GROVE
research & advisory
THE SECURE INVESTMENT SPECIALISTS

15 February 2008

Cate Trivers
PO Box 20
WYONG NSW 2259

Dear Cate

Portfolio Review December 2007

Please find enclosed your portfolio report and market commentary for the period to December 2007.

The problems in credit markets triggered by the US sub prime mortgage debacle, and the unforeseeable extent to which the fallout has affected even unrelated assets, have made the period under review one of the most tumultuous in living memory.

The attached document sets out the issues in summary form and quantifies the impact on your portfolio. We also provide our views on the future and analyse how your portfolio would fare under different assumptions for credit markets in the second half of the financial year. This analysis also considers the question of how an allocation to term deposits would affect the outcome. The results may surprise you.

We also attach recommendations for your portfolio. This advice is based on Grove's outlook for the market / individual products. We welcome discussion on these recommendations.

For those that would like a more detailed explanation of the factors that have driven market performance, and how those factors translate into different product types, Grove's research department have prepared a detailed and insightful analysis of various market sectors, as attachments at the back of your report.

Finally, we would like to reflect on the importance of clear sighted analysis and strategy when investing. In doing so, we provide 2 pertinent quotes from renowned investor Warren Buffet:

- "Only when the tide goes out do you discover who's been swimming naked."
- "Look at market fluctuations as your friend rather than your enemy; profit from the folly rather than participate in it."

For us, the first quote reinforces the importance of investing based on fundamental merit of an investment with appropriate regard to risk. Good investments generally recover from adversity whilst poor investments can wallow indefinitely or collapse. Whilst we share our clients' concern whenever any assets underperform, we also believe that our clients hold quality investments for the right reasons. This contrasts markedly with investors who have taken conflicted and inferior advice, or in some cases no advice at all, many of whom are now facing severe impairments, defaults and illiquidity.

The second quote can be seen as a warning against excessive emotion when investing. The times of greatest disappointment with investment markets are often the times when greatest value is to be had. Now is such a time. Grove's clients are generally cautious with many stakeholders to consider. Our clients are not speculators and generally not even opportunists. Whilst this is understood, out counsel to investors is firstly to not be panicked into discarding embedded value in *existing* quality investments, and secondly to be open to sensible opportunities for which a good case can be made.

We cannot be sure about when market recovery will come, but we do know that it inevitably will and that disciplined investors will benefit.

We look forward to assisting you and welcome any questions you may have following your review of this document.

Yours sincerely

AVallner

Brett Sanders　　　　Andrew Vallner

Chief Executive Officer　　　　Head of Research

cc:　Stephen Goldborough

　　Hannah Sorensen

Wyong Shire Council

Portfolio Review

As at 31 December 2007

Prepared by

GROVE research & advisory

Confidential

GROVE
research & advisory
THE SECURE INVESTMENT SPECIALISTS

MARKET OVERVIEW

DECEMBER 2007

Economic Overview

The economic outlook for Australian investors is influenced by differing domestic and international factors. Australia has benefited enormously from demand for our resources from emerging economies and more established trading partners such as Japan. Unemployment remains very low at 4.3%, retail sales are up 8.1% on a year ago and the RBA's preferred measure of inflation has risen to a year on year rate of 3.6% - a figure that has set off alarm bells. The central bank's attention is now to slowing the economy and containing inflation. Interest rates rose 3 times in the period 1 January 2007 to 12 February 2008, and the official cash rate now sits at 7.00 per cent. The newly elected federal Labor government has indicated that it intends to try and reduce spending initiatives to also help slow the economy. The promised tax cuts were affirmed on February 8, but future fiscal initiatives will be directed to building surpluses and cutting spending. Any spending initiatives are likely to be directed to the areas the incoming government sees as crucial supply-side initiatives: Infrastructure and education.

Offshore the US Federal Reserve (the US equivalent to our Reserve Bank) is trying to stimulate the world's biggest economy through aggressive interest rate cuts, while improving credit market function by injecting massive amounts of liquidity. The US economy slowed to a modest +0.6% annualised growth in Q4, and employment rose to 4.9% from 4.6% at mid-year. Problems in the US construction and mortgage markets have threatened to extend further into the broader economy through a fall in consumer spending and reduced availability of credit to households and businesses. Rates have been slashed from 5.25% to 3% since mid-year, with an unprecedented 1.25% of that coming in January alone. The US Federal Reserve has been "late to the party," having maintained a "hawkish" stance on inflation until late November – deteriorating credit conditions, softening employment and plunging sharemarkets shocked them into single-minded action to defend economic growth.

The US is widely expected to suffer a mild recession or "soft landing." However, given such massive monetary stimulus and strong trading partners (particularly rapidly growing Asia), a rapid recovery would not surprise.

Other offshore economies present a mixed picture as follows:

Europe: Enters 2008 in a precarious situation, with inflation remaining stubbornly high but growth clearly decelerating. The IMF cut its 2008 growth forecast for the region to +1.6%, from +2.1%. On waning growth, the Bank of England cut its benchmark rate to 5.5% in December – the first reduction since August 2005 – while speculation mounts that the European Central Bank will be forced to follow suit.

Japan: Remains fragile with weak growth recorded in the third-quarter on rising energy costs and weaker demand from emerging economies. Corporate profits fell for the first time in five years. Market commentators expect a 50% probability of a Japanese recession in 2008. Bank of Japan remains mildly optimistic anticipating growth of +1% in 2008, down from an earlier projection of +1.2%.

China: After a turbo charged +11.5% growth rate in 2007 (the fastest pace in 13 years), growth is expected to be pared back after the 2008 Olympics. Government attempts to clamp down on excessive growth - including 1.5% of interest rate increases, restrictions on credit, price freezes and currency adjustments – have been tokenistic to date. However, declining growth in key export markets (US, Europe and Japan) will require China to conform to a slower growth world. Given the government's concern about commodity prices and domestic inflation, this may be a welcome development for them.

Other: The rest of the "BRIC" economies - Brazil, Russia and India – are also industrialising rapidly, with Brazil and Russia having the advantage of being major commodity exporters. Africa is trying to become a major commodity producer and exporter, in many cases with China's assistance. Their success in building reliable infrastructure and production will be a significant determinant of commodity prices, which influence Australia's export prices, and conversely global inflation pressures.

Investment Market Summary

A range of markets and products are discussed. Not all of these will be directly investible or applicable for all clients, depending on their specific regulation and Policy.

A summary of returns are listed below (3 and 6 month returns are **not** annualised):

Index	3 months	6 months	1 Year	3 Years (% p.a.)	5 Years (% p.a.)
Australian Shares (S&P/ASX 300 Accum.)	-2.67%	+2.90%	+16.22%	+21.01%	+21.11%
International Shares $US (MSCI World ex-Aust gross)	-2.74%	-0.85%	+7.09%	+12.39%	+14.93%
International Shares $A (MSCI World ex-Aust gross)	-2.44%	-3.92%	-3.77%	+2.91%	+5.15%
Australian Listed Property (S&P/ASX200 Property Accum.)	-13.10%	-8.30%	-8.41%	+11.36%	+14.68%
Australian Fixed Interest (UBS Aust All Mat. Composite)	+0.25%	+1.74%	+3.46%	+4.13%	+4.47%
Cash (UBS Aust Bank Bill Index)	+1.74%	+3.41%	+6.73%	+6.16%	+5.80%
Australian Dollar (*vs* $US)	-0.31%	+3.20%	+11.29%	+3.92%	+9.30%

Cash and Credit

The value of all credit investments such as bank debt, corporate debt and mortgage securities has fallen significantly in the past 7 months. Pricing is reflected in "credit spreads", which are the interest margin that borrowers must pay above a "risk free rate" such as the bank bill index. When the market perceives risks are low and money is freely available, such as 12 months ago, spreads are also low. When the market is more concerned about counterparty risk and defaults, and credit availability is rationed by banks, spreads are higher. Effectively the component of the interest rate charged to compensate for risk goes up.

Credit spreads for many classes of debt are now at record levels – a highly unusual state of affairs given the absence of an official recession in any major economy and generally sound company fundamentals of earnings and balance sheets which had been rebuilt after the merger mania of the 2000 "tech bubble."

The rise in credit spreads has been driven by a severe deterioration of liquidity in global credit markets, which in turn was triggered by the much publicised problems in the US construction and mortgage markets. Banks around the world are the primary traders in interest rate markets, both fixed and floating. They also issue their own debt securities to support their business activities. What has happened to markets is that banks have become more cautious about accepting counterparty exposure to borrowers and other banks, whether that results from settlement risk attached to trading with them or longer term credit risk from holding their securities. This caution arises from fears that the counterparty may have undisclosed exposure to US sub prime investments in sufficient quantity to fundamentally change the risk profile of the counterparty. Whilst billions of dollars in sub prime assets have been written off the world over, there remains potential for significant further write downs prompted by the following:

- to market rather than "modelled" value, based on the trading prices of sub-prime mortgages (as opposed to the losses expected by rating agencies and economists, which are less severe)
- where banks have "insured" exposures with bond insurers that subsequently get severely downgraded, requiring another round of provisions
- wider contagion – for example, loan losses in credit cards and auto loans (no longer refinanced into home equity loans), prime mortgages (also subject to the same employment and property price sensitivities, to a lesser degree)

Whilst this fear has severely affected the balance between supply and demand in credit markets, it is important to note that this is quite different from markets repricing because of deeper fundamental concerns around credit conditions, such as would occur in the event of a severe recession like 2002. Whilst the US economy is widely anticipated to be heading for mild recession and world growth is slowing, credit conditions outside of the US housing market and related sectors are considered to be sufficiently robust that domestic credit defaults should not significantly exceed historical averages.

Certainly, the price of many credits directly exposed to the US housing market has deteriorated due to fundamental issues. Equally, Australian banks remain extremely strong and profitable, and their senior debt credit spreads have also widened by a factor of 10 with almost no exposure to the US housing cycle – likewise Australian mortgages have traded very poorly. Therefore, a lot of the selling of credit assets has been independent of credit quality or proximity to the US housing market.

This in turn means that when sub prime induced fears, and attendant impacts such as the current problems with monoline insurers are resolved, that credit markets should return to less extreme pricing levels. We do not believe that credit spreads will return to anything like the levels of 12 months ago. Rather we would expect some modest retracement in capital valuations and that the market will then settle at higher spreads than those of 2006 and early 2007. This will mean that credit investments will pay income comfortably above bank bill with much less volatility than seen in recent months.

Recommendations

Grove cannot be sure how long it will take for liquidity conditions in markets to normalise. We think it highly likely though that volatility will continue for months yet. This does not imply months of constant underperformance though – markets will likely swing in both directions as good and bad news is released. We also think it likely that on a 6 and 12 month view that credit rated funds will outperform bank bills.

- Investors should seek to minimise trading activity on AA and A rated funds to reduce the impact of market trading costs on their performance;
- Funds holding quality investment grade debt, particularly with domestic financial institutions, represent very good value and should be held where the managers have been adding value relative to a falling market, circumstances allowing;
- Senior and subordinated debt of leading Australian banks provides an attractive alternative to term deposits. Matching investment term with your investment horizon with the funds employed is important, and commitments always need to adhere to policy limits. However, very high yields are available on bank debt with terms as short as 14 months which should be compatible with most investment horizons;

- AAA funds have shown consistent performance characteristics and carry little credit market exposure – they offer a useful home for at-call money.

Please see Attachment A for a more detailed discussion of credit markets for the 6 months to December 2007.

Australian Shares

The recent January lows marked a fall of more than 20% from the peak – an official "bear market." However, by the time investors were reading it in the papers, the US Fed had already cut rates aggressively in their January emergency meeting and the futures market was already indicating a gain of more than 200 points. The "bear market" therefore lasted less than 12 hours!

There seems no reason economically that growth cannot continue at a modest rate in line with long-term returns (as opposed to the spectacular returns of the last 4 years). Global growth has been as synchronised throughout the world as most commentators can remember. China, and hence much of Australia, is booming, the EU and Japan are growing and even the laggard US continues to report positive economic growth. Expectations of a mild US slowdown have alarmed markets, but now appear to have been priced in at the cheap earnings multiples that now apply.

The biggest barrier is sentiment. The poor lending practices in a property boom that led to the losses in US sub-prime mortgages may well have been replicated amongst borrowers with good histories. Spill-over losses, and generalised fear about where losses could be discovered next, have led to periodic desertion of risky assets. These have typically been followed by extraordinarily strong recoveries from oversold levels, usually prompted by central bank actions.

