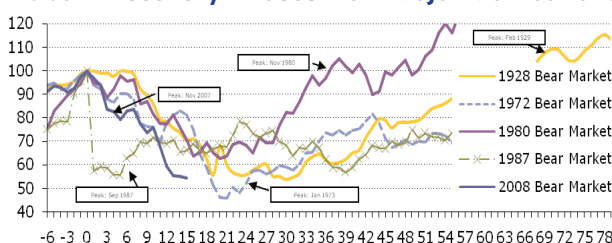
Duration of the downturn

The bears would have you believe the current economic downturn will last for many years as the debt deflation spiral locks us into a protracted period of economic stagnation.

Taking 100 years of data from The National Bureau of Economic Research (NBER), since WWII, there have been 11 US recessions & in that time, the average recession has lasted about 10 months, the two worst recessions in 1973 and 1981 lasted 16 months.

If this recession, which is already a year old, runs for 16 months which is equivalent to the 2 worst in the post war period, then the US recession could be finished by mid 2009. If so, the best time to buy is typically 4-6 months before the end of the recession - as the market anticipates the coming recovery, i.e. in the next few months (fig 06).

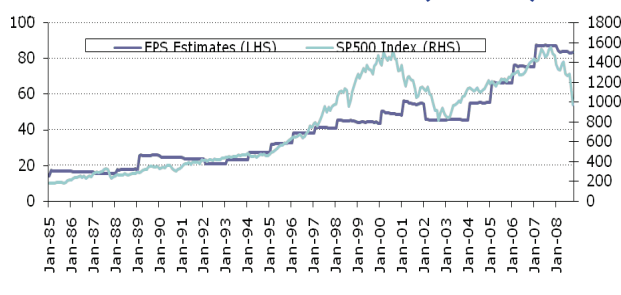
FIG 06 Recovery Phases from Major Market Falls



What is the market factoring in?

Inflation adjusted corporate earnings for US companies declined by an average of -13% through the 11 recessions in the post war period. In the worst recessions of 1973 and 1981 earnings fell between 17-20%. While earnings forecasts are still inevitably far too high, the market is factoring in a contraction in corporate profits which appears far worse than 1973 and 1981 (fig 07).

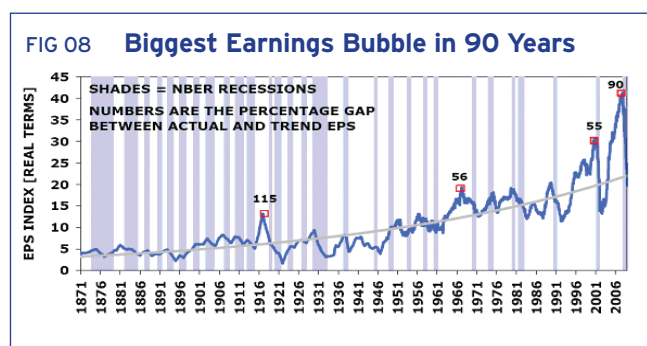
FIG 07 S&P 500 EPS Estimates (Historic)



Over time market indexes should broadly track corporate earnings. Fig 07 would suggest earnings could fall by at least 30% and shares would still be fairly valued. This earnings cycle is quite different to the "tech bubble" of 2000 where shares were clearly over valued when measured against underlying earnings. The surprise this time around is that shares have fallen so far given the market represented fair value back in 2007 based on underlying earnings.

With corporate earnings having doubled in a handful of years fuelled by excessive credit expansion, the risk with the current cycle is that earnings fall far more than in previous cycles.

The “earnings bubble” has been a worldwide phenomenon; (fig 08) depicts earnings growth for companies in the MSCI Europe index. In every previous downturn, profits have retreated below the longer term trend, suggesting the risk in this cycle is with a much larger than expected contraction in earnings.



So is it time to buy?

With the S&P 500 having rallied by 25% from the November low, the market appears to be following the script outlined above, confident that policy stimulus will lead a recovery in the second half of the year. As the rally continues it is useful to consider the risk case which has the recovery pushed out further into 2010.

