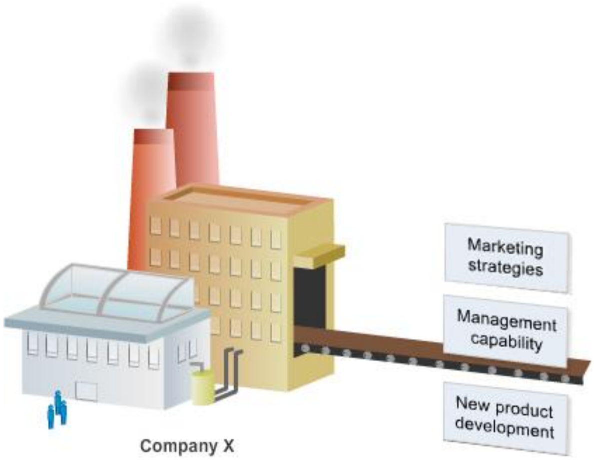
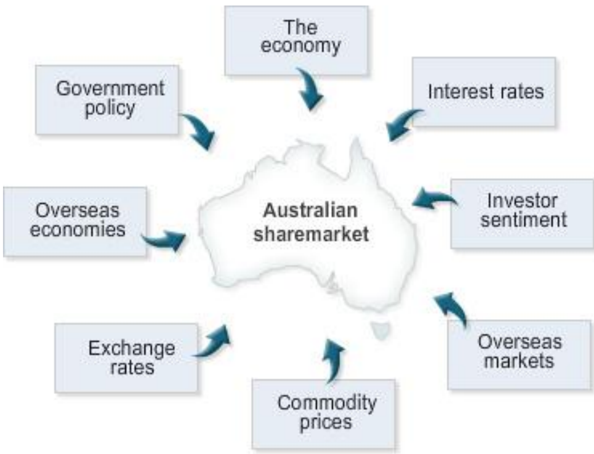
Topic 1: Understanding the economy

To determine the value of shares in a particular company you must pay close attention to its operating environment. The state of the global and Australian economies, events in the political arena and changes in an industry sector can have profound effects on individual companies, over which they have no control.



The key point is that in analysing the outlook for a company's share price it is necessary to consider a wide range of factors that will impact on the company's current and future earnings. Some of these factors are 'internal' to the company in the sense that they are directly subject to the company's control. Examples include management capability, marketing strategies and new product development.

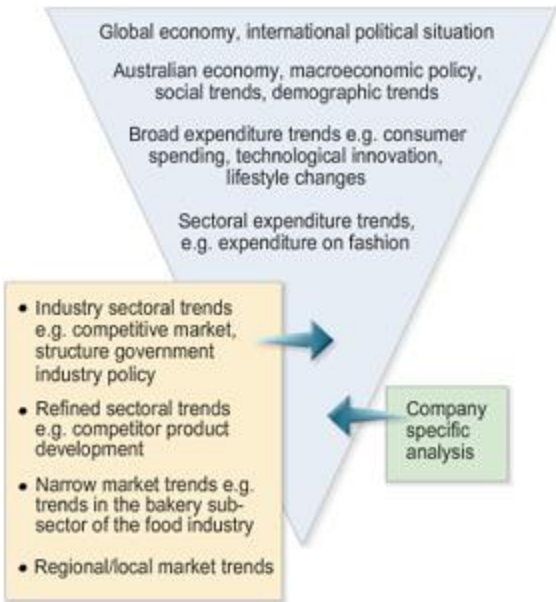
However, there are also many factors that will influence a company's earnings performance that are largely 'external' to the company in the sense that the management of the company has little or no control over them. Some of these factors may be broad developments that impact across the economy. Examples include the rate of economic growth, the level of interest rates and government fiscal policy. Structural shifts can also be identified, such as the increased internationalisation of the Australian economy.



A top-down approach to investment analysis

Taking a top-down approach to analysing a company's prospects involves a staged approach looking first at the broad macroeconomic, social and political environment. Then the focus of analysis is progressively narrowed to consider the more industry specific or even regional influences on a company's earnings. This pattern of analysis has the benefit of ensuring that relevant information is included in a consistent way. As well, it makes sure that important background information is fully taken account of and that the interactions between broad macroeconomic conditions and more industry specific factors are highlighted.

