Welcome to the June 2012 edition of the Martin Bros. Monitior.

A Genuine Buyers Strike

What an eight weeks it has been in world equity markets. Right when we (prices) were looking better and things seemed to be on their way, along came Europe once again to derail the rally and send us back down to the bottom of the trading range for the last twelve months. Fantastic!? If you are like many accumulators that make a large superannuation contribution towards financial year end. Although you may not feel better about seeing a lower portfolio value than last quarter, ask yourself, “are you happier paying 10% less for the same quality business (stock) than you would have a couple of months ago? Of course you would be. People in this category should be thanking Europe, not complaining about them.

Let’s not forget about those of you in pension phase though. With active portfolio management you have still benefited from chipping away and adding to positions in long term, reliable dividend paying businesses. Many companies continue to pay increasing dividends half on half.

We have talked about the “bubble” in global bond yields before and like any true “bubble”, this one has ballooned for longer and reached more extreme levels than we could have previously thought possible. The global bond “bubble” is extreme and anyone who is not well versed in global money markets (every retail investor) is taking on un-imaginable risk with every dollar they invest in this theoretical “safe haven” asset class.

In our Christmas 2011 edition of MBM we wrote about the spread (difference) between the Australian

Government 10 year bond yield and the average gross dividend from Australian bank shares. At the time the Australian 10 year bond yield was at 3.33%. This has now fallen to 2.97% after reaching a low of 2.70%. Post the Christmas edition of the MBM this bond yield increased to over 4% and coincided (not coincidently) with a rally in equity prices. It has now fallen back to 2.97% as stated above. The difference between this yield and the average gross bank dividend yield (of the big four) is now at an all time high.

One of two things is likely to happen in the near term (within the next 12 months). One, bank dividend yields are going to be cut substantially, or two, bond yields will rise. Why do we say this? Because domestic and global money (short term focused funds) chase return and a large part of total return is income. We believe the former (banks cutting dividends substantially) is a very very low probability. In fact, these are likely to continue to increase. If they remain at least flat then this yield differential between bonds and dividends will not last. Bonds will be sold off which means an increase in yield. Contrary to popular belief this is bad for bond holders as it creates a capital loss as yields increase. Once the flood gates open on this trade and the real switch out of bonds occurs, it will be an almighty stampede. One which may rival the GFC sell off in equities.

We have highlighted here the difference between bank yields and bond yields. The same principal holds true for many other share dividend yields outside of the big four bank. The regional banks are another example (see below on Wide Bay Australia). So too are many stocks that are traditionally known as "growth" stocks. Many of the gross yields available on these growth stocks are greater than the ten year bond yield too.

This historical high seen between bond yields and gross bank yields has occurred at the same time the big four bank share prices have held up relative to the overall market. If these shares had sold off in the last two months like the rest of the market then this yield differential would be even greater and the equity market as a whole would be some 200 points lower. The fact that our bank share prices have held up is the best indicator of the health of the global financial markets. Put simply, there is not another Global Financial Crisis pending because of the mess in Europe. The few peripheral (put bluntly – completely irrelevant in terms of global output) countries causing the crisis in confidence is not a global financial market crisis but a buyer of "risk" assets crisis. Simply, it has created a buyers strike in "risk" assets (equities) at a time when valuations are at extremely low levels and comparative "safe" assets are now "dangerous". With current prices in these asset classes, we feel there is a greater chance of a "melt up" in equity prices rather than a "melt down".