The risk case

As noted above this is not a normal industrial cycle. Deflation cycles tend to last longer and so the duration of downturns in the post war period may not be a good measure of what to expect. It is normal for the strains on economic activity from asset liquidation and debt repayment to last a number of years.

There is a very close association between the household savings rate and household wealth (90% correlation). Over the last 20 years households have saved through asset accumulation. As asset prices have risen, consumers have spent most their disposable income. With household wealth imploding, households will now save more from disposable income to replenish

lost savings and reduce gearing. This will ensure a protracted period of suboptimal growth.

To put this in perspective, \$20 trillion has been lost from US household wealth in the last 6 months, leaving households 20% poorer. This is already twice the wealth lost in the “Tech Wreck” of 2001 and many times the loss of value experienced in 1975, the worst economic downturn in the post war period. The loss of wealth is already half that experienced during the Great Depression and trending lower as the housing contraction continues. By the time the dust settles, households may lose a quarter of their wealth. This will have a profound impact on savings and discretionary spending in the economy going forward.

The market is betting that the government stimulus will spark a recovery in the second half. Past experience (particularly Japan) would suggest we should not expect too much from government intervention. In any event, we are unlikely to see the weight of money spent until well into 2010 as projects will take time to approve and sanction. In the final analysis government spending may only cushion the weakness in the private sector and may not act as the panacea for economic recovery investors are looking for.

I suspect the market is ahead of itself in factoring in a mid-year recovery, hopes of which may be dashed in coming months.

Portfolio Strategy for a Bear Market

With the share market already factoring in a sharp contraction in economic activity it is timely to consider a portfolio strategy for the recovery when it eventually comes.

Whilst most shares look cheap on a medium term basis, given the poor prospects for corporate profits in 2009, there is no obvious place to hide:

- Banks are still at risk from emerging non performing loans and a slowing credit cycle
- Resources will struggle as growth expectations and commodity prices move lower

- Industrial shares will come under pressure as earnings disappoint with the economy slowing
- Property will see ongoing equity supply and downward revisions to valuations

Given this dire outlook, investors have pushed the premium on earnings certainty and balance sheet strength to extremes. Companies with defensive earnings and strong balance sheets have outperformed significantly in 2008 (fig 09).

Many of these so called “defensive” sectors such as healthcare, telecom, utilities and consumer staples now look expensive when adopting a medium term view. The best performing stocks in the S&P 500 last year were Wal Mart and McDonalds i.e. food.

The best value can be found in the financial and cyclical sectors of the market which have been battered in the expectation of weaker results. While these companies will inevitably report poor results in 2009, given the weakness in their shares, the bad news appears factored in. When the cycle turns and the economy recovers these are the sectors that will appreciate the most.

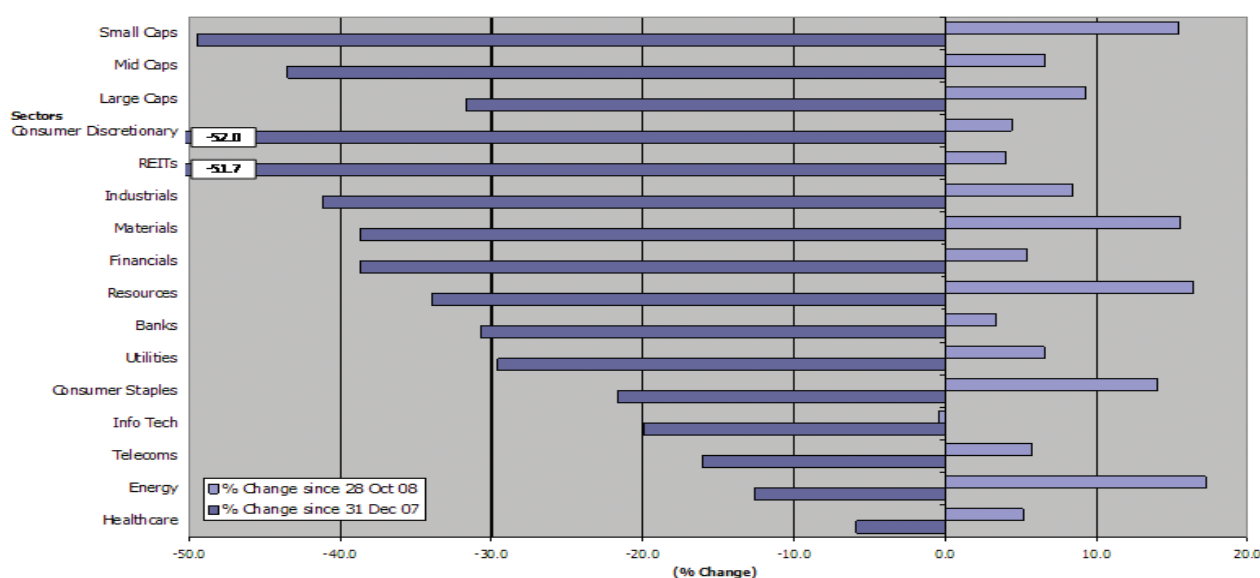
Our preference is to maintain a significant cash weighting (the best defensive asset) and