In undertaking a top-down analysis it is also useful to consider alternative scenarios, for example incorporating different assumptions about economic conditions, and what these different scenarios might mean for the performance of a particular company.



One point to remember is that equity market prices are largely a reflection of investor expectations for future company earnings. In other words, the prevailing share price for a company already factors in investor thinking about future economic conditions and company performance against this background. However, investor expectations are not stable, constantly shifting as new information becomes available. As investor expectations change so will the share price.

The Australian economy

Australian economic conditions will often be an important influence on corporate performance. Some of the many broad economic factors that may impact on a company include the rate of economic growth, the rate of inflation, the rate of employment growth, the level of interest rates, the exchange rate and the various arms of economic policy.

The key pieces of data to monitor are the following: gross domestic product (GDP), interest rates, unemployment, inflation, the Australian dollar, the balance of payments and the current account deficit. However, you don't have to be an economist to analyse this data. After all, you are merely looking to identify an overall trend and make a judgement on its impact on market sentiment, not analysing what happened last year or prescribing solutions for economic problems.

RESERVE BANK OF AUSTRALIA

Home • Publications & Research • Statements on Monetary Policy

STATEMENT ON MONETARY POLICY

Contents

Introduction

International Economic Developments

International and Foreign Exchange Markets

Domestic Economic Conditions

Foreign Trade and Capital Flows

Domestic Financial Markets and Conditions

Inflation trends and Prospects

List of graphs

List of tables

Sample taken from the Reserve Bank of Australia website

Keeping up-to-date

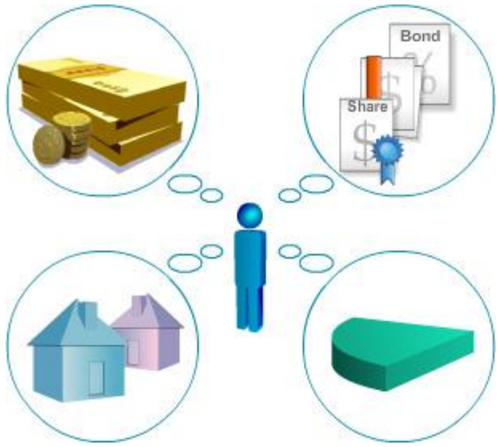
Keeping up-to-date with Australian economic conditions is relatively easy, as long as you are prepared to invest a little bit of time. The Reserve Bank of Australia's Statement on Monetary Policy is published quarterly and is an excellent commentary on the Australian economy. www.rba.gov.au

The newspapers, particularly the Australian Financial Review, also carry stories on new economic information. The research departments of banks and stockbrokers often produce regular material on the Australian economy including forecast economic conditions.

Summary

- All investment decisions should be made in light of the broader economy.
- By understanding the direction of the domestic and international economy, you will be better placed to make an informed decision on which sectors are going to benefit or suffer in the future.
- Information on the economy can be gathered from a number of sources. The RBA's 'Quarterly Statement on Monetary Policy' is available from their website www.rba.gov.au Business sections of newspapers, business oriented websites and other financial media provide extensive reporting on the state of the economy.

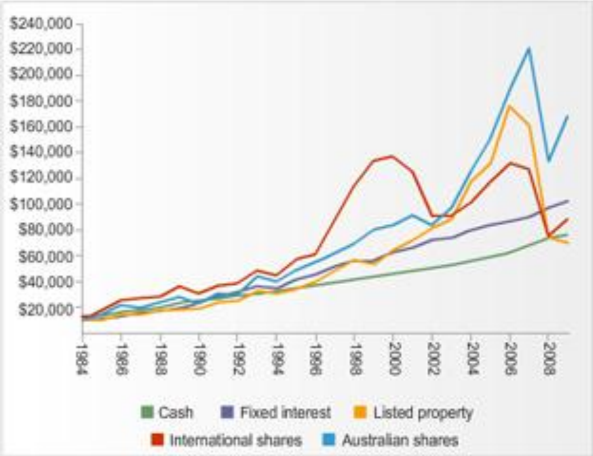
Topic 2: Strategies to consider



Following your broad analysis of the economy, you will need to focus on the detail of what areas you want to make your investment in.