Our cautious view is that the correction results in a combination of good value in stocks AND a strong global economic environment with relatively low inflation and borrowing costs - this should sound like a buying opportunity. However, it is difficult to imagine a strong uptrend until credit conditions resolve themselves. While the difficult credit conditions persist, there is a constant threat hanging over the equity market:

- That some companies will produce the wrong kind of headlines by being unable to manage their balance sheets, following RAMS and Centro;
- The higher credit costs, and in Australia rising interest rates, will flow through to aggregate corporate earnings – at a time when the more economically sensitive companies are already producing occasional earnings disappointments.

Quite apart from slowing US economic growth, credit conditions are also placing other strains on the sharemarket:

- Companies are being more careful in their balance sheet management, minimising debt at the expense of stock buy-backs;
- Leveraged buyout activity (the dominant driver of stock prices through much of 2006-07) has slowed to a crawl due to the near impossibility of obtaining LBO debt at viable prices;
- Slowing global economic growth as the sub-prime crisis bites into the real economy would inevitably weigh on commodity prices and hence resource earnings.

Increased corporate merger activity replacing private equity buying would provide support for the view that the market is cheap at these levels. The mega-takeover bid by BHP Billiton for Rio Tinto confirms that debt is available, but lenders are more likely to favour the largest and strongest than a buyout fund. Corporate activity is therefore likely to be directed at mergers and consolidation.

Recommendations

It is unambiguously getting more difficult for share prices now than it was earlier in the year. However, the corporate sector overall has continued to produce strong earnings – the resource sector the major beneficiary of strong export conditions.

Investors will be looking to the completion of the current "earnings season." At this stage, Citigroup is forecasting a year-on-year growth for 2007-08 of +8.4%, in which case the case for ongoing share price growth would be well and truly intact. A broad-based disappointment would make it very difficult for shares to outperform cash, as earnings multiples are unlikely to expand in an earnings-recession.

We believe that valuations are now attractive from a medium-term perspective, even taking into account the difficulties stemming from slower economic growth and tighter credit. However, we do not anticipate the level of returns in 2008 that investors had grown accustomed to in recent times. Traditional returns of a few % points above cash rates would be a more than acceptable result given the maturity of the economic cycle.

Please see Attachment B for a more detailed discussion of equity markets and implementation issues for equity investors.

Property

The Property return shown the table on an earlier page disguises the further severe weakness in property since year end. Following the near-collapse of the Centro Group (which may yet become a full collapse) through their failure to manage debt maturities, the listed property sector has fallen severely across the board. In January 2008, Grove published a report on the property sector –a copy is enclosed.

Bonds (Fixed Interest)

Bonds continued to under perform, with brief spurts of flight to safety when recession fears were at the worst, but overall returned around half the cash rate over both 6-month and 12-month periods.

There is a scenario in which bonds outperform strongly, as they did during the 2002 recession amidst fears of deflation. More likely though, this downturn is likely to be accompanied by rising inflationary pressures as a delayed reaction to the commodity price increases of recent years. A better (although more extreme) analogy is probably the early 1970s stagflation.

It is difficult to see value in bonds, given the dual pressure of an already inverse yield curve and the ongoing upward pressure on inflation being highlighted by the RBA (and the incoming Federal government).

Product Types – Successes and Failures

The last few years has seen a range of different product types introduced to the market that Grove typically serves by a range of providers. Given market stresses over the review period, it is worth commenting briefly on how different product types have performed.

Structured Securities

A "structured" investment is one where the risk profile of the investment varies from raw exposure to the underlying assets. This may occur through leverage, asset protection strategies, deferral / acceleration of income etc. Leverage is the most common feature. When combined with poor quality assets in a hostile market the effect of leverage on portfolio valuations has been devastating.

We stress that some product types have never been recommended by Grove and that all Grove recommendations are based on detailed analysis of the individual investment.

Structure	**Comment**
Sub Prime Collateralised Debt Obligations (CDOs)	Wrong product at the wrong time and certainly strongly recommended **against** by Grove in the *April 2007 Direct Securities Report*. Highly likely that every sub prime CDO we have seen in our market place will default. Investors will receive a small amount of income before losing their capital.
Corporate CDOs	Have vastly underperformed with valuations below 50 cents in the dollar in some cases. Many contain names directly exposed to the US housing and mortgage market. Expecting some corporate CDOs to default outright. Portfolio quality is the main issue when evaluating CDOs, and many CDO portfolios are severely impaired. Some were very poor even at issue.
Constant Proportion Debt Obligations (CPDOs)	Valuations poor, ranging from 70 to 85 at year end. However, prospects for recovery superior to CDOs, as arrangers did not have the opportunity to select an adverse portfolio. While many CDOs are already under threat from the market deterioration to date, CPDOs will require a market event of much greater severity to fail. At higher spreads, within reason, CPDOs actually strengthen - in the absence of early defaults. However, spreads are getting to levels where if 2008 repeats the previously unparalleled experience of 2007, default becomes a realistic possibility. Most need a year to build excess "carry" to be out of danger.
Constant Proportion Portfolio Insurance (CPPI) Notes	Grove has consistently pointed out that deleverage is the primary risk of CPPI notes, and recent market volatility in a number of markets has seen partial deleverage of many notes. The structures are performing as designed, but investors may look again to unprotected alternatives that are always fully invested.
"Bond plus option" Structures	As these remain fully invested, they track the underlying assets in a "symmetrical" manner – a rebound of the underlying assets means a rebound in the note / fund valuation and investors cannot be permanently locked out of any market recovery. Option pricing can be somewhat expensive, but in general no more than compensating for the lack of deleverage risk.
Collateralised Commodity Obligations (CCOs)	Have been performing well in relative terms, posting returns generally at or ahead of bank bills when many CDOs have fallen 50-90%. Subject to the same sort of risks as CDOs but better quality portfolios and better structuring of products in the market has seen them deliver pleasing outcomes.
Collateralised Loan Obligations	Bank balance sheet CLOs have performed very well, with any defaults resulting in very high recovery rates due to the strong loan protections. CLOs referencing speculative-grade loans or other weakening loan classes have started to trade poorly as the underlying assets have underperformed.

Other Investments

Many credit rated funds have suffered over the review period from an overweight exposure to what were traditionally considered defensive credits – banks and other well rated financials and asset backed securities. See our more detailed comments in Attachment A as to factors affecting credit markets, particularly financials, over the period. Some had small exposures to structured securities, albeit this was generally short dated CLOs considered by the market to be very conservative assets.

Structure	Comment
AAA funds	Have provided returns in line with bank bills on a gross basis.
AA funds	Have underperformed bills significantly due to revaluation of underlying securities. Median 1 year return of 5.97%. Now earning income yields in the vicinity of 0.60 to 0.80 over bank bills.
A funds	Have underperformed bills significantly due to revaluation of underlying securities. Now earning income yields in the vicinity of 0.90 to 1.5% over bank bills.
A Income Funds	12 month median return of 4.95%. Average running yield of 1.40% p.a. above bank bills. More varied portfolio compositions and exposure to credit recovery. Expect significant variation in performance of funds in this sector to continue. Prospects in a post-bear market scenario are generally very good.
Capital Stable Funds (Unrated)	For the 12-months to December Capital Stable Funds provided a median return of 5.62%. This level of performance was below longer-term averages, with a wide variance between individual fund returns.
Balanced Funds (Unrated)	Balanced Funds provided a 12-month median return of 7.20%. Like Capital Stable Funds return was below longer term averages, with a wide variance between individual fund returns.
Floating Rate Notes	Yields on Floating Rate Notes (FRNs) rose sharply during the six-months to December, particularly within Financial names. Trading margins in the secondary market for AA rated Australian banks' sub debt passed 100bp, from 20-25bp one year prior. Values fell accordingly, but accounting treatments can in some cases quarantine FRNs from investors' profit and loss.
Term Deposits	Yields never trade far from the bank bill rate in the major institutions. Credit unions are paying somewhat higher to obtain much needed funding, given the difficulties accessing securitisation markets. At time of writing, the outlook for further rate rises has created apparent value in the 12-month deposit range.
Bank Bills	Bank Bill yields reached levels not seen since July 1996 on a combination of the RBA's growing inflation concerns, and dislocation in global credit markets pushing bank rates well ahead of the official cash rate.

Reporting Issues

Volatility in credit, equity and product markets has highlighted some important issues around reporting:

Annualising returns is a poor practice: Annualising volatile monthly results is misleading and should be discouraged at every opportunity. This is an issue in both rising and falling markets. We actively encourage investors that report using annualised returns for periods less than one year to use recent volatility as justification for discontinuing the process. Grove's reporting systems provide a full suite of reports that do not use annualisation.

Volatility of growth assets swamps returns on defensive assets: Portfolios that contain equity, property and leveraged investments will demonstrate more volatility on a month to month basis. This swamps returns on defensive assets and make review of portfolio performance more difficult. We encourage investors to return to the basic motivations for buying investments and to use that as an additional reporting perspective. For example, Grove classifies investments as to whether they are predominantly used to provide income or growth. Grove Portfolio Online then provides reports that subtotal returns allowing defensive asset performance to be considered separate to growth asset performance.

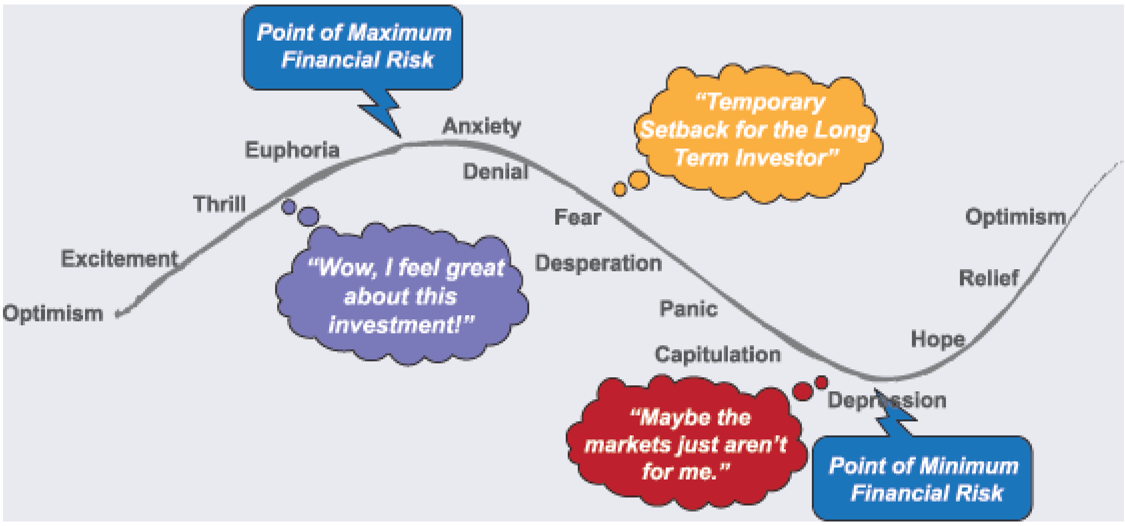
Accounting Issues

For investors holding term securities, the option exists to carry investments in monthly reporting on a "hold to maturity" basis. This effectively sees investments held at historical cost rather than mark to market values. Grove is not qualified to offer advice on accounting standards and clients should consult their auditors and other experts concerning the different valuations bases available and the obligations that attach to each. Grove advocates the hold to maturity approach to valuation where investors are eligible and considers it a sensible election to take.

However, we also note that use of this treatment has caused investors to make erroneous comparisons leading to dubious investment decisions. Better *reported returns* don't necessarily mean an investment is superior. Sub prime CDOs are clearly inferior investments to quality managed funds, even if CDO returns reported on a historical cost basis suggest otherwise (see our earlier comments about the near certain default of these assets.) The point to make here is that it is important to always look through to the fundamental character of investments and to assess them accordingly. An investment on the brink of default is not a successful investment, regardless of how much income it paid in the preceding year.

Market Cycle / Emotional Cycle

In our cover letter we commented on the importance of not being too swayed by emotion when making investment decisions, and instead focussing on fundamental value. The following chart plots the rise and fall of market cycles and the emotions that accompany this movement.