selectively invest in quality industrial names trading below their medium term valuations. With credit markets constrained, companies are being forced to raise new equity to repair stretched balance sheets. By retaining a large cash weighting we can participate in these equity issues on attractive terms.

As everything is effectively “on sale” - a winning strategy is to:

- Stick to stronger companies. In the good times even the weakest companies look good. Investors will be surprised at the contraction in the profits of weaker businesses as conditions deteriorate. The strong will get stronger and the weak will fall by the wayside;
- Avoid leveraged balance sheets as these companies will inevitably have to issue equity and sell assets at depressed values diluting existing shareholders;
- Cash is the only truly defensive asset, so called “defensive companies” are overvalued;
- Buy cheap structural growth companies. The structurally impaired will be weaker coming out of this cycle; and
- Participate in the recapitalisation of good companies with weaker balance sheets as they issue equity on attractive term

FIG 09 Sector Performance



In looking at the portfolio at 31 December 2008 (Table 01, page 9), the important positions to consider can be summarised as follows:

Underweight Defensive Sectors (8% weight Vs 28% for market)

As with all assets classes, investors are paying a premium for earnings certainty. Shares in consumer staples, healthcare, telecommunications and utilities have outperformed significantly and look expensive when adopting a medium term view of the world.

Nowhere is this more evident than in infrastructure where we hold some of our largest short positions. Investors for years have been led to believe these businesses should be valued differently because of the certainty of earnings in public infrastructure. The reality is these assets are no different to any other going concern. They are expensive and in many cases thinly capitalised. Infrastructure shares are the perfect source of long term portfolio funding (shorts) as these securities are grossly overvalued and likely to underperform over a long period of time.

We are short a number of healthcare names mainly on valuation grounds. We would expect the private hospital operators (Ramsay Healthcare and Healthscope) to struggle in the medium term as the profitability of health insurance providers come under pressure. The health insurers are being squeezed by recent changes to the Medicare Surcharge Levy (MSL) and lower investment returns.

Assuming the outlook does not deteriorate further, the value in holding defensive assets has passed. The only truly defensive asset is cash which we include in this sector weighting. When the cycle turns, shares in these companies will underperform as investors sell these securities to increase their leverage to a recovery.

Overweight Financials (52% weight Vs 38% for Market)

The banks lead the market lower as the depths of the financial crisis became evident and are likely to lead the recovery. The risk in owning banks peaked along

with credit spreads (fig01) at the end of last year. The Australian banks are fundamentally sound, they are well capitalised and have strengthened their competitive position with foreign banks and non bank financial institutions (NBFIs) withdrawing from the market.

For 20 years NBFIs and foreign banks have been taking share from the domestic banks, as disintermediation of financial system has followed the emergence of credit securitisation. With the securitisation markets now closed to intermediaries such as RAMS and Aussie Homes Loans, most NBFIs have disappeared. Many of the large foreign banks have been imperilled by losses in credit markets and are also withdrawing.

The banking oligopoly is back with the major trading banks the only game in town. This is clearly evident in their improved trading terms and stronger margins. While bad and doubtful debts will deteriorate in the short term, the banks are well provisioned. So long as the downturn is no worse than we are expecting, the banks should see returns improve in 2010.

