



## Titanium Asset Management Ltd

(TAM) is an investment manager registered with ASIC (AFSL 331088). TAM is also the Responsible Entity of the TAM ASX200 All-Weather Fund (The Fund). TAM considers the Fund unique in a number of key areas:

1. It is a 'true' market-neutral fund (with matched long and short portfolios) in the sense that TAM does not allow the Fund to take significant market positions that can represent substantial risk in volatile markets. This is in contrast to many similar funds that allow the taking of such positions;
2. The Fund employs a unique stock valuation and selection process that has been developed over 20 years which has been shown to be highly effective in the consistent selection of both "long" and "short" portfolios that has outperformed the market regardless of market conditions.
3. The Fund only invests in current constituents of the ASX200; the 200 largest and most extensively researched stocks listed on the Australian Stock Exchange (ASX). No other assets are invested in by the Fund (including derivatives of any form), and the Fund does not borrow cash to invest.

TAM's methodology has generally proven to achieve consistent returns in the most difficult of market conditions, with minimum market risk. The market-neutral fund strategy used has been used in the Australian market for over a decade, but the ability to achieve sufficient consistency in stock portfolio selection to achieve acceptable returns has been missing. This is where the investment process is critical to the performance of the Fund.

## Fund Report Headlines

- A new year has bought a small burst of optimism to equity markets, even though there has been little fundamental news to justify that optimism yet. The Australian market has risen by 2.2% since our last report, and both the US and UK markets are up.
- While that is somewhat encouraging, the lack of fundamentals to support such a move creates more concern than joy at this stage. S&P has poured cold water on markets with downgrades for most of the Eurozone despite the optimism of bourses.
- We underperformed on both the long and short sides, but that is likely to be reversed in the next fortnight.

## Economic Report Headlines

- The S&P downgrades for 9 of the 17 Eurozone countries is a weak start to the New Year along with Greece's continued issues with its banks, and is likely to reverse the short rally that we have seen so far.
- The US is showing some economic life, but not enough to offset Europe's impact on global growth.
- The ASX200 has produced negative returns and underperformed the US in each of the past two years, but is still not cheap on our measures. Risk is now almost as high as at the peak of the GFC, and EPS growth is poor.

*Investments can go up and down. Past performance is not necessarily indicative of future performance. Past distribution figures are not intended to be a forecast of future performance.*

### Performance History: % based on net investment asset values (NAV, monthly)

Class A: Retail \* MTD return.

Month	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2011	-2.66%	-4.29%	0.57%	1.02%	-3.34%	6.79%	-5.06%	5.21%	13.85%	-10.60%	-2.52%	2.41%
2010	0.82%	-2.06%	1.08%	-1.64%	1.59%	5.61%	1.02%	4.55%	2.53%	-0.49%	0.65%	-6.20%
2009		-7.32%	-13.32%	2.32%	7.68%	7.78%	0.81%	2.81%	5.76%	-6.59%	-4.51%	-2.47%

## Comparative Performance

31st December 2011

Source: TAM, RBA, IRESS

■ TAM - All Weather Fund ■ RBA Cash Rate ■ ASX200





## Fund Report

20th December to 12<sup>th</sup> January 2012

### Portfolio Characteristics

	PER	Yield	F'cast EPG	Payout Ratio	TAM Beta	Mkt Cap \$M
Long	7.7	6.0%	7.0%	44.7%	1.19	\$ 19,477
Short	7.2	1.3%	5.0%	23.6%	1.27	\$ 2,167

Investor spirits rose with the season and into the early weeks of the New Year amid hopes of a better 2012. Does this sound familiar? You may recall that the outlook for markets was even rosier in March 2011 before the collapse in world markets on the back of Euro debt problems, a Japanese earthquake and social unrest across North Africa.

In the 9 months to December 2011, the ASX200 fell 16% with only 2 sectors (telecommunications and utilities) providing a positive return. In the same period, the All Weather Fund returned 6.2% while the RBA cash returned 3.6%.

With the Euro debt problem unresolved, the risks in equity market investment outweighs the potential upside. This is explored further in the Economic commentary. Markets will of course be subject to animal spirits with bouts of enthusiasm then despair – but this is not helpful when constructing an investment portfolio. In this environment, a market neutral fund such as the AWF provides access to equity like returns without the most significant risk – that of the market itself.

In the very short term, the AWF portfolio was weaker due mainly to the rebound in the small material companies – most reporting losses and with little immediate prospect of earnings. The Fund fell 2.4% in contrast to a rise of 2.2% in the ASX200. We expect to recover this under-performance in the weeks ahead.