Point of Maximum Financial Risk
"Temporary Setback for the Long Term Investor"
Anxiety
Euphoria
Denial
Thrill
Fear
Optimism
Excitement
"Wow, I feel great about this investment!"
Desperation
Relief
Optimism
Panic
Hope
Capitulation
Depression
"Maybe the markets just aren't for me."
Point of Minimum Financial Risk

Source: Sydney Morning Herald & Nick Pantu

The point to note is that financial risk is highest at the peak of a market and lowest at the bottom. The chart is clearly simplistic. Markets can always rise and fall further than anticipated. No one can be sure when the credit market recovery will commence, but the broad message is there; emotions run counter to markets. We think we are at or near the point of greatest investment opportunity that credit markets have seen for some time. That is not an unqualified recommendation to invest however. Returning to, and updating, prior comments made by Grove, we think the pre-conditions for a conscious overweighting to credit markets are:

1. Visibility that writedowns have been completed and financial institutions that need it have been recapitalised.

2. In particular, the threat of major downgrades or even defaults of the bond insurers is the major threat to credit market stability. While there are actions to form a recapitalisation consortium, clarity that it will be successful is important if a further round of selling is to be avoided.

3. An indication as to the peak level of credit defaults in the next cycle. While currently at record lows, they will certainly rise. Markets will be looking for guidance as to whether they will peak at 2002 levels, or closer to the middle of historical ranges. (Given the absence of high interest rates that worsened the 1991 recession, or the weak corporate balance sheets after the 2000 Tech Bubble, there is cause for optimism about the size of this default cycle.)

4. Stability and recovery in credit indices. Given that physical markets lagged derivatives in the August sell-off, it is not necessary to entirely anticipate turning points. (However, we do expect the earliest months of the credit cycle to be the strongest.)

5. Market liquidity, two-way trading, credit managers happy to take on additional holdings and receiving institutional inflows.

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INVESTMENT PORTFOLIO REVIEW

PORTFOLIO STRUCTURE & PERFORMANCE REVIEW
DECEMBER 2007

	Portfolio Structure				Portfolio Performance Analysis				
					Annualised Returns ending 31/12/2007				
	As at		Current		(after fees)				Returns
Wyong Shire Council	30/06/2007		31/12/2007		6 mths	1 yr	2 yrs	3 yrs	Profile
Investment Portfolio by Horizon	$m	%	$m	%	%	%	%	%	
Working Capital (0-3 Months)									
BT Institutional Managed Cash	8.97	8.94	60.30	45.94	6.73	6.55	6.18	5.96	Income
T-Corp Term Deposit	-	-	7.40	5.64	-	-	-	-	Income
Sub-Total	**8.97**	**8.94**	**67.71**	**51.58**					
11am Cash Rate					**6.54**	**6.40**	**6.10**	**5.89**	
Short Term (3-12 Months)									
LGFS Fixed Outperformance Cash	-	-	1.20	0.92	*7.38*	*7.23*	-	-	Income
Perennial Cash Enhanced	9.27	9.24	2.39	1.82	4.23	5.43	5.71	5.76	Income
QIC Cash Enhanced	6.46	6.44	2.13	1.62	5.01	5.78	*5.97*	-	Income
Sub-Total	**15.72**	**15.68**	**5.73**	**4.36**					
Short-Medium Term (1-2 Years)									
Aberdeen Cash Plus	20.51	20.46	11.34	8.64	3.40	5.00	5.56	5.80	Income
ING Enhanced Cash	15.87	15.83	9.14	6.97	3.67	5.14	5.65	*5.83*	Income
Macquarie Income Plus	21.97	21.91	22.36	17.04	3.58	5.07	5.60	*5.86*	Income
Sub-Total	**58.36**	**58.21**	**42.85**	**32.65**					
Medium Term (2-5 Years)									
BlackRock Diversified Credit	12.15	12.12	14.97	11.41	-2.25	2.40	*4.40*	*5.05*	Income
Perpetual Structured Income	5.06	5.05	-	-	-	-	-	-	Income
Sub-Total	**17.21**	**17.17**	**14.97**	**11.41**					
Total Managed Fund Portfolio		**0.00**		**0.00**	**2.95**	**4.75**	**5.44**	**5.64**	
Total Direct Security Portfolio		**0.00**		**0.00**					
Total Investment Portfolio	**100.26**	**100.00**	**131.25**	**100.00**					
UBS Aust. Bank Bill Index					**6.88**	**6.73**	**6.38**	**6.16**	
S&P ASX 300 Accumulation Index					**5.84**	**16.22**	**20.30**	**21.01**	
S&P ASX 200 Property Trusts Acc Index					**-15.80**	**-8.41**	**10.80**	**11.36**	
MSCI World Ex Aus in $A (unhedged)					**-7.62**	**-3.77**	**2.91**	**6.58**	
Median Conservative Fund Return					**2.53**	**4.92**	**6.90**	**7.86**	
Median Growth Fund Return					**0.28**	**5.88**	**10.33**	**12.04**	

Note: Shifts in portfolio value from 31/12/06 to 30/06/07 reflect fund performance and the impact of applications and redemptions.

INVESTMENT PORTFOLIO REVIEW

This section of the report reviews Wyong's portfolio performance for the period to 31 December as quantified in the table on the prior page. Grove's views on what changes, if any, are required to your portfolio are set out later in this report.

Performance Review

Performance Against Objectives

Your investment portfolio has:

- underperformed the UBS Australian Bank Bill Index after fees by 1.96% over the six months to December 31 2007 and
- underperformed the UBS Australian Bank Bill Index after fees by 1.98% p.a. over the year ending December 31 2007
- These returns reflect the negative and extreme environment for credit related investments described earlier in this report. Falling valuations for credit securities, especially those issued by banks and financials detracted from strong income returns.
- We note that for credit investments, underperformance arising from falling valuations in for a period is not usually a permanent loss. Provided that underlying credit investments continue to pay income as promised, then the value of the investment must return to par at maturity when capital is repaid. In other words, it is a characteristic of credit securities that as long as a security does not default, its value will return to 100 per cent. Accordingly, we look to fundamental credit quality of investments and conclude that for most credit rated funds the performance outlook over the average life of the securities held is strong.
- Running yields of many credit rated funds are now at record levels, reflecting the unprecedented yields on highly-rated credit assets.
- Timely withdrawal from the Structured Income Fund (an alternative to the Grange IMP) avoided a major underperformance of this asset class.

Fund Specific Performance Commentary

Aberdeen Cash Plus (Af Rated)

	Jul	Aug	Sep	Oct	Nov	Dec	6 Months
Fund	+0.32	+0.30	+0.50	+0.43	-0.07	+0.34	+1.83
Bank Bill Index	+0.53	+0.53	+0.57	+0.57	+0.56	+0.60	+3.41
Value Added	**-0.21**	**-0.23**	**-0.07**	**-0.14**	**-0.63**	**-0.26**	**-1.58**

Fund Statistics	
Running Yield	7.53%
Credit Duration	1.68

The Aberdeen Cash Plus Fund (Af rated) underperformed the UBSA Bank Bill Index by -158bp (gross actual) over the six months to December – with the fund recording its first negative monthly return in November since inception. Fund performance was adversely impacted by exposure to all credit sectors, particularly large diversified banks, high grade bank sub-debt and domestic mortgage backed securities (RMBS). Both banking and RMBS sectors have borne the brunt of recent volatility in credit markets, even where not exposed to the US. Partially offsetting these factors was an underweight exposure to credit in much of the period, resulting in underperformance less than would be expected in comparable securities.

Aberdeen expects credit markets to remain volatile over the New Year with corporate defaults rising in a slowing global economy. As such, they will retain an overweight position in defensive sectors (until market volatility subsides), such as domestic RMBS and high-grade bank debt. They anticipate a number of value enhancing trades to emerge, particularly in financials where spreads now trade at similar levels to where they would in a recession. The manager will actively switch out of bonds that no longer offer appropriate risk/return payoffs while focusing on companies with solid credit fundamentals. Aberdeen will maintain a strong cash buffer with a neutral index position.

BT Managed Cash (AAAm Rated)

	Jul	Aug	Sep	Oct	Nov	Dec	6 Months
Fund	+0.55	+0.55	+0.56	+0.58	+0.57	+0.60	+3.45
Bank Bill Index	+0.53	+0.53	+0.57	+0.57	+0.56	+0.60	+3.41
Value Added	**+0.02**	**+0.02**	**-0.01**	**+0.01**	**+0.01**	**-**	**+0.04**

The AAA fund contains little credit exposure and runs very short credit duration; therefore it closely tracked cash rates. It does not have any direct unit price participation in the credit cycle. The outperformance of the bank bill rate is very creditable for a fund generally benchmarked against the lower official rate.

ING Enhanced Cash Fund (Af Rated)

	Jul	Aug	Sep	Oct	Nov	Dec	6 Months
Fund	+0.41	+0.23	+0.52	+0.38	-0.04	+0.43	+1.94
Bank Bill Index	+0.53	+0.53	+0.57	+0.57	+0.56	+0.60	+3.41
Value Added	**-0.12**	**-0.30**	**-0.05**	**-0.19**	**-0.60**	**-0.17**	**-1.47**

Fund Statistics	
Running Yield	7.56%
Credit Duration	2.97 years

The ING Enhanced Cash Fund (Af rated) underperformed the UBSA Bank Bill Index by -147bp (gross actual) over the six-months to December – the second best performing A rated Cash Enhanced Fund on Grove's *Credit Rated Funds Performance Survey*. Nevertheless, the Fund recorded its first ever negative monthly return since inception in November.

Impacting performance was an overweight allocation to AAA rated Residential Mortgage Backed Securities (RMBS) and bank subordinated debt – both considered defensive sectors prior to the recent credit crash. Exposure to CMBS and monoline wrapped securities also detracted from performance, with the former impacted by Centro related contagion and the latter on the possibility of credit rating downgrades. Partially offsetting these factors was an underweight position in subordinated RMBS debt, no exposure to US investment banks and a number of swap positions.

ING/ANZ believe credit fundamentals remain largely sound, but do not anticipate any immediate improvement in sentiment. They remain unconcerned over the fund's underlying assets and mention that most recent rating actions have been positive. Going forward, ING/ANZ will look to add value using alternative strategies such as duration, yield curve, swaps and CDS hedge positions.

Macquarie Income Plus Fund (Af Rated)

	Jul	Aug	Sep	Oct	Nov	Dec	6 Months
Fund	+0.46	+0.25	+0.43	+0.41	-0.06	+0.39	+1.89
Bank Bill Index	+0.53	+0.53	+0.57	+0.57	+0.56	+0.60	+3.41
Value Added	**-0.07**	**-0.28**	**-0.14**	**-0.16**	**-0.62**	**-0.21**	**-1.52**

Fund Statistics	
Running Yield	8.55%
Credit Duration	1.10 Years

The Macquarie Income Plus Fund (Af rated) underperformed the UBSA Bank Bill Index by -152bps (gross actual) over the six months to December – with the Fund recording its first ever negative monthly return since inception in November. Macquarie started the half-year with a reduced exposure to credit spreads and a cautious sectoral portfolio structure, as well as having a preference to shorter-dated securities in less volatile sectors. Nevertheless, severe credit market deterioration saw spreads widened in even the most defensive sectors, with the Fund's exposure to corporate credit driving underperformance. Partially offsetting this was a number of low cost CDS (hedge) positions, helping the Fund to be near the top of the A rated Income Funds on Grove's *Credit Rated Funds Performance Survey*.

Going forward, Macquarie will retain a preference to more defensive market sectors, including short-dated, highly rated, Australian RMBS, other asset backed securities and cash. Macquarie will avoid longer dated and lower rated securities, including specific sectors such as bank sub-debt and financials. Although they enter 2008 with a defensive strategy, Macquarie anticipates that a number of attractive opportunities will emerge, presenting an excellent risk/return payoff.

Perennial Cash Enhanced (AAf Rated)

	Jul	Aug	Sep	Oct	Nov	Dec	6 Months
Fund	+0.26	+0.33	+0.63	+0.38	-0.14	+0.75	+2.23
Bank Bill Index	+0.53	+0.53	+0.57	+0.57	+0.56	+0.60	+3.41
Value Added	**-0.27**	**-0.20**	**+0.06**	**-0.19**	**-0.70**	**+0.15**	**-1.18**

Fund Statistics	
Running Yield	7.72%
Credit Duration	1.89 Years

The Perennial Cash Enhanced Fund (Af rated) underperformed the UBSA Bank Bill index by -118bp (gross actual) over the six-months to December – with the Fund recording its first negative monthly return in November since inception. Performance was adversely impacted by spread widening amongst the Fund's floating rate notes (FRNs), domestic residential mortgage backed securities (RMBS) and corporate financials. Perennial's interest rate strategies also detracted from performance.

Going forward, the Fund will retain a long duration strategy on the belief that the domestic yield curve is currently pricing in the worst case scenario – two interest rate rises in 2008. Perennial believes this is at odds with a deteriorating global macroeconomic outlook. The manager will retain an overweight allocation to corporate and asset backed FRNs, with the sector's strong running yield present attractive risk/return payoffs. Perennial expect market volatility to subside in coming months and trend back towards more normalised long-term levels.