There are a number of ways to approach share investing and building an investment portfolio. Most important though is asset allocation, how you divide your money and where you chose to place your money.

Choosing appropriate asset allocation

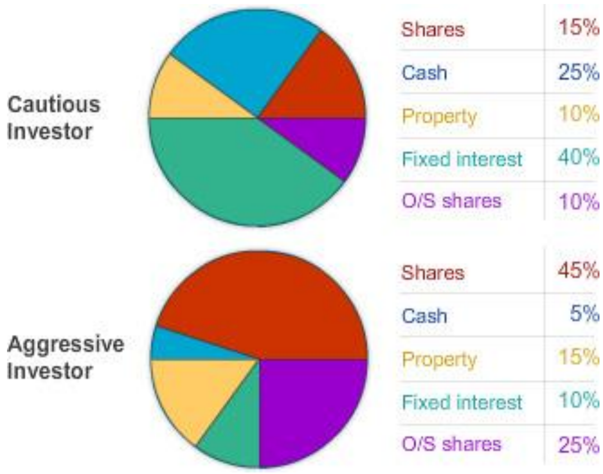


Once you have determined your risk profile, current financial position, your investment objectives, timeframe and your liquidity requirements, you need to work out what proportion of your total capital you should invest in shares, property, fixed interest and cash. This is called asset allocation.

Each sector should be weighted in accordance with economic conditions and investment prospects. This helps to reduce volatility and risk in your portfolio. Of equal importance is the need to achieve a balance between income and growth whilst minimising your taxation liability.

If your income requirement is high, you may consider investing in fixed interest, cash and listed property trusts. You may also consider reducing your exposure to the international share sector and increasing your exposure to the higher dividend-paying Australian shares, paying due regard to fully franked dividends (note that not all companies pay a fully franked dividend).

If you require growth rather than income, then a lesser emphasis may be given to fixed interest and property, in favour of achieving greater exposure from both Australian and international shares. For instance, a retired married couple with a portfolio of $600,000 may not be too concerned if their portfolio falls in value, providing they continue to receive an after-tax income of $45,000 p.a. without having to draw down (sell) assets to do so.



If, however, their portfolio contains several highly speculative investments which have not been successful, and they have lost assets as well as investment income, then there is a good chance the portfolio may be outside their risk parameters.

What do the professionals do?

The asset allocation practices of professional fund managers can often provide a useful investment guide. For example, when investing for a self-managed superannuation fund, investors may find it useful to follow a strategy similar to that used by large, pooled superannuation funds.

These large funds generally have a strong bias toward shares, particularly Australian shares. Firstly, their investment horizon is typically long term, therefore they weight their investments towards asset classes which perform better over time. Secondly, they usually have a significant amount of fixed-interest investments from which they can earn income and which they can trade to make capital profits.

What are the advantages of managed portfolio services?

They offer an alternative to managed funds, but maintain the advantages of direct investment by having a portfolio individually tailored to meet the investor's investment objectives. Trustees of private self-managed superannuation funds may also find the portfolio service useful.

Typically, an investment adviser would determine the investment objectives of his or her client together with the risk they are prepared to accept. From this information, a portfolio would be constructed from a select range of shares which are closely researched and monitored by the stockbroking firm concerned. To provide exposure to foreign markets, a balanced portfolio may also include foreign shares and/or fixed interest, or a combination of overseas focused managed funds.

Once established, the portfolio would be actively monitored and decisions to buy or sell individual holdings taken by the adviser according to directions given by the investor/client. The adviser's objective would be to achieve a return that exceeds that of the general market, thereby meeting the investment objectives of the investor. Note: caution should be exercised when giving any third party total discretion over your investment decisions.

General planning tips

- Never buy shares on tips or rumours alone. Try and understand the type of business the company is involved in before you invest.

- Remember, the higher the potential return, the greater the risk. Real rates of return (i.e. adjusted for tax and inflation) average around 4 per cent to 5 per cent per annum over the longer term (seven to ten years). Don't be misled by apparently impressive historical investment statistics: past performance is no indication of things to come.