We are not predicting that we are currently seeing the precise bottom in equity markets. However, a growing range of indicators such as fundamentals, technicals and psychological reasons are converging to create the start of an equity market rally at some point. Europe might steal the headlines in the short term, but with their bank recapitalisations almost over, money will soon start to flow back into "risk" assets. It will be a trickle to begin with, but once the herd catches on, it will gain steam and the "buyers strike" will turn into a "sellers strike" and cause a "melt up". Volatility and lack of liquidity is the enemy on the way down. These days it is exacerbated by computer driven algorithmic trading. However, this same volatility and lack of liquidity is our friend on the way up. All of this is just "noise" of course, and nothing detracts from the ***business*** that you are buying into when you are buying a share. These businesses operate in the ***real*** world where you and I do. Their share prices operate in the ***perceived*** world where fear and sentiment try to trick us into doing exactly the wrong thing at the wrong time. Simply put, sell low and buy high. From time to time the equity market presents us with an opportunity to add to our long term wealth creation, whether in accumulation or retirement phase. History will show we are currently in one of these times right now.

Stock Review - Wide Bay Australia Ltd (WBB)

We have covered Wide Bay in our MBM twice before, in the Christmas 2007 and Christmas 2009 editions. The latter was close to the stocks GFC lows. We now find ourselves back to these GFC lows (currently $5.71) after recovering to the $11 region in 2010/11.

So what's changed? Apart from general market sentiment, we have now had the Queensland floods and cyclone Yasi in early 2011. As a result, Wide Bay had a marginal increase in non performing loans which left them with a dozen or so of repossessed homes. These were largely cleared out in the half year ended December 2011.

This led to a reported net profit after tax for the half some 25% below that of the prior corresponding period (December half 2010). The largest negative contribution coming from their Mortgage Risk Management (MRM) business which recorded a profit of $67,000 versus a profit of $1.6m in the prior corresponding half.

This MRM business has now been closed down and all loans requiring mortgage insurance are externally underwritten. The closing of this business unit will release a large amount of capital back onto the parent balance sheet that previously could not be reported as part of the banks capital.

Due to the December 2011 profit decline their interim dividend was reduced to 22.5 cents for the half (previously 30 cents). This puts Wide Bay on a historical dividend yield of 9.20% fully franked, or 13.14% gross yield. We believe this yield will again increase over time after what appears to be a one off cut for the December 2011 half.

We met with management recently and they are very confident of a return to improving results. Wide Bay operates throughout Queensland in all major regional towns such as Mackay, Bundaberg, Rockhampton etc. Our analysis and feedback from people on the ground is that Queensland regional development is continuing unabated on the back of expanding and new resource projects. Together with a recent change of government in the sunshine state and falling interest rates, we are confident in the markets in which Wide Bay Australia operate.

In addition to the above fundamental view, we take a great deal of comfort in the fact that the Managing Director, Mr Ron Hancock, is also by far the largest shareholder in Wide Bay Australia. This is a rare occurrence these days.

We believe this is another clear example of equity market mis-pricing.

Technical Update

BEWARE of super contribution limit changes for 2012/13

In keeping with the competing interests of helping people save for retirement versus collecting more taxes, the government has cut the concessional contribution limit for over 50’s to $25,000 for the 2012/13 year onwards.

This seems a ridiculously low limit given most people only have the means to make larger contributions to superannuation once they reach their later working years. Alas, that is how it stands for now (we think this will ultimately be changed back to the higher limit for over 50's) so we need to be aware of this change.

Please refer to the below if in doubt on the concessional and non concessional contribution limits for 2012/13. Of course, as always, please feel free to contact us to discuss.

Contributions Schedule for 2012/13 Financial Year

<u>Concessional Contributions (deductable)</u>

- Up to age 75 - $25,000 p.a. per person
- If over 65, must meet work test
- Excess tax rate on contributions over Concessional Cap (in addition to standard 15% contributions) - 31.5%

<u>Non-Concessional Contributions (non-deductable)</u>

- Up to age 75 - $150,000 p.a. per person;
- Or $450,000 per person (over 3 year period), up to age 65 (incl. turning 65 in that financial year as long as contribution is made on or before 30 June of that year) - Please note: if $450,000 non-concessional contribution is made after turning 65 in that financial year, it must be made in 3 parcels of $150,000 each on different days
- If over 65, must meet work test
- Excess tax rate on contributions over Non-Concessional Cap - 46.5%