QIC Cash Enhanced (AAf Rated)

	Jul	Aug	Sep	Oct	Nov	Dec	6 Months
Fund	+0.36	+0.37	+0.58	+0.43	+0.24	+0.56	+2.56
Bank Bill Index	+0.53	+0.53	+0.57	+0.57	+0.56	+0.60	+3.41
Value Added	**-0.17**	**-0.16**	**+0.01**	**-0.14**	**-0.32**	**-0.04**	**-0.85**

Fund Statistics	
Running Yield	7.61%
Credit Duration	1.98 years

The QIC Cash Enhanced Fund (Af rated) underperformed the UBSA Bank Bill Index by -85bp (gross actual) over the six-months to December – broadly in line with equivalent AA rated Cash Enhanced Funds on Grove's *Credit Rated Funds Performance Survey*. Performance was adversely impacted by spread widening in the portfolio's exposure to financial institutions (domestic and international banks) and AA rated Australian residential mortgage backed securities (RMBS) – two sectors previously described as highly defensive.

Going forward, QIC will remain defensively positioned by retaining an overweight allocation to regional financials and AAA domestic RMBS. The manager remains highly convicted in the creditworthiness of all securities in the portfolio and believe that fundamentals remain broadly positive with good global growth, positive earnings and low corporate default rates. QIC will look to high conviction strategies if opportunities emerge during the current period of dislocation in credit markets.

BlackRock Diversified Credit Fund (Af Rated)

	Jul	Aug	Sep	Oct	Nov	Dec	6 Months
Fund	+0.26	-0.81	+0.19	+0.82	-2.03	+0.52	-1.08
Bank Bill Index	+0.53	+0.53	+0.57	+0.57	+0.56	+0.60	+3.41
Value Added	**-0.27**	**-1.34**	**-0.38**	**+0.25**	**-2.59**	**-0.083**	**-4.49**

Fund Statistics	
Running Yield	8.34%
Credit Duration	4.21

The BlackRock Diversified Credit Fund underperformed the UBSA Bank Bill Index by -449bp over the six-months to December, while over the full calendar year performance was -416bp below benchmark.

The primary detractor from performance was the Fund's strong tilt towards overseas credits (just over 50%), particularly high quality, large money centre banks and an underweight position in corporates. The former has worn the brunt of recent credit market volatility while the latter has outperformed.

BlackRock continues to believe that the broader credit market fundamentals remain sound. They anticipate an environment whereby financial institutions will outperform corporates during 2008. The manager anticipates a number of opportunistic trades with value emerging in an oversold market.

Commentary

Grove has not lost faith in the capabilities of the manager, despite the substantial level of underperformance recorded over the six-months to December. We consider the underlying assets' yield is highly attractive relative to their credit quality. This is not a situation where a manager has lost money on defaults or inappropriate trades. On that basis, we would not downgrade the fund to "sell" at what is an historically extreme point in asset values. We continue to see BlackRock as earning CDO-like yields with superior credit quality. With the fund heavily invested in major bank debt the Fund represents (paradoxically) a defensive investment. We attach a copy of our recent paper.

Portfolio Outlook Modelling

As mentioned in our cover letter, we wanted to provide investors with a reasonable sense of "what could happen from here" with credit markets, how that would impact your portfolio returns and how the outcome would change if term deposits were employed in different concentrations. To do this, we first capture your credit rated funds holdings at 31 December along with relevant data relating to the funds.

We now model the performance of four scenarios (shown below) with each reflecting a greater weighting to assets with a known future return, and stable capital value (i.e. not susceptible to market revaluation). We have assumed use of term deposits for this purpose. In each scenario we also assess the impact of changes in the capital value of credit funds, as reflected in notional changes in credit spreads. (see explanation of credit spreads below, marked with an *). Each reallocation is assumed to occur at 31 December 2007.

This analysis is important as it has been changes in market value of credit investments that has been driving recent returns. Income has been relatively stable. This analysis identifies the sensitivity of your portfolio to such changes in market value. As can be seen, given the high income levels currently generated by the funds the impact of further spread widening is not as pronounced as investors may have feared. (It is fair to say that results for the 2008 calendar year to date have been very adverse due to the bond insurer downgrades, consistent with the more adverse scenarios.)

Scenario 1 – **Existing Credit-Exposed Portfolio**

		Returns Under Different Assumptions		
		1	**2**	**3**
		No change in credit spreads*	**+50% widening in spreads***	**-50% contraction in spreads***
Average Net Yield		1.02%	1.60%	0.43%
FY2008 1H		**1.11%**	**1.11%**	**1.11%**
FY2008 2H		**4.26%**	**3.01%**	**5.51%**
2008		5.37%	4.12%	6.62%
2009	BBSW (7.50%)	8.52%	9.10%	7.93%
2010	BBSW (7.50%)	8.52%	9.10%	7.93%

Scenario 2 – **35% allocation to zero duration assets (Term Deposits) and 65% to existing funds**

		Returns Under Different Assumptions		
		1	2	3
		No change in credit spreads*	+50% widening in spreads*	-50% contraction in spreads*
Average Net Yield		0.64%	1.02%	0.26%
FY2008 1H		**1.11%**	**1.11%**	**1.11%**
FY2008 2H		**3.98%**	**3.10%**	**4.85%**
2008		5.09%	4.21%	5.96%
2009	BBSW (7.50%)	7.95%	8.20%	7.71%
2010	BBSW (7.50%)	7.95%	8.20%	7.71%
3 Year Cumulative p.a.		**6.99%**	**6.85%**	**7.12%**

Scenario 3 - **45% allocation to zero duration assets (Term Deposits) and 55% to existing funds**

		Returns Under Different Assumptions		
		1	2	3
		No change in credit spreads*	+50% widening in spreads*	-50% contraction in spreads*
Average Net Yield		0.54%	0.86%	0.22%
FY2008 1H		**1.11%**	**1.11%**	**1.11%**
FY2008 2H		**3.92%**	**3.16%**	**4.68%**
2008		5.03%	4.27%	5.79%
2009	BBSW (7.50%)	7.84%	8.02%	7.66%
2010	BBSW (7.50%)	7.84%	8.02%	7.66%
3 Year Cumulative p.a.		**6.89%**	**6.75%**	**7.03%**

Scenario 4 – **100% allocation to zero duration assets (Term Deposits)**

		Returns Under Different Assumptions		
		1	2	3
		No change in credit spreads*	+50% widening in spreads*	-50% contraction in spreads*
Average Net Yield		-0.05%	-0.05%	-0.05%
FY2008 1H		**1.11%**	**1.11%**	**1.11%**
FY2008 2H		**3.80%**	**3.80%**	**3.80%**
2008		4.91%	4.91%	4.91%
2009	BBSW (7.50%)	7.60%	7.60%	7.60%
2010	BBSW (7.50%)	7.60%	7.60%	7.60%
3 Year Cumulative p.a.		**6.70%**	**6.70%**	**6.70%**

*Credit spreads, in this context, are the measure of an investment's income yield, over and above the bank bill rate. As a credit investment's capital value falls, the spread or income yield increases. Conversely, as capital values increase, spreads fall. *e.g.* Consider a credit investment worth $100.00 paying an annual coupon of $8.00 (equating to 8 per cent income), and where the bank bill rate is 7.00%. The credit spread on the investment is therefore 1.00% p.a. (8.00% minus 7.00%) The market is saying that the risk of the investment is such it requires 1.00% p.a. to compensate it for the risk of holding the investment relative to a "risk free" asset such as a bank bill. Should the market demand a higher reward for risk and the yield on the investment increase 0.40% to 8.4 per cent, this implies a fall in capital value of 1.2 per cent - 0.40 % rise in yield x credit duration of (say) 3 years) and a new credit spread of 1.4 % p.a.

Comments on Scenario Modelling

The above modelling shows that under the adverse case scenario (+50% widening on the sample portfolio) expected return to June 2008 is +4.12%. This compares to the 100% allocation to term deposit allocation (Scenario 4) which delivers +4.91%. However, if credit spreads do not change, or if they narrow, the existing fund portfolio will outperform the 100 % term deposit portfolio by +0.46% and +1.71% respectively. This suggests that while utilising term deposits may generate a better return if credit markets continue to deteriorate badly (we think a 50 per cent credit widening on average for the next 6 months is a pessimistic assumption), there is a real possibility it could result in under performance over the period.

Further, the model considers what happens if the different scenarios remain in place. We note that the 100% term deposit allocation will underperform the existing strategy by 0.76% p.a. if the strategy was to remain in place for the next three years and spreads were stable; representing the portfolio running yield. On a $50m portfolio (ignoring the investments not exposed to market risk), that equates to over $1.1m in yield over 3 years.

This relationship is followed throughout – that is, **a higher allocation to zero-duration assets dilutes expected return over the longer term.** This relationship stands even if spreads were to rise +50% from current levels and remain elevated for three years.

Of course the ideal outcome is if it were possible to hold term deposits for as long as credit funds underperform and then switch back to funds or other credit investments just prior to when credit markets recover. Whilst a notionally appealing objective, we advise against trying to ‘time the market’. Credit spreads have historically moved very quickly on changing sentiment making this tactical strategy near impossible and resulting in the probable crystallisation of underperformance and exposure to a second round of market falls if the recovery proves to be a false start.

In our view, the optimal use of zero duration assets such as term deposits is when they will confidently generate a higher return over a market cycle than the asset they are replacing in the portfolio. The other circumstance in which their use could be argued in the current environment is where your organisation is seeking absolute certainty around financial year end performance, and is willing to sacrifice a reasonable chance of a higher return in order to achieve this objective.

Model Disclaimer:

This analysis is intended to be broadly illustrative and it should not be used in isolation as the basis of investment decision making. Whilst the “adverse case” scenario modelled is considered to be quite conservative, it cannot be presumed that credit spreads will not widen further than the assumed amount. In particular, funds would be likely to underperform these scenarios should they receive major outflows that overwhelm the ability of illiquid markets to fund them, which would result in them receiving below market prices as forced sellers.

Statement of Advice

Our indicative advice to Wyong Shire Council setting out our recommendations for your portfolio is as follows:

Credit Securities:

We do not believe that now is the time to reduce credit exposure, at times of record credit spreads for high quality assets such as paper issued by highly profitable, well capitalised and well regulated Australian banks. However, there could well be advantages in changing the form of credit exposure as discussed in the recent paper (enclosed).

Subject to the ability to use hold-to-maturity accounting treatment, there are significant accounting / reporting benefits of investing directly in securities rather than managed funds. *We stress that the benefits are purely presentational* – securities have the same volatility of market values that fund unit prices, if not more so. In the current environment of extreme spread fluctuations, the values of securities are equally affected. The approach is purely one of convenience for stability of reporting income for budget purposes.

We recommend that Wyong Shire Council give in principle approval to various investments, which would enable the required rapid response as rate sheets are published. Investments to consider include:

- Regional bank FRNs: Examples include Adelaide Bank, and Bank of Qld Q2 2009 senior FRNs have been paying up to BBSW+90bp. We consider these a highly attractive alternative to term deposits with the same institution. (We do not recommend extending to the space occupied by unrated institutions in the middle of a period of significant financial distress – while the probability of an institution failing is low, the reward for the additional risk is generally quite low and unnecessary given the yields available.)
- Major bank sub-debt: The highest yield we have seen is BBSW+130bp for major Australian bank sub-debt, callable in 4 years. We consider this a very attractive level. (There is the potential for sub-debt to be rolled over for up to 5 additional years, but there are several structural incentives for the issuer not to do so.)
- Other bank paper: Many global banks issue in $A – these include the equivalents to our majors, such as HSBC, HBOS, Wachovia, Citibank *etc*. We recommend sticking with major global banks that are considered "too large to fail."
- NSW TCorp Hour-Glass Long Term Growth Facility: This is a 70/30 aggressive growth fund, and the only one eligible under the Minister's Order. It has tracked movements in equity markets, and given substantial falls in the global sharemarkets this may represent an attractive entry point. The Hour-Glass Facility is, of course, not subject to capital protection and the significant monthly volatility has to be taken to account. The benefit is that fees are vastly lower than capital-protected securities, and the Hour-Glass is not exposed to risks such as deleverage.
- Equity-linked notes: This is a subject for further discussion – we enclose our paper on the CPPI structure in general.

These options were addressed in the recent paper following our pre-review meeting, enclosed.