Property trusts also lead the market lower starting with the demise of the Centro Property Group. Unlike the banks the recovery in property will be slow as most of these vehicles have over extended balance sheets and need to raise capital. Asset sales will play an important role here but this will take time as liquidity slowly returns to credit markets. While the recovery in property securities will be slow in coming, we have been presented with some great opportunities to buy quality property portfolios cheaply as these trusts/stapled securities have been forced to raise equity on highly attractive terms.

Domestic Cyclical (9% weight Vs 9% for Market)

We have limited our exposure to deep cyclical (Steel, Paper & Packaging, Contractors, and Building Materials) as the depth of the downturn is uncertain. These shares however will inevitably deliver the best results when the recovery does eventually come.

The best value in the market can be found amongst those quality industrial companies that have been oversold. Our

focus has been to invest in structural growth companies offering superior medium term profit growth.

The wealth managers are a case in point. These companies will benefit longer term from the growth in mandated savings and they offer outstanding medium term value (AMP, Henderson Group, IRESS Technologies, ASX).

This cycle may be long and protracted. The structurally impaired will be far weaker coming out of this cycle, whilst new emerging business models will be stronger. Pursuing this theme, we have acquired interests in a number of new media and internet platforms that have suffered as investors have fled to the safety of earnings certainty. We have accumulated positions in Seek, Webjet, Wotif.com, Melbourne IT and Consolidated Media Holdings.

Resources

(13% weight Vs 26% for Market)

Equity markets are rallying in the expectation that global growth will recover in the second half of the year. This is clearly evident in the strength of mining shares lead by BHP Billiton. While we held 10% of the fund in BHP back in November when it was \$20, we have completely sold out of our position following the 60% increase in the company's share price. (BHP ADRs listed on the NYSE have doubled in value).

Mining shares were the last sector to fall in this bear market back in March 2008, well after industrial shares had peaked. However this sector is staging the strongest recovery! The Mining and Oil and Gas sectors have significantly outperformed the broader market, which is counterintuitive given the backdrop of the worst downturn in economic activity since 1982.

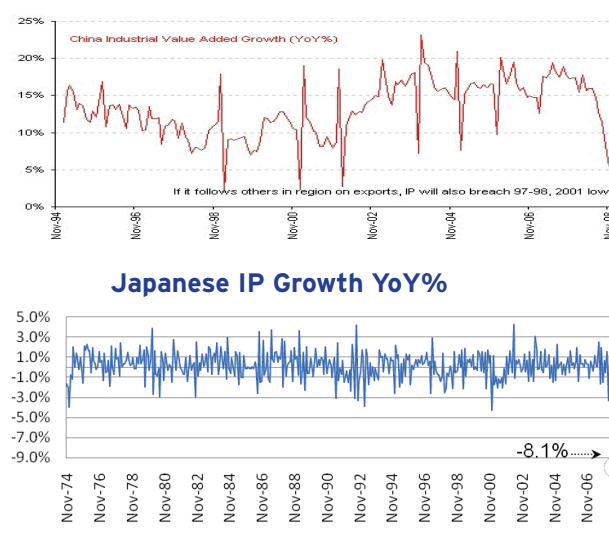
Trade in commodities ground to a halt during the worst months of the credit crisis as merchants were unable to get letters of credit to exchange cargoes, clearly evident in the Baltic freight index which collapsed.

Similarly, with base metals, prices for nickel and zinc have fallen so far on weak demand that producers have been forced to cut production. Spot prices for bulk commodities have followed a similar path and now look to be stabilising. Investors have taken comfort from

this price signal and bought mining shares.

In our assessment commodity prices still have a lot of work to do before we can confidently buy shares in these companies. It is far from clear when Chinese demand for commodities will return. We certainly do not gain any confidence from the latest production data out of China and Japan (figs 10).

FIG 10 China Industrial Production



Whilst we have sold out of BHP, we are finding better value elsewhere in the sector. We continue to accumulate positions in some of the second tier miners where we can buy quality long life reserves cheaply in companies that will survive even under the most challenging circumstances (Equinox and Mirabella).