We had success with many of the stocks in the long portfolio as shown below:

Monadelphous	7.3%
Westfield Group	6.6%
Boral	6.4%
QR National	5.5%
Mirvac	4.6%
Stockland	4.0%

Rebounds in small company materials and energy stocks detracted from performance in the short portfolio. However, we still found some over-valued stocks to benefit the Fund as follows:

Mesoblast	-10.4%
Primary Health Care	-8.6%
Treasury Wine	-2.7%
Alacer Gold	-1.6%
Mineral Deposits	-0.2%

## Economic Report

### Is the Aussie Market Cheap after a poor 2011? Given Europe, it is hard to argue “Yes”.

After a poor 2011 in which the ASX200 fell by 14.5%, the big question facing investors is whether or not the Australian market is now cheap, and therefore worth buying?

Unfortunately, this is not an easy question to answer, despite what many will try and suggest.

As readers of this report over the past year-or-so will understand, the global situation is a major starting point, with the US and Europe being the biggest influences. In 2011, though, the influence of the US on our market has been less than consistent, with the S&P500 being flat, and therefore outperforming our market by 14.5% for the year, despite the fact that our economy has performed substantially better than the US over that period. In 2010, that outperformance was 15.4%: again, our economy did better than the US at that time.

So, it is not all about pure economics, but it is a substantial influence. But to what degree?

Let's talk about what we do know.

**Firstly, Europe is now the biggest single-currency trading block in the world**, and therefore has a major influence on other trading-based nations such as China (and much of the developing world) as we have discussed in recent reports.

**Secondly, it will also have a major influence on currency, bond and commodity markets**, depending on how it performs economically.

**Thirdly, given Eurozone sovereign debt that is €3.2trillion in excess of mandated maximum levels, there is a need to cut government spending dramatically. That is likely to see the region go into recession for the rest of the decade** (see *IR 21/12/2011*).

**Fourthly, the US is struggling to compensate for these negative influences in terms of global economic growth** due to their own government debt ceiling, political gridlock, high unemployment and a heavily-depressed property market.

**The biggest single factor for the Australian market is that we are more dependent upon global influences than the US market** due to the huge exposure to the Finance and Resources sectors (the ASX200 has almost **60% of its market cap in Basic Materials, Oil and Gas, and Banks and Finance**), as well as our level of trade relative to GDP.

Europe remains the biggest single overhang for global markets. Friday's move by S&P to downgrade the credit rating on 9 of the 17 Eurozone countries highlights the difficulties associated with the crisis. Given that we have had concerted efforts by the trading block to address the bond market's issues with the region over the past few months, the move suggests an independent rejection of those efforts to solve the problems involved. At the same time, discussions between Greece and its



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creditors failed to reach agreement on a

forward move in what should be one of the smaller issues in addressing the problems.

Imagine the mess if Italy ends up in a similar position, which is looking more-and-more likely!!

The simple fact is that, despite the hope of financial markets, **there are no easy (or even palatable) solutions. A reduction of sovereign debt to acceptable levels will result in long-term recession across the region, which will have a substantial negative impact on global growth rates**, as well as creating significant political turmoil and unrest in that market. **That means poor market returns on a global basis.**

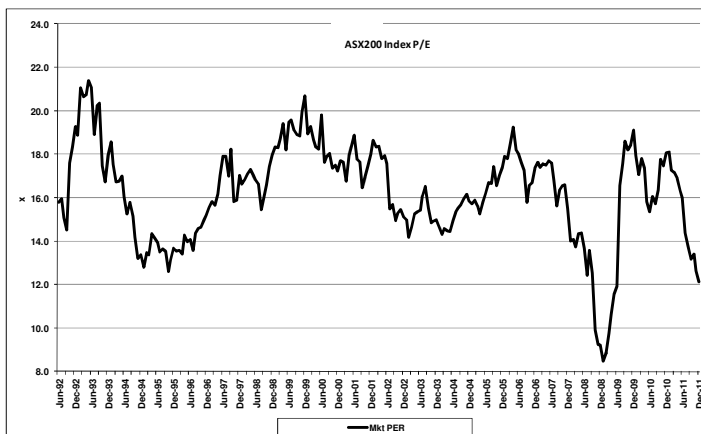
**If there is no forced long-term recession, sovereign debt can't be repaid, which means a possible collapse of the Euro and a new global banking crisis and a collapse in developing-world growth** (especially China) as well as that of Europe.

Unfortunately, the options aren't pretty, but soon Europe is going to have to choose one option and try and manage the negative outcomes, which will produce substantial headwinds for our market for the foreseeable future.

Given that, are there opportunities in the Australian equity market?

Of course there will be, but finding them consistently will not be easy, and having a deeper understanding of how the market works will be critical for quite some time.