Disclaimer

The information and recommendations contained in this document are for the benefit of the addressee only and are made as at the above date in reliance on information provided by you to Grove as to your financial objectives, situation and needs. Any investments made as a result of any of these recommendations are subject to investment risks including loss of income and the performance of investments is subject to external economic factors that can change at any time. Grove does not guarantee any rate of return, the performance of an investment nor the repayment of capital. Nothing in this document constitutes an offer to invest.

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Attachments

A – Detailed Discussion of Credit Markets for 12 Months to December 2007

B – Detailed Discussion of Sharemarkets for 12 Months to December 2007

C – Detailed Discussion of Property Markets – January 2008

D - Investment Options Statement of Advice – January 2008

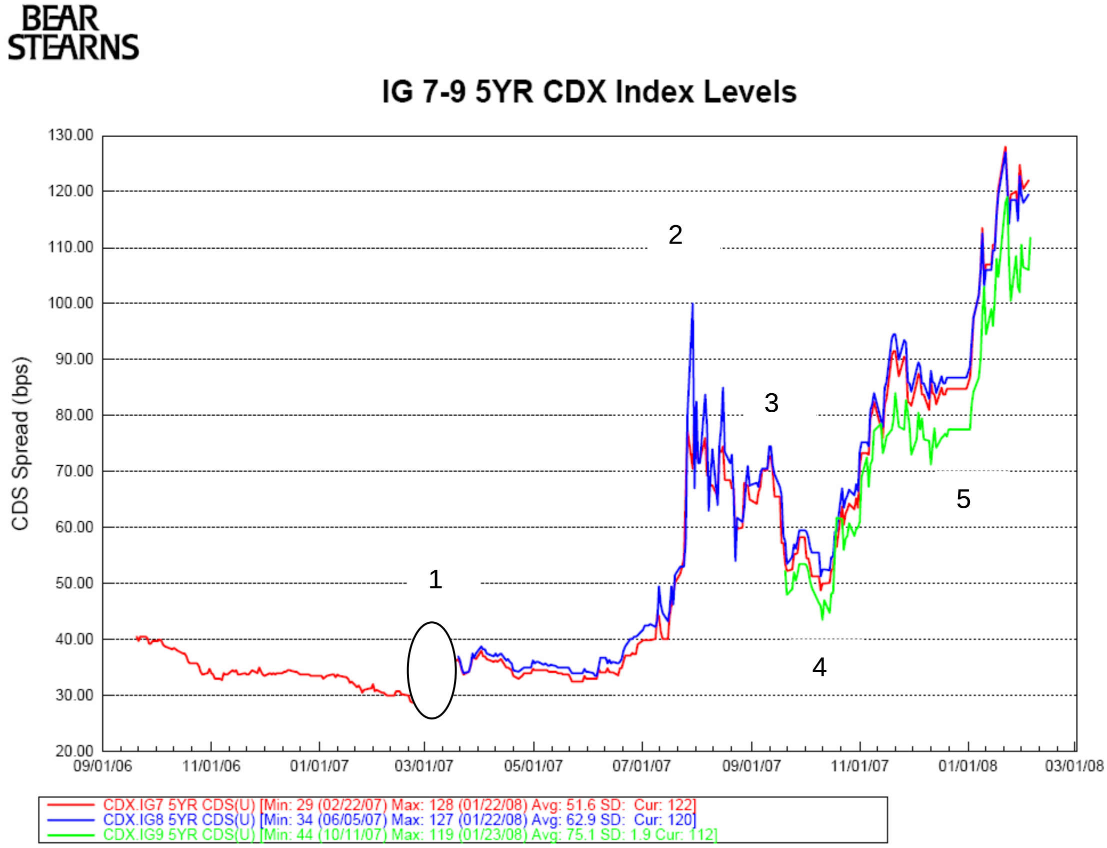
E - BlackRock Comment – January 2008

Attachment A – Detailed Discussion of Credit Markets for 12 Months to December 2007

Markets

From their December 2006 lows, credit indices ground slightly wider over the first half of 2007 – not an unexpected development and one that resulted in flat but not disastrous returns from credit. The following chart maps the movements of investment-grade credit – the sector most relevant to our clients:

Chart 1



Looking at the major events in turn, labelled in the chart above:

1. Shanghai stockmarket plunges – former US Federal Reserve chairman Alan Greenspan talks of a possible US recession in 2007. (In fact, the US grew in every quarter of 2007.)
2. Collapse of two hedge funds due to falls in value of sub-prime assets (predominantly lower CDO tranches) and announcement that two German banks had major sub-prime losses.
3. After initially responding to the lack of inter-bank lending by injecting funds, the Federal Reserve cuts interest rates by 0.5% and produces a short but sharp market recovery – banks were easily able to offset sub-prime losses with new capital.
4. The Fed announced that "risks were balanced" and that they were as concerned about inflation, after growth figures continued to present a picture of normality. The market disagreed. After a disastrous November where they Fed governors kept repeating the October minutes, Chairman Bernanke backflipped on November 21 and restored an easing bias. December was calm, as markets awaited the next rate cuts and were soothed as the troubled bond insurers had AAA ratings affirmed (in some cases subject to capital-raising).
5. The rating agencies changed their sub-prime forecast, reversed their earlier decisions and downgraded several bond insurers. This set off a contagion through the $2tr of "wrapped" bonds including Australian infrastructure and US councils.

At the time of writing, the threat hanging over the bond insurers is continuing to wreak havoc on the credit market. The implications for the US public sector are also potentially extremely grave – institutional investors would not purchase uninsured, unrated municipal bonds, or bonds wrapped by an insurer of uncertain credit quality. This does not imply the financial catastrophe that some commentators have foreshadowed – new bonds can simply be issued through a different AAA insurer such as the newly licensed Berkshire Hathaway – but it does imply a large volume of forced selling of existing bonds. Moreover, banks have a massive counterparty exposure to the bond insurers, and even a downgrade would make their sub-prime hedges ineffective. (Again, not necessarily worthless, but ineffective in accounting terms, requiring another round of capital-raising.)

Systemic Support

At times of economic or financial upheaval, there has always been substantive action to restore economic growth and sentiment. These are targeted to the heart of the financial system – the banks – seen at their extreme in the ongoing support of the Japanese banks through the largest asset price collapse in recorded history (the period from 1990 to 1997).

The central banks have been active to inject liquidity and provide lending facilities to the major financial institutions in effectively unlimited quantities to ensure that the financial system continues to function as well as possible. After initially spiking as high as 3% above the Treasury bond (indicating extreme aversion to dealing with each other), interbank lending rates are now within normal ranges.

Since September, this has been supplemented by interest rate cuts, including the largest cut in 25 years. Total cuts to date have reached 2¼%, with the indications of more to come as required.

There has also been readily available capital for the financial system as required. In the case of Countrywide, Bank of America contributed $2bn of convertible equity and massive credit lines earlier in the year. As these proved to be inadequate to cover further writedowns, they followed with a full $4bn takeover (currently still conditional) – believed to have been encouraged to do so by the Federal Reserve in the interests of financial stability.

For the larger institutions such as Citibank and Merrill Lynch, new capital has been sourced from sovereign wealth funds and other public sector bodies, from sources as diverse as Singapore, China, UAE and Saudi Arabia. In addition to the investment merits, these groups (as major trading partners of the US) have an interest in maintaining economic and financial stability. Conversely, the banks gain business contacts – when China is looking for an investment bank, they are more likely to call Bear Stearns given their shareholding.

The New York Insurance Commission has the regulatory responsibility for solvency of most of the bond insurers, which are licensed in New York. The Superintendent has spoken of recapitalising the insurers, through a syndicate of banks and other groups with an interest in insurers maintaining their AAA ratings. This may or may not include Federal subsidy, or other support. The amount of $16bn discussed across the sector does not represent a large investment given the extent of the dislocation that would follow their failure, and the size of capital raisings already undertaken in the financial sector.

However, investors need to be aware that recapitalising the bond insurers can take many forms, some of which have adverse impacts elsewhere. For example, if the insurers cease dividend payments, then the parent companies are unable to service their debts and would therefore be insolvent. In our view, this is not the most likely outcome – it would be difficult (to say the least) to have a well capitalised AAA rated subsidiary of a parent company in default! However, since it is usually the parent company referenced by synthetic CDOs, some investors could be adversely affected even in a bailout.

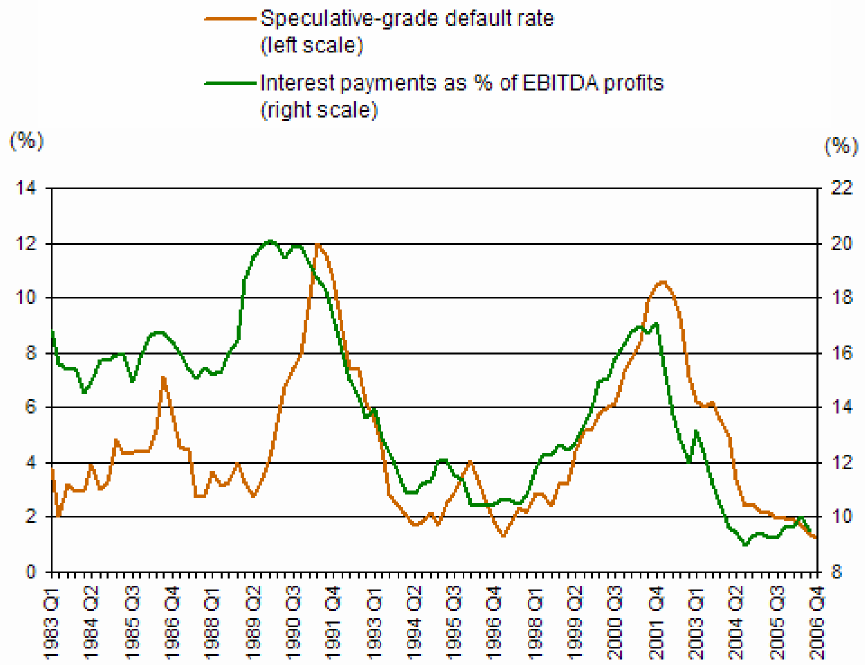
Warren Buffett (almost a financial system all by himself these days) has offered to reinsure the municipal bonds through Berkshire Hathaway – for a handsome premium. While this removes the immediate contagion through the US local government sector, it does nothing for the other infrastructure bonds insured by them globally, the counterparty exposures of the banks, or the CDOs that reference the bond insurers, as they would be left with only the mortgage-related insurances.

Outlook

The following chart shows the long-term history of "junk bond" (sub-investment-grade) defaults:

Chart 5

U.S. Speculative-Grade Default Rate Versus Interest Burden



Sources: Bureau of Economic Analysis, Standard & Poor's Global Fixed Income Research, and Standard & Poor's CreditPro®.

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Obviously no-one expects the record low default environment to persist, but the question is whether the default rates return to a mid-cycle level or peak in line with recessionary periods – or even more pessimistic scenarios.

Standard and Poor's recently forecast defaults to rise from the 25-year low of 1.26%. On their optimistic scenario, defaults will continue to inch up to 1.5%, with the pessimistic assumption (which would seem a reasonable base case now) seeing them nearly triple to 3.5%.

In support of the moderate default scenario, we contrast the current environment to previous peaks:

- 2002 had the coincidence of a global recession and very weak corporate balance sheets – interest service costs were near record highs after the merger frenzy of the 1990's.
- In 1991, not only was there a global recession but also very expensive money – interest rates peaked in the high teens in many OECD countries (including Australia).

By contrast, corporate balance sheets are in strong shape, and the global economy is growing strongly even if the US economy is not. Interest rates are low, and there is plenty of capital available to purchase assets cheaply – in contrast to 2000 when all free capital had been used up purchasing expensive assets.

We expect a return to "normal" levels of corporate defaults. This are likely to be concentrated in companies closest to the US property sector – particularly where companies have not managed their debts and have taken excessive gearing into a debt rollover period. (The Centro and Quebecor World examples are instructive.)

Credit assets are certainly well and truly priced for this scenario, particularly in the Australian financial sector which remains very profitable and all indications are that it will continue to. The Australian banking system has already passed through a property cycle recently without any noticeable effect, but has now followed global leads to unheard-of yields on credit. Short term fixed rate paper has also become very attractive, given the number of rate increases already being factored in. With the 12 month BBSW at close to 8%, short-dated bank fixed rate bonds will be paying almost 8.5% in some cases.