We are more confident in the outlook for Oil than for other commodities and have tempered our modest exposure to mining shares with significant positions in Oil and Gas (Oilsearch and Worley Parsons). We would expect OPEC to act decisively in rebalancing oil markets by cutting supply as demand softens supporting prices. The industry needs oil prices well above \$75/barrel to provide the incentive to invest in deep sea and unconventional oil if depleted reserves are to be replaced.

We also have sizeable positions in a number of mining service companies (Orica, Transfield, Worley, Bradken) which represent better value than the large diversified miners and will participate in a broader recovery in the sector.

Sector Allocation (ASX)

Table 01

	Company Name	Upside	%Long	%Short	Net Wght	Weight
Defensives	TRANSURBAN GROUP-DEF	21%	-	3.1		0.8
	AGL ENERGY LTD	1%	-	4.3		0.9
	APA GROUP	26%	-	4.8		0.1
	TELSTRA CORPORATION LTD	37%	2.9	-		5.6
	PRIMARY HEALTHCARE	50%	6.9	-		1.0
	ANSELL LTD	13%	-	5.9		0.2
	SIGMA PHARMACEUTICALS LTD	30%	-	1.4		0.1
	HEALTHSCOPE LIMITED	20%	-	0.5		0.1
	RESMED INC	6%	-	3.0		0.2
	RAMSAY HEALTH CARE LIMITED	17%	-	3.5		0.1
	TATTERSALL'S LTD	8%	-	2.6		0.4
	CROWN LTD	104%	8.1	-		0.3
	ARISTOCRAT LEISURE LTD	40%	1.7	-		0.2
	FOSTER'S GROUP LIMITED	7%	-	2.9		1.4
	GOODMAN FIELDER LTD	34%	5.0	-		0.2
CASH		15			-7	12
		40	32		8	28
Financials/ Property	COMMONWEALTH BANK OF AUSTRALIA	59%	7.2	-		6.0
	NATIONAL AUSTRALIA BANK LTD	21%	7.2	-		4.8
	WESTPAC BANKING CORP	34%	6.1	-		6.0
	AUSTRALIA & NEW ZEALAND BANKING	25%	5.7	-		3.8
	BENDIGO BANK LIMITED	4%	-	1.5		0.4
	MACQUARIE GROUP LTD	96%	1.9	-		1.1
	ASX LTD	20%	3.4	-		0.7
	PERPETUAL LTD	14%	-	4.0		0.2
	HENDERSON GROUP PLC	50%	3.8	-		0.1
	IRESS MARKET TECHNOLOGY LTD	40%	4.7	-		0.0
	QBE INSURANCE GROUP LIMITED	10%	2.7	-		2.7
	AMP LIMITED	30%	5.9	-		1.3
	GPT GROUP	25%	1.2	-		0.5
	LEND LEASE CORP	67%	2.0	-		0.3
	DEXUS PROPERTY GROUP	97%	2.7	-		0.3
MIRVAC GROUP	123%	2.6	-		0.3	
		57	6		52	38
Domestic Cyclical	FAIRFAX MEDIA LTD	88%	2.0	-		0.2
	NEWS CORP INC	37%	4.8	-		0.5
	CONSOLIDATED MEDIA HOLDINGS LTD	48%	4.3	-		0.1
	SEEK LTD	96%	4.2	-		0.1
	TEN NETWORK	3%	-	3.9		0.0
	CABCHARGE AUSTRALIA LIMITED	31%	-	4.2		0.1
	BRAMBLES LIMITED	12%	-	3.6		1.3
	LEIGHTON HOLDINGS LIMITED	98%	-	4.8		0.5
	TRANSFIELD SERVICES LIMITED	263%	5.9	-		0.1
	BILLABONG INTERNATIONAL LTD	78%	3.4	-		0.2
	DAVID JONES LTD	36%	-	2.3		0.2
	BLUESCOPE STEEL LIMITED	114%	1.4	-		0.4
	TOLL HOLDINGS LTD	29%	2.3	-		0.5
	AMCOR LIMITED	8%	-	7.6		0.7
	BORAL LIMITED	16%	-	1.3		0.3
	JAMES HARDIE INDUSTRIES NV	20%	-	1.3		0.2
	NUFARM LIMITED	84%	4.2	-		0.1
	GUNNS LTD	68%	3.7	-		0.1
	ONESTEEL LIMITED	202%	2.2	-		0.3
		38	29		9	9
Resources	RIO TINTO LIMITED	307%	1.9	-		1.7
	NEWCREST MINING LTD	-6%	-	2.2		1.5
	FORTESCUE METALS GROUP LTD	145%	1.4	-		0.3
	LIHIR GOLD LIMITED	-9%	-	3.4		0.6
	ILUKA RESOURCES LIMITED	19%	2.3	-		0.2
	OIL SEARCH LTD	38%	4.3	-		0.4
	ROC OIL COMPANY LTD	302%	1.2	-		0.1
	INCITEC PIVOT LTD	238%	1.5	-		0.7
	WORLEYPARSONS LTD	140%	4.0	-		0.6
	ORICA LIMITED	116%	2.0	-		0.7
			19	(6)		13