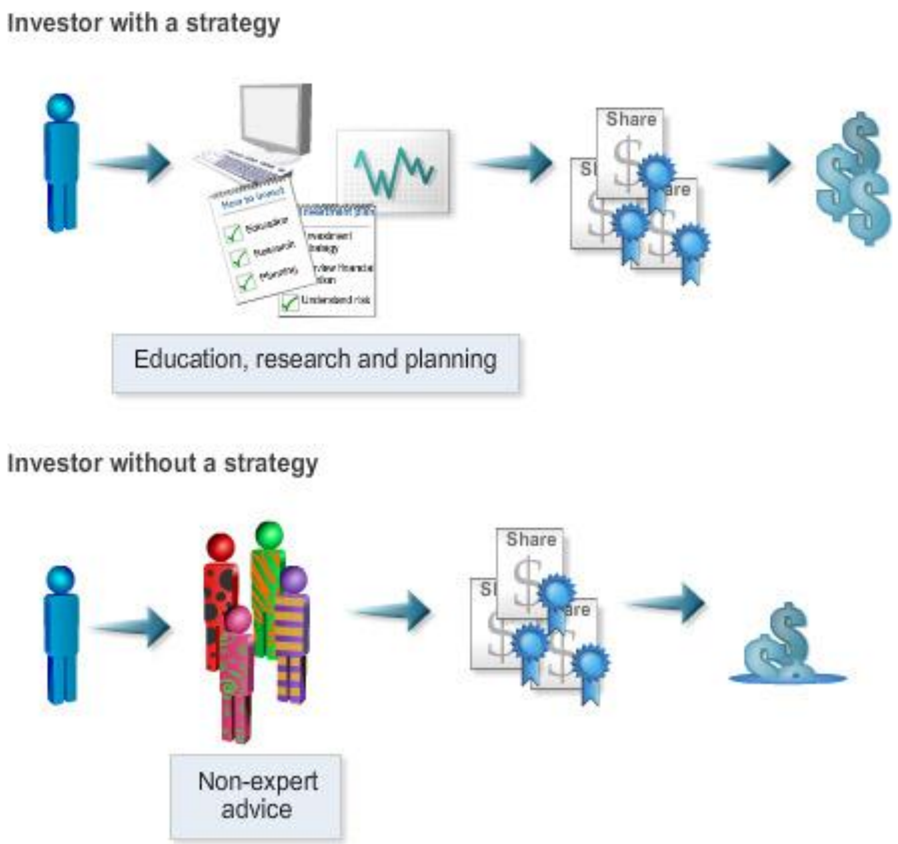
- Keep your portfolio manageable by concentrating on a relatively small number of quality investments. To do this, avoid acquiring lots of speculative stocks.

- Check the liquidity of each investment (how long it takes for your money to be returned if you decide to cash out).

- Understand all transaction costs, including early withdrawal penalties and tax implications.

- Always maintain an adequate cash reserve to cover unexpected expenditures, emergencies and new investment opportunities.

- To minimise risk and maximise growth, you should assess how much risk you are prepared to take and spread your investments across several investment types and different companies.



Topic 3: Direct vs. indirect investment

Direct vs. indirect investment

Investments in individual asset classes can be made either directly through the purchase of discrete assets, or indirectly through investments in managed funds. The managers of these funds invest your capital in one or a combination of the major asset classes.

Your investment goals, risk profile, experience and the amount you have to invest will influence whether it is better to invest directly or indirectly in fixed interest, property or shares. For example, you may choose to invest directly in Australian shares, while investing indirectly in international shares to achieve greater diversity. A balanced portfolio will often have a blend of direct and indirect investments.

Direct investments

When you make a direct investment, you are purchasing a specific share, property or fixed-interest product. For example, a direct investment in shares may involve purchasing shares in BHP Billiton, Coca-Cola Amatil Ltd, etc.

Why invest directly?

Direct investment gives the investor control over those assets and investments, including the making of decisions relating to those investments and their day-to-day management and administration. Accordingly, direct investment will suit those investors with the time and expertise required to manage their own affairs, either by themselves, or in conjunction with an adviser.