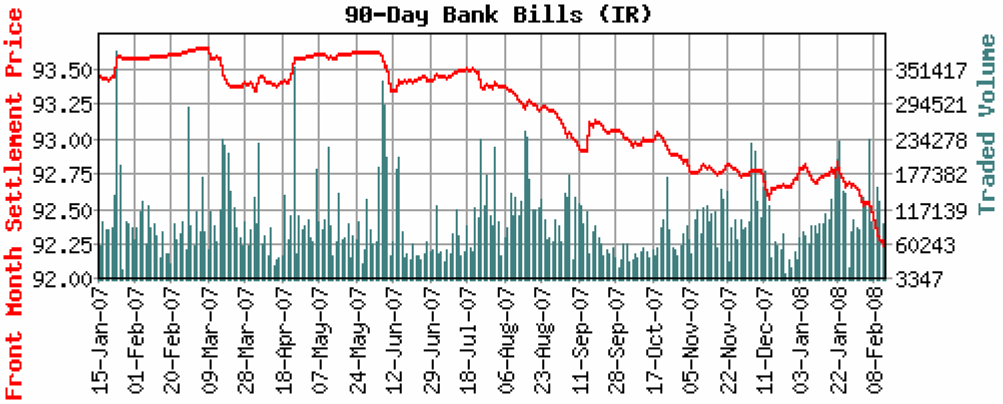
The other major "single name" event besides default has been the leveraged buyout, which typically sees credit ratings fall 4-6 notches and credit cost rerated severely (causing large falls in prices) as well as impacting the ratings of structured products that refer to them.

The leveraged buyout activity of 2006 and early 2007 has certainly come to a near standstill if not a complete halt – the only modest source of comfort to credit investors. Banks have around $180bn of recent LBO debt still to be syndicated, and this will result in a significant writedown at current market prices. New transactions will find their debt cost far higher than in recent times, restricting their ability to outbid in-sector mergers.

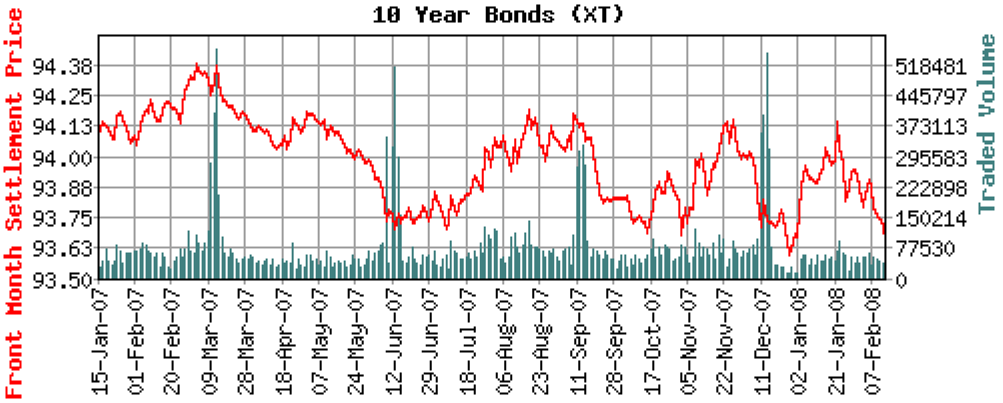
Fixed Interest

Interest rates rose twice in 2007, with the market factoring in accelerating Reserve Bank action over 2008. 6 months BBSW exceeds 8%, compared to the cash rate of 7% currently. The market is interpreting recent RBA comments as implying that they fear a lengthy period of above-target inflation, and are prepared to take harsh action to force growth down from 4%+ p.a. to a more sustainable 2.5%.

The futures chart (an inverted basis, so falling prices indicate higher interest rate expectations) show the acceleration since year end:



Contrasted with that is the relatively muted response from long-dated bonds. The bond futures have trended sideways:



This indicates that:

- Expectations about inflation and interest rates reflect a short-term view, with the market expecting the inflation pressures to be a short-term phenomenon before eventual retracement to the long-term level;
- Bond markets are torn between a strong domestic economy with above-trend growth, capacity constraints and rising inflation - against an offshore lead driven by recession fears;
- Foreign buying of financial assets is directed at bonds, rather than cash; and
- The gap between bills and 10-year bonds is now the widest it has been for many years, indicating poor value for long bonds.

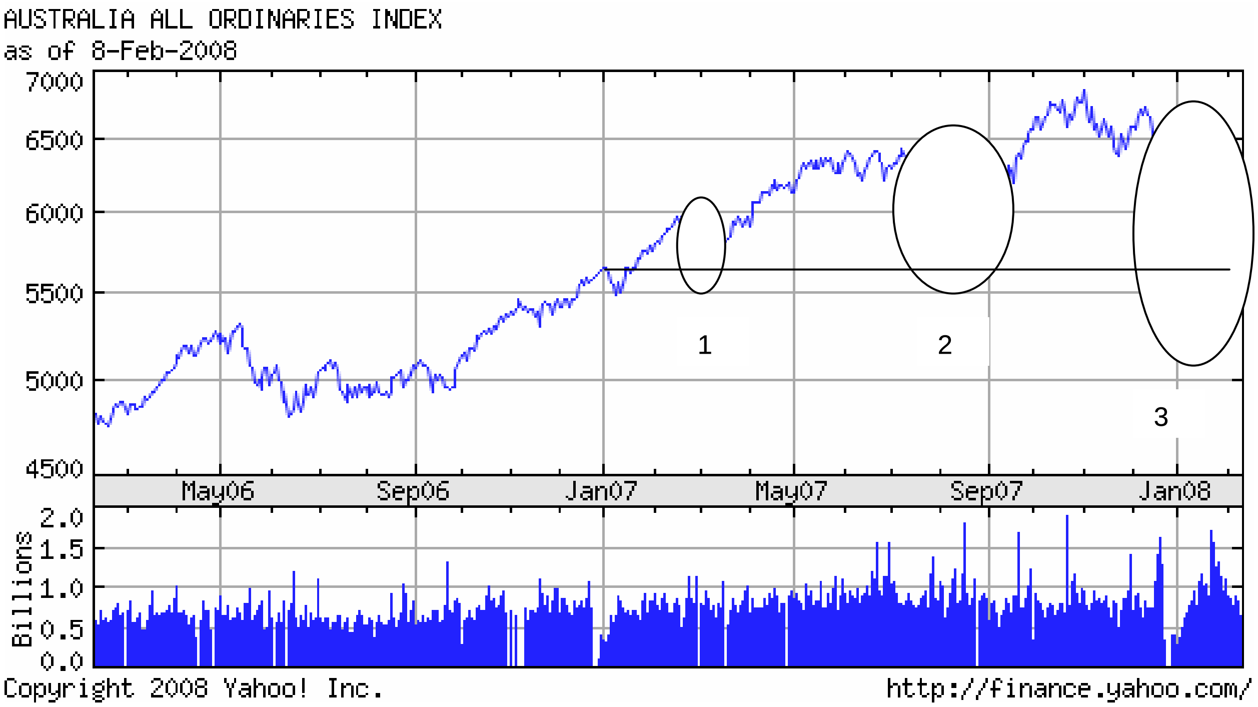
We do not encourage very long-term fixed rate investments, but believe there is value in the range 6-12 months. In particular, buying short bank bonds gives investors exposure to both the yield curve steepness and the size of credit spreads –term deposits can only provide the former.

Attachment B – Detailed Discussion of Sharemarkets - 12 Months to December 2007

What a roller-coaster year for the Australian equity market!

Actually, no – this is what a normal year looks like. The 16% return has been pared back to single figures by the market weakness in January, but the market has traded sideways broadly sideways. At least one correction of more than 10% are expected in a given year. Excluding property trusts (normally regarded as a separate sector), returns from shares are considerably stronger again.

The major events affecting the sharemarket during the year are shown below:



1. February – March: Shanghai stockmarket falls over 9% in a day, prompting Alan Greenspan to warn of a possible US recession. The Australian market (having just hit the 6000 milestone for the first time) suffers a 400 point fall in the week, but regains previous highs a month later.
2. In August, having largely turned a blind eye to credit markets, the stockmarket plunged 15% after sub-prime losses spread from hedge funds to banks. However, at the first sign of central bank action, the market staged an astonishingly rapid recovery and set new highs at the end of October.
3. The rally ended with the US Fed's change of rhetoric implying the end of the rate cutting cycle. While prices were already falling, the (near?) collapse of Centro and the unwinding of Société Generale's EUR 80bn rogue trade sent the broad index plummeting to year's lows before the Fed's change of heart saw the strongest 3 day spike since 1987.

The recent lows marked a fall of more than 20% from the peak – an official "bear market." However, by the time investors were reading it in the papers, the US Fed had already cut rates aggressively in their January emergency meeting and the futures market was already indicating a gain of more than 200 points. The "bear market" therefore lasted less than 12 hours!

There seems no reason economically that growth cannot continue at a modest rate in line with long-term returns (as opposed to the spectacular returns of the last 4 years). Global growth has been as synchronised throughout the world as most commentators can remember. China, and hence much of Australia, is booming, the EU and Japan are growing and even the laggard US continues to report positive economic growth. Expectations of a mild

US slowdown have alarmed markets, but now appear to have been priced in at the cheap earnings multiples that now apply.

The biggest barrier is sentiment. The poor lending practices in a property boom that led to the losses in US sub-prime mortgages may well have been replicated amongst borrowers with good histories. Spill-over losses, and generalised fear about where losses could be discovered next, have led to periodic desertion of risky assets. These have typically been followed by extraordinarily strong recoveries from oversold levels, usually prompted by central bank actions.

Our cautious view is that the correction results in a combination of good value in stocks AND a strong global economic environment with relatively low inflation and borrowing costs - this should sound like a buying opportunity. However, it is difficult to imagine a strong uptrend until credit conditions resolve themselves. While the difficult credit conditions persist, there is a constant threat hanging over the equity market:

- That some companies will produce the wrong kind of headlines by being unable to manage its balance sheet, following RAMS and Centro;
- The higher credit costs, and in Australia rising interest rates, will flow through to aggregate corporate earnings – at a time when the more economically sensitive companies are already producing occasional earnings disappointments.

Quite apart from slowing US economic growth, credit conditions are also placing other strains on the sharemarket:

- Companies are being more careful in their balance sheet management, minimising debt at the expense of stock buy-backs;
- Leveraged buyout activity (the dominant driver of stock prices through much of 2006-07) has slowed to a crawl due to the near impossibility of obtaining LBO debt at viable prices;
- Slowing global economic growth as the sub-prime crisis bites into the real economy would inevitably weigh on commodity prices and hence resource earnings.

Increased corporate merger activity replacing private equity buying would provide support for the view that the market is cheap at these levels. The mega-takeover bid by BHP Billiton for Rio Tinto confirms that debt is available, but lenders are more likely to favour the largest and strongest than a buyout fund. Corporate activity is therefore likely to be directed at mergers and consolidation.

Equity Investment Alternatives

Investors will need to consider their approach to growth assets:

> *Long-term investor* – happy to accept market fluctuations, not seeking to add value through market timing except perhaps through rebalancing to their long-term allocation should prices get too far out of line.
>
> *Momentum investor* – looking to avoid down markets. Happy to buy higher in order to participate in strong markets. However, they risk selling lows, and repeatedly buying highs before suffering further losses if markets whip-saw up and down. (As it did in January.)
>
> *Value investor* – buying weakness where share price movements overshoot earnings fundamentals. Nerves (and stakeholder support) strong enough to buy when the news is very grim. Conversely, if prices run ahead of fundamentals, selling when there is no reason to and when all news is universally positive.

The middle approach is the most difficult of all. For most investors, the less ambitious first option is the one less vulnerable to disappointment. Nothing in the recent market movements invalidates the principles of long-term investment, although at the lows the range had been among the larger in recent times.

Also, the appropriate choice of vehicle is important. Depending on regulation, there are three significant approaches:

Sector funds – these enable more specifically targeted investments to be made, and asset allocation to be more precisely managed. However, the volatility of individual investments will generally be greater.

Balanced funds – these are likely to be less volatile than individual sectors. The manager is able to implement some asset allocation decisions, within ranges. This takes some decisions away from the investor – for example, one who already holds other cash and bond investments will generally not be able to avoid getting more in Balanced funds.

Capital-protected notes – these will often have a risk of deleverage events, in which equity allocations are reduced in the event of a market fall. This is not a theoretical risk – many notes have suffered partial deleverage recently. Apart from the real and political benefits capital protection, notes do offer the advantage of hold-to-maturity accounting treatment in some cases.

Our Advice

It is unambiguously getting more difficult for share prices now than it was earlier in the year. However, the corporate sector overall has continued to produce strong earnings – the resource sector the major beneficiary of strong export conditions.