Small Caps

18.3

The short selling debate and hedge funds

It is important to set the record straight with regard to short selling in light of recent criticism suggesting the practice has contributed to market losses.

With most of the commentary coming from “experts” with little or no experience in short selling I feel it is important to start with the facts. Although data is limited, it has been conspicuously absent from the debate so far.

The pool of borrowed securities lent to hedge funds represents approximately 2.5% of the capitalisation of the Australian Equity market. This is consistent with the data reported on Bloomberg in the US, where 3.5% of securities on the NYSE have been lent out.

The message is quite clear, the numbers are very small; it is highly unlikely short selling is having a material impact on the overall market, clearly evident last October when the ban was in place.

The role of short selling in the investment process of most hedge funds is also misunderstood. The newspapers would have you believe short sellers are trying to drive everyone out of business and disrupt the market place. While there may be some isolated examples of this, in most cases this is far from the truth.

Short selling is an unfortunate parlance; it implies a form of short term speculative activity. To the contrary, in our process borrowed securities that are sold (short) are an attractive source of medium term funding for the company's balance sheet. It is a highly attractive source of funding as the carrying costs are extremely low at 0.5% for most ASX 100 securities. Furthermore, as there is a natural hedge between the asset and liability (borrowed securities), both will tend to move up and down together so market risk is not increased.

Professional investors make money for their clients by buying and selling mispriced securities. The strength of any investment process ultimately rests with the security selection success of the manager. How the portfolio is funded, whether by shareholders funds, finance or from borrowed securities should be considered separately, consistent with first principles of finance.

We hope to employ our security selection skills in identifying mispriced shares to secure an advantage in accessing a cheap source of portfolio funding by selling overvalued securities.

In practice most hedge funds engage a similar process to a traditional manager but employ a different funding structure. The steps taken in selecting securities is similar. Like a traditional manager, the hedge fund will typically rank the universe of shares (ASX 200) by a range of qualitative criteria, constructing portfolios from the highest ranking shares. The hedge fund takes this process to the next logical step and sells (short) the securities of companies that rank poorly on the same selection criteria in the expectation these securities will underperform over the medium term.

The funds raised from selling these borrowed shares are either reinvested back into the portfolio or held as cash depending on the exposure the manager wishes to retain to the market (refer balance sheet page 12).

The value in hedge funds

The legitimate role of short selling in a well constructed investment process has also been brought into question recently. Again returning to the facts, we find the performance data would suggest these claims are unfounded.

An index of 70 Australian hedge funds provided by Hapfield Liptak has fallen by -19% over the year ending October 2008. The Australian Equities market over this period has fallen by almost twice this amount at -38%.

The average performance of the 69 traditional funds followed by Intech fell by -35%. The best result from a traditional fund was a loss of -28%, significantly worse than the average hedge fund. The performance delivered by hedge funds in these troubled times has been outstanding and the clearest endorsement of this product.

Traditional managers will be quick to point out that a straight comparison with long only funds is unfair as most of the hedge funds are not fully exposed to the market. This is exactly to my point. If you look



at the distribution of returns from traditional funds, which jointly manage \$568 billion in superannuation invested in Australian shares, you find they are all huddled around the index. As their investment process targets relative performance and views risk as the prospect of underperforming the index, this is hardly surprising.

These long only funds at the end of the day employ a similar process and are delivering similar results. I would venture to say that given the way these funds are structured it would have been impossible for any of the major funds to have delivered a result similar to the average achieved by the hedge fund industry.