Direct share investments offer a number of advantages:

- Liquidity (quick conversion to cash)
- Daily valuation of your investment

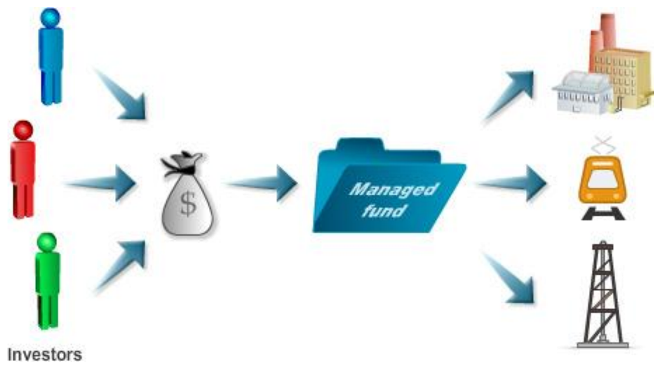
- Growth through new issues (e.g. bonus issues)
- Flexibility
- Safeguards/security – ASX and the Australian Securities and Investments Commission (ASIC)
- Free and open market
- Convenient and easily transferred ownership, and
- Usually no holding cost once purchased

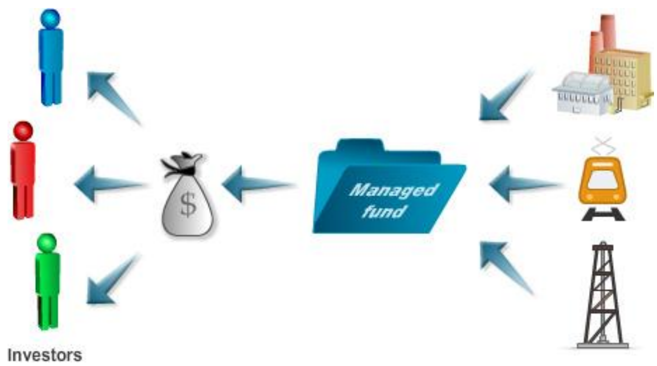
Indirect (managed) investments

Investments can also be made indirectly by buying units in a managed fund.

Typically, managed funds have the following features:

- Investors pool their money to purchase assets collectively
- Funds are invested, managed and administered by a promoter/manager
- Investors delegate the investment decisions and day-to-day management of their funds to the manager
- Investors collectively share in the risks associated with the investments of those funds.



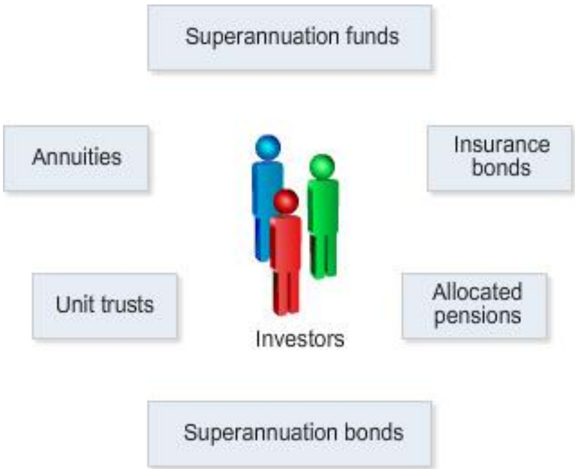


Most Australians are already indirect investors in the sharemarket thanks to the near universal membership of occupational superannuation and retirement funds, most of which invest a substantial proportion of their funds in shares.

Managed investments include unit trusts, insurance bonds, superannuation bonds, annuities and allocated pensions. Investors are able to purchase units in the fund and then rely on the manager's expertise to fulfil their needs, along with the needs of all the other investors in the fund.

Typically, the cost of a managed investment includes:

- Entry costs of 1 to 4 per cent of the investment amount, or
- Nil entry with withdrawal penalties
- Ongoing costs of 1.0 per cent to 2.5 per cent per annum



Other common characteristics include:

- May be broad based or sector specific, local or international focused with their investments
- May be diversified across asset classes and within an asset class
- The individuals within the management company may vary over time
- The fund size can range from one or two million dollars to several hundreds of millions of dollars, and
- They aim to provide income or growth, or a combination of both, with a moderate degree of volatility relative to the market concerned.