The Australian market has now produced two consecutive years of negative returns (although 2010 was small); a fact that has started the market in a more optimistic mood than we saw over most of the last half of 2011. And rightly, the current ASX200 P/E of 12.2x 2012 earnings is relatively low (See Chart below).



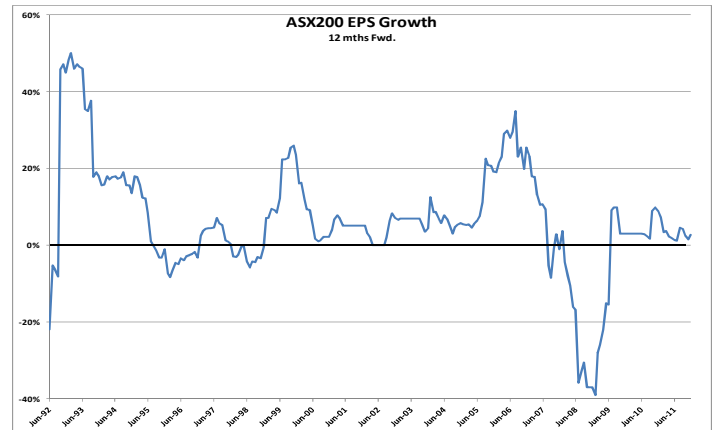
But a low price itself does not make the market cheap; there are a few things to consider.....

Stocks are financial assets: therefore, "cheap" or "expensive" **only** has meaning relative to expected returns and risk-a simple thing to say, but difficult to quantify systematically.

So, does the Australian market look cheap if we view it from that angle? Let's look firstly at earnings growth rates....

By looking at both the following chart, and the one above, it is not difficult to see that there is generally a significant relationship between expected future EPS growth and market

P/E rating, although the relationships are more complex than they may first appear. However, this is where the "Aussie market is cheap" argument hits its first hurdle.



We know from our numbers 12 months ago that the market was looking for EPS growth in the mid-teens after the poor results in the post-GFC aftermath. However, as the chart above shows, those results were not achieved, and we are still looking at forecast EPS growth barely positive.

Consensus data for the current financial year (to June 2012) shows expectations of virtually no growth again.

As a result, the Australian market has gone from a P/E based on EPS growth of around 15% 12 months ago, to a current P/E now based on virtually no growth.

And that is primarily why the Index has performed poorly over the past 12 months.

The main reason for the optimism in the market rating in late '09 and the first half of '10 was the continued strength in commodity prices and the high exposure of our market to commodity-related stocks.

Unfortunately, however, that exposure has not translated into reported earnings growth, and therefore continued returns. A relatively large percentage of our listed resources sector is still a long way from producing earned profits, and as a result, our market becomes highly susceptible to hope and wishful thinking, which is heavily influenced by perceived investment risk (which we will discuss below). Of the 65 stocks in the ASX200 classified as Resources based (Basic Materials and/or Oil and Gas), 25 are expected to make losses this year (based on current Bloomberg consensus earnings forecasts), while a further 15 are trading on P/E multiples in excess of 20x current year EPS forecasts.

Based on consensus estimates, growth forecasts are not significantly greater a further 12 months out, with average 2 year EPS growth for the Basic Materials sector being a mere 8%, and only 4% for the Oil and Gas sector. At the same time, the average dividend payout ratio for the sector(s) is half that of the overall Index (the relevance of which is discussed further below).

With the Finance sector also struggling to produce positive earnings growth over the next two years (3% compound

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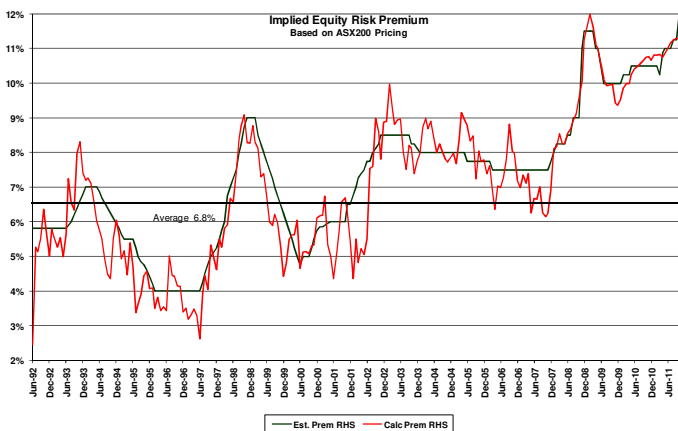
growth), it is not a surprise as to why our market has suffered despite good overall economic results. On the more positive side, consensus numbers for FY12/13 are again reasonably optimistic, but are they realistic? Mid-teen

growth is again forecast, but given recent results, it has obviously been difficult for the market to place much faith in those estimates. Not only that, if our prognosis for Europe is anything close to correct, then achieving EPS growth of that level will be increasingly difficult to achieve.