If you wanted to preserve your capital last year and invest in Australian equities your only choice was a good hedge fund. What bemuses me is that no one can see the value in what these funds have to offer!

My case is fundamentally one of choice; hedge funds offer investors the prospect of materially different results to what is on offer in the broader market place, making them a valuable proposition. While we have one of the world's largest superannuation industries, we are well behind our Northern Hemisphere peers in developing hedge fund products. As with any emerging industry, there are many poorly considered investment strategies as well as some worthy strategies delivering outstanding results.

Process and performance:

ALF takes the traditional investment process one step further. Not only do we buy shares that are fundamentally undervalued. We also sell overvalued (borrowed) shares as well.

As the shares are borrowed, leverage is introduced into the structure. The risk associated with this leverage is only to the stock selection success of the manager. Market risk is in not increased.

This provides an attractive low cost source of funding for our portfolio with the added benefit of a natural hedge in the balance sheet structure.

By taking advantage of mispricing in all segments of the market and capturing a low cost source of funding, we are able to target much higher returns than a traditional fund.

As a reminder we employ the same investment targets as an institutional manager. As we construct the investment portfolio, our goal is to outperform the market by 3%. We take this same process one step further and sell a portfolio of overvalued securities (borrowed) that we expect to underperform by 3%. The leverage in the structure ensures shareholders funds will outperform by a multiple of 3% depending on the portion of the balance sheet funded from borrowed shares.

Looking at the 2 year period from 1 January 2006 to 31 December 2008 (since we started breaking out Long/Short attribution data) we are pleased to report that the return profile is consistent with our investment objectives.

Over this period the Investment portfolio fell by 27% Vs the All Ordinaries Index which fell by 30%. Approximately one third of the balance sheet was funded from borrowed securities that fell in value by 32.4% over the 2 year period leaving shareholders funds 22.5% lower outperforming the benchmark by 7%.

Whilst this is a pleasing result in challenging times, in truth we have strengthened our process considerably over this period and hope to perform even better in the period ahead. ■