Listed managed investments

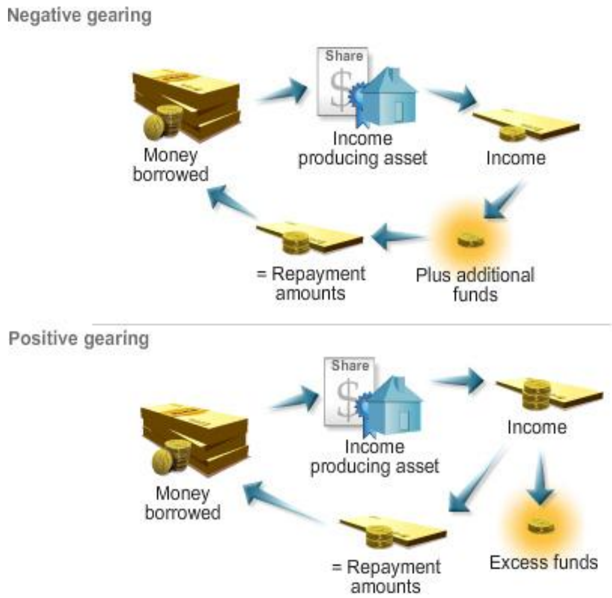
As the name implies, listed managed investments are managed equity trusts or companies quoted on the sharemarket. A number of features distinguish listed equity investments from their unlisted counterparts:

- Listed managed investments are typically company structures, therefore they have the ability to retain earnings and grow shareholders' wealth over time.
- Listed managed investments have the advantage of being tradable like ordinary shares while unlisted alternatives require you to make a redemption request through the manager.
- Listed managed investments are subject to market forces and can trade above or below their asset backing, whereas unlisted funds are usually purchased and redeemed at their net tangible asset backing.

Topic 4: Gearing and Margin Lending

Types of gearing

The term gearing refers to borrowing. When investors borrow, they are able to increase the amount of money they can invest, and with it their potential investment returns.



Negative gearing - occurs when money is borrowed to invest in an income producing asset and the income received from that asset is not sufficient to cover the interest payment on the monies borrowed. That is, the income is less than the interest expense. In some circumstances, the interest paid on borrowed funds is tax deductible.

Neutral gearing - occurs when money is borrowed to invest in an income producing asset and the income received from that asset approximates the interest payment on the monies borrowed. In other words, the investment becomes self-funding.

Positive gearing - usually occurs when money is borrowed to invest in an income producing asset and the income received from that asset exceeds the interest payment on the monies borrowed. Such investments are income positive.

Risk

When you gear or borrow, you increase the potential risk. As an investor, you should not gear unless you:

- Understand the risk of your investment
- Are prepared to accept the risk, and
- Have the financial resources to meet the risk.

You must always look at the worst case scenario and assess your ability to handle this situation if it occurs. If you borrow you will be required at all times to:

- Meet the loan repayment obligation, and
- Maintain the loan within the agreed lending margin.

Where these requirements are breached, you may have to offer more security to the lender or reduce the loan to meet the agreed lending margin. Remember, negative gearing means you have a loss and a negative cashflow. In order to meet your obligation, you may need to draw funds from other sources. Always consider your other sources of funds when you consider a negative gearing situation. You will generally require secure regular income to meet the interest on the borrowing.

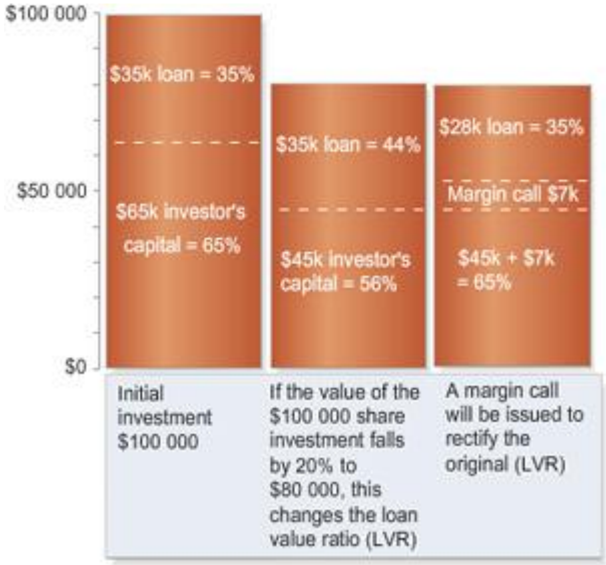
Margin lending

Margin lending is the term used for borrowing money from a broking firm or a bank to buy shares and using those shares as collateral for the loan. Investors use margin lending to buy more shares than they would otherwise be able to.