Investors will be looking to the completion of the current "earnings season." At this stage, Citigroup is forecasting a year-on-year growth for 2007-08 of +8.4%, in which case the case for ongoing share price growth would be well and truly intact. A broad-based disappointment would make it very difficult for shares to outperform cash as earnings multiples are unlikely to expand in an earnings-recession.

We believe that valuations are now attractive from a medium-term perspective, even taking into account the difficulties stemming from slower economic growth and tighter credit. However, we do not anticipate the level of returns in 2008 that investors had grown accustomed to in recent times. Traditional returns of a few % points above cash rates would be a more than acceptable result given the maturity of the economic cycle.

DIRECT SECURITIES REPORT
JANUARY 2008

Property

Warnings about inability to roll their maturing debt brought about a collapse in the values of Centro group companies. Centro Group itself (ASX: CNP) has already slid from $10 to near $6, but now trades for around 50c (down 50%)[1] with Centro Retail (ASX: CER) managed by Centro also in deep trouble. It is effectively now an option over some residual value that might be retained if an acceptable asset sale / recapitalisation programme can be arranged.

The fear that this is not an isolated instance caused the rest of the sector to fall dramatically, particularly highly geared trusts with US assets. This report looks at what happened to the sector, and the outlook for the sector going forward – is this a "guilt by association" or is there a fundamental problem in the sector?

We believe that with the cautionary example of Centro and now MFS, there will be no other situations like these – all will allow plenty of time to finalise debt rollovers and/or raise capital.

Summary of Events

- The cost of commercial mortgage funding in the US had been tracking wider through 2H07, partly in sympathy with all credit assets after the sub-prime crisis, but partly reflecting particular concerns about peaking property prices.
- The Listed Property index (ASX200 Property) had been weak through this period, in a proportionate response to funding costs.
- Initially, CNP intended to fund their debt in US commercial mortgage-backed securities. The cost proved prohibitive, and they turned their attention to bank debt.
- On December 13th, CNP and CER entered a trading halt. They subsequently advised that this was in anticipation of having to downgrade its forecast distribution on learning that debt costs were higher than expected.
- Over that weekend they found that, not only was debt more expensive than expected, but in fact they could not complete their rollover. An interim extension to February 15th was agreed with their banks, pending an action plan for asset sales or other measures to reduce gearing.
- The fall on relisting from $6 to under $1 put paid to hopes of a rights issue – they are now reliant on either selling properties, funds, management rights, or an outright takeover to achieve any material value for shareholders.
- Meanwhile, the entire sector has been regarded with extreme scepticism by the market, even those without impending debt maturities.

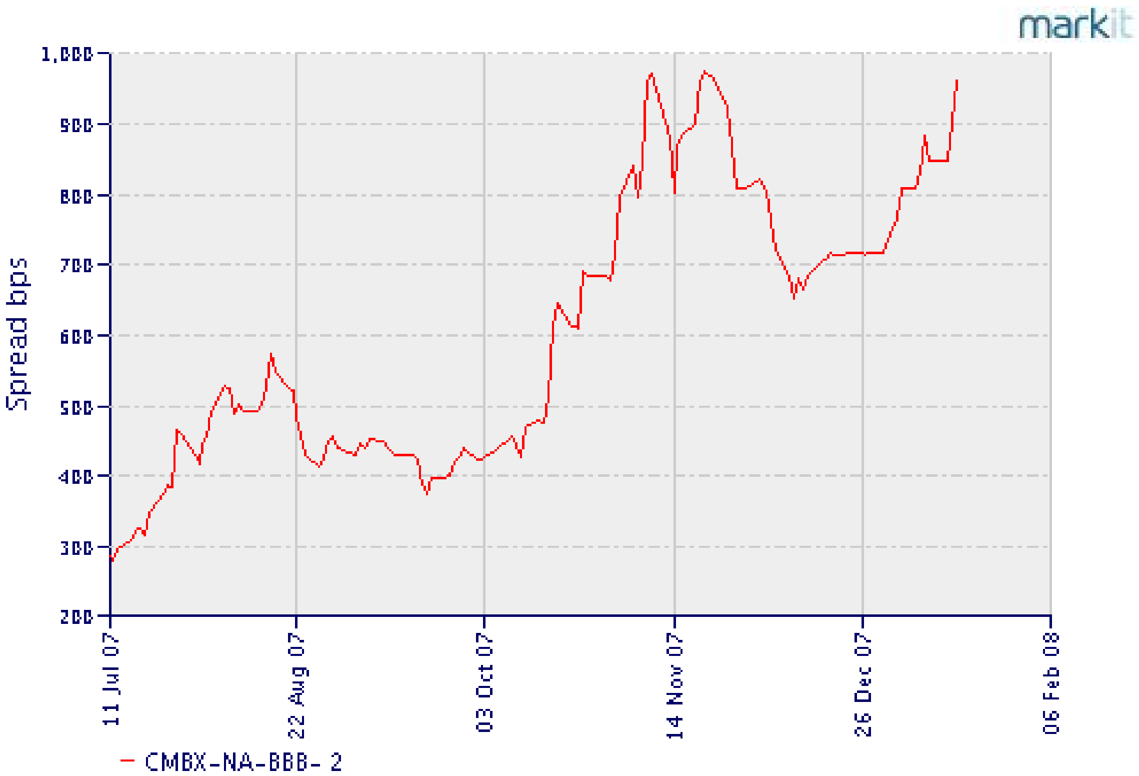
Debt Costs

Commercial mortgage-backed securities (CMBS) have been trading as if they are the "next sub-prime" despite little apparent similarity other than their "tranching" into multiple slices from first-loss to super-senior. On the face of it, the security should be better quality properties, with income secured by long leases to major corporations. There are none of the traits that led to the sub-prime debacle.

Except one – a perception (if not yet stastically documented) of falling underlying property prices and hence diminishing security for the mortgage. The result has been even investment-grade loans trading like junk – the following graph shows some recent indices of CMBS (known as the "CMBX (Series 2)":

[1] Interestingly, the most recent revised guidance for FY08 distribution was around 40c!

Chart 2



Note that this BBB- index was originally issued at an average 87bp spread, compared to the current **962**! The strong perception by the market is that many investment-grade CMBS in the US will default – somewhat short of the universal default of recent BBB (and A) rated sub-prime factored by the market, but certainly far outside the rating expectations.

Interestingly, unlike 2006 sub-prime which has now started its downgrade progression, the CMBX components have all kept their ratings.

(The corresponding AAA tranche trades at a spread of 81.67bp, compared to its initial spread of 7bp!)

In this debt market, it is not surprising that funding costs have risen sharply; inevitably this will flow through to the value that acquirers are prepared to pay and particularly the level of interest in the sector from private equity. Volumes are also down over 80% from their peak.

Not surprisingly, Centro decided to pursue bank debt rather than the US CMBS market. What is surprising is that circumstances led to this being conducted so late that debt refinancing could not be completed – especially in this market. It appears from public comment that they had relied on being able to achieve CMBS funding, and did not have a back-up.

Effect on Centro Companies

The effect on the price of their securities has been catastrophic:

Chart 3

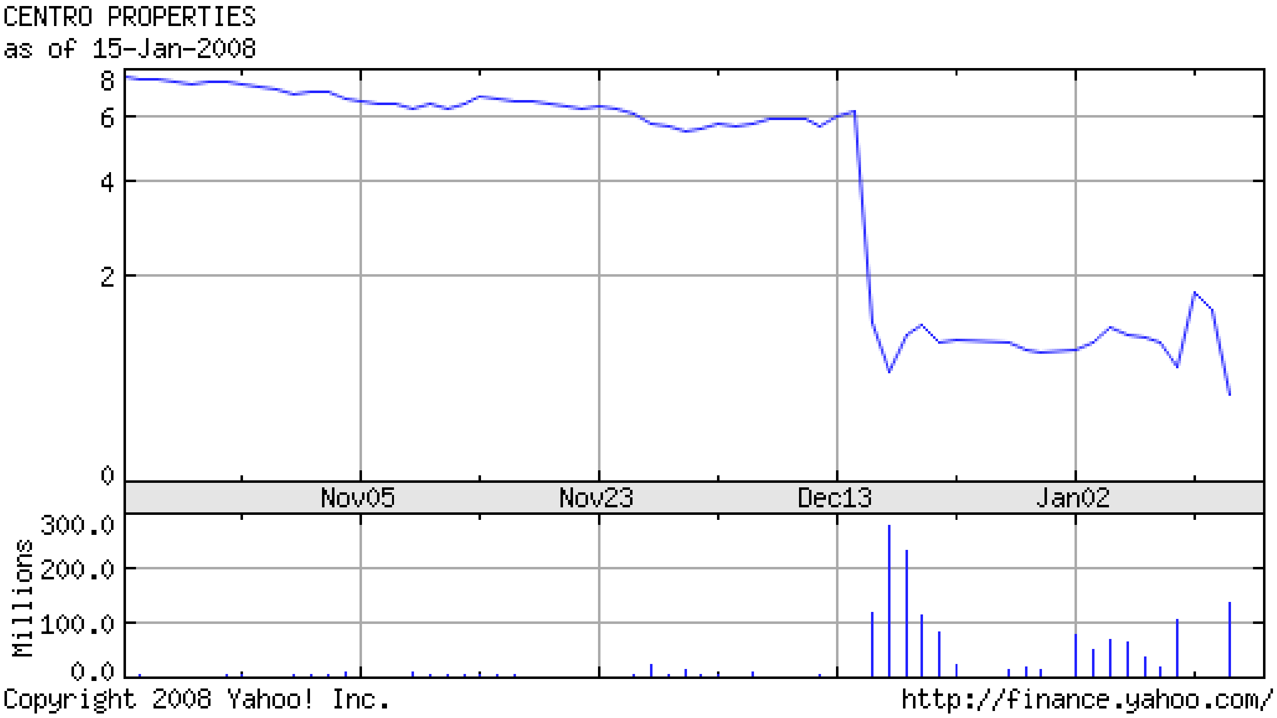
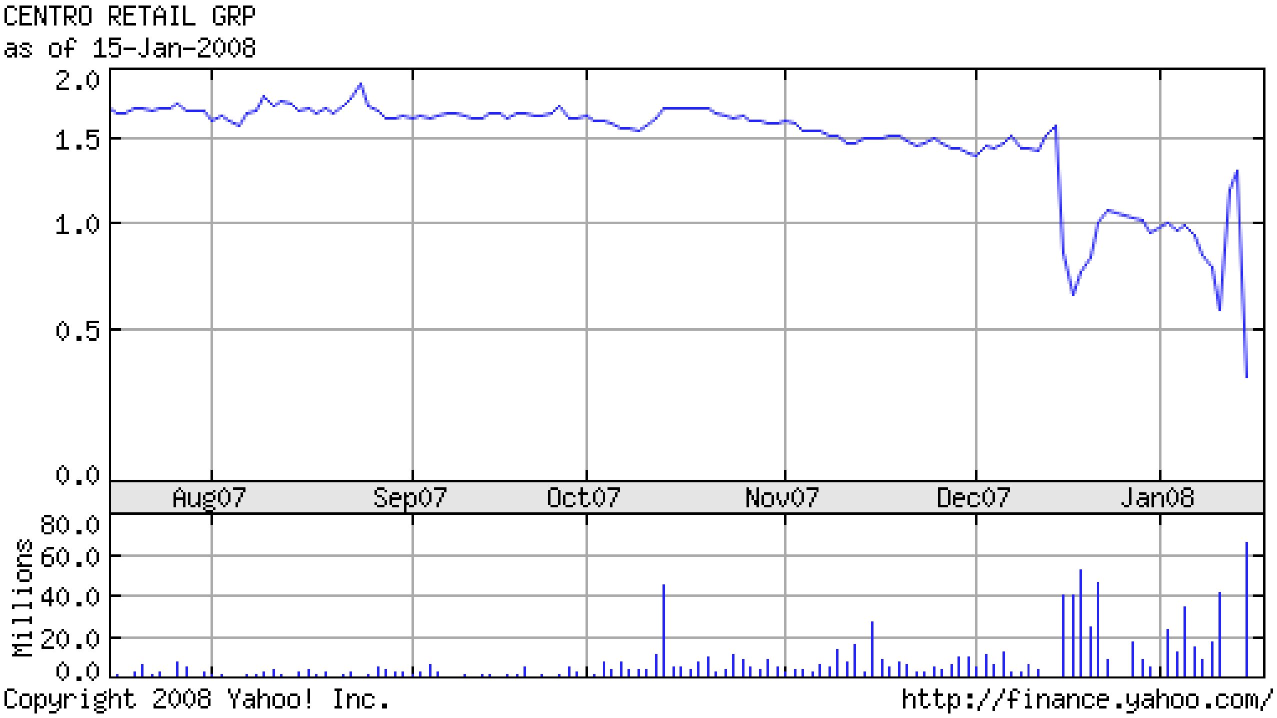