Regards

Justin Braitling | CHAIRMAN

ALF Unaudited Balance Sheet 31st December 2008*

Assets				Funding																																																							
Long Portfolio				Shareholder's Funds \$66.0m																																																							
	Market Value '000's			Shares on issue 72,518,793 X Estimated Net Assets before selling costs (0.9107)																																																							
		MIRVAC GROUP	1,152	Borrowed Securities/(Shorts) \$42.0m <table border="1"> <thead> <tr> <th></th> <th>Market Value '000's</th> <th></th> <th></th> </tr> </thead> <tbody> <tr> <td>AMCOR</td> <td>3,909</td> <td>LIHIR GOLD LIMITED</td> <td>1,738</td> </tr> <tr> <td>ANSELL</td> <td>3,884</td> <td>RESMED INC</td> <td>1,616</td> </tr> <tr> <td>TRANSURBAN GROUP</td> <td>3,279</td> <td>FOSTER'S GROUP</td> <td>1,540</td> </tr> <tr> <td>LEIGHTON HOLDINGS</td> <td>2,765</td> <td>TATTS GROUP</td> <td>1,499</td> </tr> <tr> <td>AUSTRALIAN PIPELINE TRUST</td> <td>2,527</td> <td>DAVID JONES</td> <td>1,272</td> </tr> <tr> <td>CABCHARGE AUSTRALIA</td> <td>2,287</td> <td>NEWCREST MINING</td> <td>1,186</td> </tr> <tr> <td>AGL ENERGY LIMITED</td> <td>2,213</td> <td>HEALTHSCOPE</td> <td>884</td> </tr> <tr> <td>PERPETUAL TRUSTEES</td> <td></td> <td>BENDIGO BANK</td> <td>783</td> </tr> <tr> <td>AUSTRALIA</td> <td>2,195</td> <td>JAMES HARDIE INDUSTRIES NV</td> <td>654</td> </tr> <tr> <td>TEN NETWORK HOLDINGS</td> <td>2,176</td> <td>BORAL</td> <td>647</td> </tr> <tr> <td>RAMSAY HEALTH CARE</td> <td>1,941</td> <td>IOOF HOLDINGS</td> <td>554</td> </tr> <tr> <td>BRAMBLES</td> <td>1,861</td> <td>SIGMA PHARMACEUTICALS</td> <td>480</td> </tr> </tbody> </table>					Market Value '000's			AMCOR	3,909	LIHIR GOLD LIMITED	1,738	ANSELL	3,884	RESMED INC	1,616	TRANSURBAN GROUP	3,279	FOSTER'S GROUP	1,540	LEIGHTON HOLDINGS	2,765	TATTS GROUP	1,499	AUSTRALIAN PIPELINE TRUST	2,527	DAVID JONES	1,272	CABCHARGE AUSTRALIA	2,287	NEWCREST MINING	1,186	AGL ENERGY LIMITED	2,213	HEALTHSCOPE	884	PERPETUAL TRUSTEES		BENDIGO BANK	783	AUSTRALIA	2,195	JAMES HARDIE INDUSTRIES NV	654	TEN NETWORK HOLDINGS	2,176	BORAL	647	RAMSAY HEALTH CARE	1,941	IOOF HOLDINGS	554	BRAMBLES	1,861	SIGMA PHARMACEUTICALS	480
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CBA	3,902	ORICA	1,049																																																								
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NAB	3,776	RIO TINTO	1,029																																																								
CONSOLIDATED MEDIA HOLDINGS	3,473	MELBOURNE IT	1,028																																																								
AMP	3,409	MACQUARIE GROUP	1,008																																																								
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TRANSFIELD SERVICES	3,185	AUSTERO GROUP	899																																																								
ANZ BANKING GROUP	2,948	ARISTOCRAT LEISURE	873																																																								
WORLEY PARSONS	2,614	INCITEC PIVOT	848																																																								
GOODMAN FIELDER	2,554	BLUESCOPE STEEL	775																																																								
NEWS CORPORATION	2,531	FORTESCUE METAL GROUP	772																																																								
SEEK	2,495	WEBJET	772																																																								
IRESS MARKET TECHNOLOGY	2,459	EQUINOX MINERALS	753																																																								
OIL SEARCH	2,353	ROC OIL COMPANY 629																																																									
NUFARM	2,348	SKY CITY ENTERTAINMENT GROUP	514																																																								
GRAINCORP	2,344	COMPUTERSHARE	425																																																								
VIRGIN BLUE HOLDINGS	2,213	MIRABELA NICKEL	404																																																								
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GUNNS	2,045																																																										
ASX	1,832		92,087																																																								
BILLABONG INTERNATIONAL	1,773	CASH	8,932																																																								
RHG	1,760																																																										
MCMILLAN SHAKESPEARE	1,666	Net Tax Assets	6,978																																																								
QBE INSURANCE GROUP	1,547																																																										
TELSTRA	1,532																																																										
DEXUS PROPERTY GROUP	1,517																																																										
REVERSE CORP	1,400																																																										
WOTIF.COM HOLDINGS	1,299																																																										
ILUKA RESOURCES	1,249																																																										
TOLL HOLDINGS	1,234																																																										
ONESTEEL	1,230																																																										
Total Long Portfolio \$108.0m				Total Long Portfolio & Equity \$108.0m																																																							

*Estimated

Comparative Performance at 31 December 2008: **Portfolio ALF** Inception 10 Feb 2004

1 Month	Portfolio 3.2%	Benchmark -0.08%	Value Add 3.3%
3 Months	Portfolio -18.7%	Benchmark -20.2%	Value Add 1.6
6 Months	Portfolio -19.5%	Benchmark -29.7%	Value Add 10.3%
1 Year	Portfolio -34.5%	Benchmark -40.4%	Value Add 5.9%
2 Years (Annualised)	Portfolio -11.9%	Benchmark -16.1%	Value Add 4.2%
3 Years (Annualised)	Portfolio 1.4%	Benchmark -4.2%	Value Add 5.6%
Since Inception	Portfolio 8.2%	Benchmark -6.6%	Value Add 1.7%
Since Inception (Cumulative)	Portfolio 46.6%	Benchmark 35.9%	Value Add 10.7%