Loan to value ratio (LVR)

LVR - the proportion of the total investment a lender is prepared to advance for an investment in the sharemarket varies. The average value is about 35%. This means you may need to contribute 65% in ready cash or shares already in your possession prior to borrowing the money. This ratio needs to be maintained throughout the life of the loan. This means that if the value of the shares you have put up as collateral falls, then you may need to contribute additional cash to maintain the original 35:65 ratio of loan amount to collateral.

Margin calls



Lenders calculate lending margins for certain shares on ASX. Each lender has the right to alter this margin if it changes its assessment of the company's prospects and share price. Most lenders allow the margin to fluctuate adversely by up to 5 per cent before requesting the investor to provide more security (a margin call). Note that not all shares are eligible as collateral. Different shares can be given different weightings when calculating their applicability as collateral for the margin loan.

There are three ways a margin call can be met:

- A deposit of further shares (to increase the portfolio) to be held as security for the loan (mortgage), and/or
- Cash to be paid to reduce the loan, and/or
- Sale of part of the portfolio to reduce the loan.

Borrowers usually have twenty-four hours to meet a margin call. Loans are generally payable on demand, and failure to meet a margin call may constitute a loan default, in which case the amount owed becomes repayable immediately. Following a loan default on a margin call, the lender can sell the underlying shares without notifying the borrower.

Things to consider before using gearing:

- Understand the effect of all fees such as establishment costs, and ongoing charges by lending institutions including early repayment penalties.
- Use investments which produce regular income with some tax benefits.
- Don't borrow more than you can afford to service, and always build in a safety margin.
- Seek professional advice on the right strategy to employ: the choice of investments is critical.
- Consider investment returns that are reasonably viable, particularly in a relatively low-inflation climate.
- Consider the investment program as long term (seven to ten years).
- Select conservative equities and avoid using internally geared investments which increase your risks.
- Ensure you continue to receive ongoing salary and interest income.
- Income protection insurance may be considered.

Topic 5: When to sell

Many investors find deciding when to sell their shares more difficult than deciding what to buy in the first place. In particular, ASX research has found there is a tendency for inexperienced investors to 'buy and hold' without knowing why.

When thinking about a time to sell some factors to consider are outlined below.

- **The shares no longer suit your investment goals** - This might happen because your goals have changed (as they will over time) or the company you invested in has changed its direction (for example, its dividend policy).
- **You need to rebalance your portfolio** - Perhaps because one of your shares represents an overly large exposure in your portfolio. Could you rebalance your portfolio by buying some other shares rather than selling the ones you have? First consider your overall investment portfolio allocations.

You need the cash - Consider the cost of brokerage, the tax implications and the current market price when selling a parcel of shares.

Reinvestment opportunities - Before jumping into 'a better investment opportunity', think about how it fits with the rest of your portfolio and investment strategy.

Tax implications - For example, can you use capital losses to offset the CGT liability on other capital gains? How would that affect the CGT discount? Consult an expert before making a decision on the basis of your tax situation.

Share prices usually recover after a downturn - What was your original investment time frame? Has anything changed about the company's prospects for the future?

Summary

- The broad economic context that an investment is being made in is important.

- When professionals build an investment portfolio they pay careful attention to the concept of asset allocation. This is the practice of spreading your investments across different areas to match your risk and reward profile.

- It is possible to make your investment decisions yourself, you can also use the services of a professional or a combination of both approaches. Consider your knowledge, goals and ability to monitor and maintain your investments.

- Before considering more complex gearing strategies be sure to understand the risks they will involve.