This raises the issue of the perceived risk associated with the market, and the impact that it has on Index pricing. Our exposure to external global forces as a result of our heavy weighting in Resources and Finance means that the ASX200 is potentially more sensitive to forces substantially outside of our control than is the case in the US and even Europe. More than 70% of the US economy is domestic-expenditure driven, and a similar percentage of earnings for the S&P500 are effectively domestically sourced. As such, risk is assessed relative to perceived domestic economic issues.

With our market, that is not the case, and the perceived risk associated with investment in our market is far more driven by the perception of international issues.

One of the key factors in our work is to quantify the equity risk premium (ERP) implied by the pricing of the ASX200. The chart below shows those estimates.



What this shows is that the ERP has been steadily rising for the Australian market since the GFC to the point where it is now as great as it was at the height of that period. The higher the perceived risk, the lower the valuation, all other things being equal, which makes the low P/E look less relevant, **unless the market is proved to be too pessimistic.**

That is a difficult thing to argue in the current environment.

If the estimated risk premium is anything like valid, it creates a major concern for us, but highlights just how dramatically the Eurozone problems are impacting us as a result of our exposure to global issues (relative to the US), and the influence that Europe is having on that outlook.

However, what it does suggest is that if-and-when Europe sorts itself out, the Australian market is likely to be a major beneficiary as a result of our ERP falling back sharply and

valuations rising. Unfortunately, until that happens (and we see it remaining a major issue for a long time), our market is likely to struggle on an overall basis.

On a less-daunting issue, it is interesting looking at our market on a sectoral basis in trying to identify value. Below is a table of the major sectors of the ASX200, and some key value dynamics associated with the TAM valuation process.

	Std Weight	W'ghted 2YR EPS Growth	W'ghted P/E	W'ghted POR
	%	%	X	%
Basic Materials	33.1%	8%	10.6	22.7%
Consumer Goods	1.2%	32%	12.5	63.4%
Consumer Services	12.2%	15%	14.8	56.9%
Financials Ex Property & Ins.	21.1%	3%	10.4	72.1%
Insurance	3.0%	22%	13.0	88.1%
Property	5.4%	1%	11.4	67.6%
Healthcare	2.9%	13%	18.0	54.1%
Industrials	6.2%	51%	20.4	98.0%
Oil & Gas	4.6%	4%	23.2	63.1%
Technology	0.5%	11%	14.9	62.1%
Telecomms.	6.4%	-5%	12.9	87.1%
Utilities	3.5%	33%	20.8	83.0%
<b>Total</b>	<b>100.0%</b>	<b>4%</b>	<b>12.2</b>	<b>56.4%</b>

A key part of the valuation methodology that differs considerably from convention is the identification of dividends and the dividend payout ratio as key factors in market pricing. Work over the past 20 years has shown that the dividend payout ratio, and changes in that ratio, has a much greater impact on the pricing of listed stocks than corporate valuations consider across a variety of major stock markets.

In most markets, payout ratios at the Index level generally stay relatively stable meaning that identifying the influence of changes in that ratio has been limited, and as such, underappreciated.

However, by looking at the market on a sectoral basis, the impact of different payout ratios on different pricing levels becomes more obvious.

From the data above, it is clear that the Basic Materials sector has the lowest payout ratio in our market by some way, and also has close to the lowest P/E: particularly, given modest EPS growth expectations. Industrials have one of the highest P/E's, with the highest payout ratio, but also the highest EPS growth expectations.

If we compare the Utilities and Consumer Goods sectors, both have similar EPS growth forecasts, but the Utilities have a significantly higher payout ratio (83% v 63.4%) and a significantly higher P/E rating (20.8x versus 12.5x). Risk is lower for Utilities, which contributes to the higher rating, but so does the higher payout ratio, according to our analysis.

Clearly, the pricing of stocks is considerably more complex than simply looking at one dynamic or another, but our long term analysis does suggest that dividend payout ratios do have a considerable influence on market pricing, and therefore share price performance. This is in contrast with the principle of "Dividend Irrelevance" as proposed by Modigliani and Miller in

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the 1960's, and justifies the importance  
of dividend payments to investors generally.

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Company: Titanium Asset Management Limited

Author: Peter Rice (CIO)

Email: [enquires@titaniumassetmanagement.com.au](mailto:enquires@titaniumassetmanagement.com.au)

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*Profile 16th January, 2012*

**TITANIUM**  
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Postal Address:

P.O. Box 1110

Ph: 1300 785 276

Camden, NSW, 2567

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