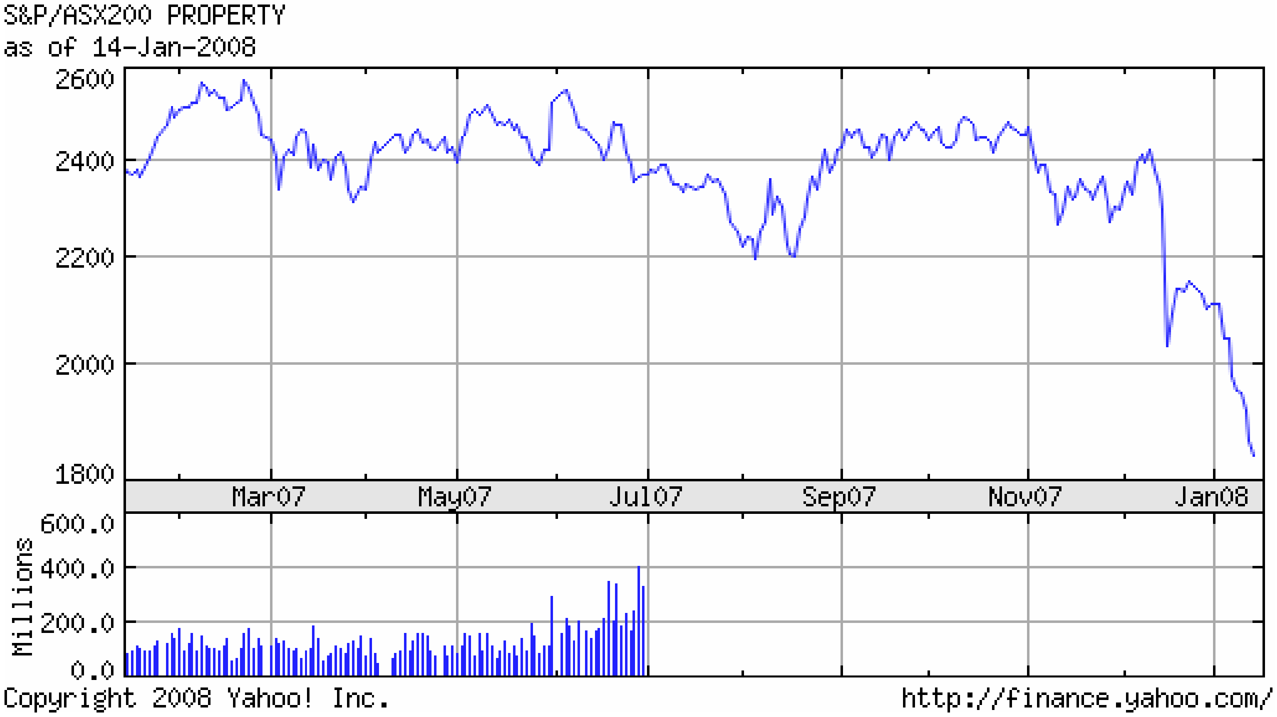
Chart 4



Index and History

Even though Centro was just a few percent of the ASX 200 Property Index, the effect has been dramatic. The entire sector is well off its highs, with the bulk of the fall coming in the last month:

Chart 5



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This is very nearly equivalent to a crash of 1987, although of course nowhere near as broad-based (the fall in the ASX 200 is about half as severe).

This size of fall in the property sector is reminiscent of the crash that followed the property bubble of the late 1980’s, after a combination of falling interest rates in 1987-88, and fear of shares after the 1987 crash drove investors towards property. However, conditions then were very different:

Then	Now
Speculative over-building – double digit vacancies	Very tight market; low vacancies, developments pre-committed, not speculative
Soaring interest rates (to high teens)	Modest interest rates, 6% bond yields
Falling rents (due to excessive vacancies aggravated by recession)	Tight vacancies and strong economic growth driving strong rentals.
Shares comparatively very cheap (down 50% from 1987 highs)	Shares fairly priced, well off 2003 lows

Cycles do repeat, but in this case they repeat for totally different reasons – underlying property earnings have been sound and it has been predominantly a funding / valuation re-rating driven event.

Rest of Sector

The rest of the sector were quick to distance themselves from the Centro debacle – all quickly reiterated December distribution guidance, and confirmed that they had no material impending maturities to be dealt with. They have provided significantly greater information to the market about debt maturity schedules than had been released previously. In general, debt maturity profiles are very manageable and companies will be in detailed discussions with their lenders about the capacity of their debt to be rolled given current market conditions. This is particularly critical to companies with significant US exposure, given the slowing economy and turnover.

This provides some comfort. However, in an environment where equal proportions of debt and equity have become the norm, lenders appear to want more conservative gearing. The depressed security prices make it difficult to raise capital without appearing “desperate” and creating rumours of a capital shortfall. At some point, debt will have to be rolled.

UBS have indicated (*Australian Financial Review*, 18 January) that 50% debt : total assets is sustainable, based on actual transactions from the US where this level of gearing has been supported by banks. While many property companies approach this target, they are not in significant danger as there are options for massaging gearing downwards.

Options available for modest additional capital-raisings include:

- mandatory / underwritten dividend reinvestment plans (which increases the equity base by 10-15% p.a. at current yields), or
- strategic shareholdings.

However, we believe that the third option - major rights issues - are not feasible.

The 70% plunge in the much smaller MFS Group suggests that large rights issues are not possible in this market. The perception of the market is that anyone announcing a rights issue at current depressed levels has been advised of a lender revolt and this becomes self-fulfilling as investors flee questionable stocks. Companies with manifestly excessive gearing will find it very difficult to survive without attracting a bailout from “deeper pockets” – either a strategic shareholder, an asset sale to other participants with excess capital, or a full takeover.

The eventual outcome of the Centro and MFS debacles will be a pointer to the degree to which strategic shareholders (either trade buyers, or private equity) are interested in the sector.

Capital-Protected Notes

A number of partial deleverage events of notes referencing the domestic property sector (and broader equities exposures, which we will cover in another note) have resulted from either inclusion of Centro companies directly, or due to the extent of the accompanying falls in the broader property sector.

Due to the terms of these notes, income will either be reduced or suspended – your Grove advisor can run through the implications for your specific holdings.

In each case, they retain a significant exposure to any recovery – none are fully deleveraged. Typically the reduction in exposure was from $100 to 65-75%.

Global property has also suffered, and partial deleverage is common.

Another Global Property Note issued by Lehman Bros and widely held is not a CPPI structure. It is a coupon participation structure. It appears likely that this note will pay no income over its life.

Outlook

We expect there will be a very small minority that will join Centro – MFS is in grave trouble but is too small to trouble a diversified property holding.

We expect that there will be capital raisings – acquisitive companies will be looking to reduce their debt, and even companies within their target gearing ranges will look to create a margin for safety. In general capital raisings are expected to be modest and not unduly disruptive.

In an environment of forced sales and tighter funding, there will not be near-term asset price growth and valuers may well start increasing capitalisation rates (decreasing valuations). Any Centro asset sales will provide a better near-term indication of where actual transactions take place, and how large the implied writedowns between carrying values and forced sale values. This should put a floor under sector valuations.

Over the slightly longer term, a renewal of interest in the sector by private equity (who were the primary drivers of prices a year ago) would be a major positive.

Upside Case

Double digit yields are prevalent for the first time in a decade. There is a lot of capital around, from Westfield Group (fresh from strengthening its acquisition capability with an equity raising and asset sales), to private equity funds. We anticipate private equity will be looking at the opportunity provided by the sharp price falls, as they had been very active in property at far higher prices in 2006 and early 2007.

Downside Case

Centro is unable to attract a strategic investor, and has to sell assets at a deep discount to stated value. It is unable to roll its debt and goes into receivership – the subsequent firesale implies major writedowns across the entire sector.

We do not provide a return forecast or nominate a precise turning point, but we consider the size of falls already at the extreme end of market ranges. The sector appears cheap on most measures, and may well provide lower risk value after some clarity emerges about financing and transaction prices. With few other assets appearing cheap, this may be an area of interest going forward.

Grove Research and Advisory

January 2008

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At our recent discussion with Council, we discussed a number of investment alternatives. This note documents the discussion.

Return Target

We are supportive of a target of BBSW+50bp, and believe it is readily achievable going forward, given the yields available in the current environment.

However, we caution that only a small subset of investments would be capable of ensuring this kind of return consistently on a mark-to-market basis. There is a trade-off:

- Longer-dated debt tends to have higher yields, and more importantly lock in above-target income for their duration, but at the cost of higher market volatility;
- Shorter-dated debt will not experience a volatile market price (in the absence of credit distress of the issuer), but risks there being a shortage of high yield replacements at maturity should high credit spreads prove a short-term phenomenon.

Certainly there should be no expectation that a portfolio including a substantial allocation to growth assets would consistently achieve this hurdle.

We therefore consider the indicative level to be appropriate as a prospective target *over a full market cycle*, and a tacit acceptance of some market risk and volatility of actual results to achieve it. The target is a valuable one for guiding against becoming overly (and inappropriately) defensive, as it is easy to do at a time of negative headlines.

The events of the past 6 months, particularly as they have manifested in the Local Government sector, certainly made it clear that promises of consistent excess returns without risk were illusory.

Defensive Assets

The fall in market prices has created the opportunity to purchase short-dated bank paper at very attractive yields as a substitute for deposit-style products. Even at the defensive end, Council's yield target of BBSW+50bp can be achieved with minimal price volatility.

Two recent examples of senior debt have been

- Adelaide Bank May 2009 FRN: **BBSW+90bp** p.a.
- Bank of Queensland June 2009 FRN: **BBSW+85bp** p.a.

The accounting treatment is outside the scope of Grove's role and will depend largely on Council's accounting policies. However, we note that at June 30 these will be within 12 months of maturity.

(The same institutions would pay around 12 months BBSW+10bp for 12 month deposits.)

Availability will be a function of broker holdings at any given time and are not predictable in advance. Therefore, an "in principle" decision to invest ahead of actual availability would make it more likely to be ready to respond to opportunities – we can discuss further as specific examples come to hand. We note that an offer for Adelaide Bank senior 2009 debt is current today.

However, we believe there will be forced selling over time of a range of investors, where they are holding illiquid assets and therefore forced to fund their normal activities by selling their saleable securities.

Intermediate Assets

Major bank subordinated debt has recently been issued at **BBSW+120bp**, and may trade even wider on the secondary market.

Sub-debt is issued for 5-year "*non-call*" terms, with an additional 5 years at the election of the *issuer*. Coupons step up by 0.5% p.a. if not called. Market convention is to describe and price the securities to the call dates, and it is therefore regarded as a 5-year note.

There are also regularly parcels for sale at shorter terms to call date, and therefore lower margins.

Large quantities can be purchased at issue. Opportunities arise regularly, but are typically only flagged hours ahead of closing. Council would need to formulate an indicative intent to participate in future sub-debt issues, and be ready to give instructions on a same-day basis. However, settlement can ordinarily be effected on the usual T+3 basis after giving instructions.

Alternatively, secondary market parcels become available on an unpredictable basis.

Call Dates

Despite the convention, there is a possibility that sub-debt is not called. While the yield steps up at that point, by definition this would only be done if funding costs were higher. Therefore, uncalled sub-debt would trade at a discount to par.

The incentives to call are:

- Avoidance of the ½% step-up.
- Reputation risk – an institution that fails to call would not only alienate their investor base, they would be flagging funding problems and likely cause significant consternation amongst their depositors.
- Capital charges – uncalled sub-debt loses 20% of their equity treatment each year (for APRA purposes), leaving the bank to replace it with even more expensive equity instruments. This makes it very expensive to not replace sub-debt.

NSWTC Hour-Glass Facilities

The Long-term Hour-Glass Facility is the only alternative to capital-protected equity products under the Minister's Order.

While the lack of capital protection can be problematic politically, the reality is negative returns on a 70/30 growth fund over the 7-year timeframe of a typical guaranteed note are extremely rare.

Capital-protected vehicles can give conservative investors a politically palatable alternative that "can't lose money" (although of course can make no money for many years in the worst case). They are also amenable to "hold-to-maturity" accounting treatment that cannot be applied to TCorp.

The offsetting advantages of the TCorp product are:

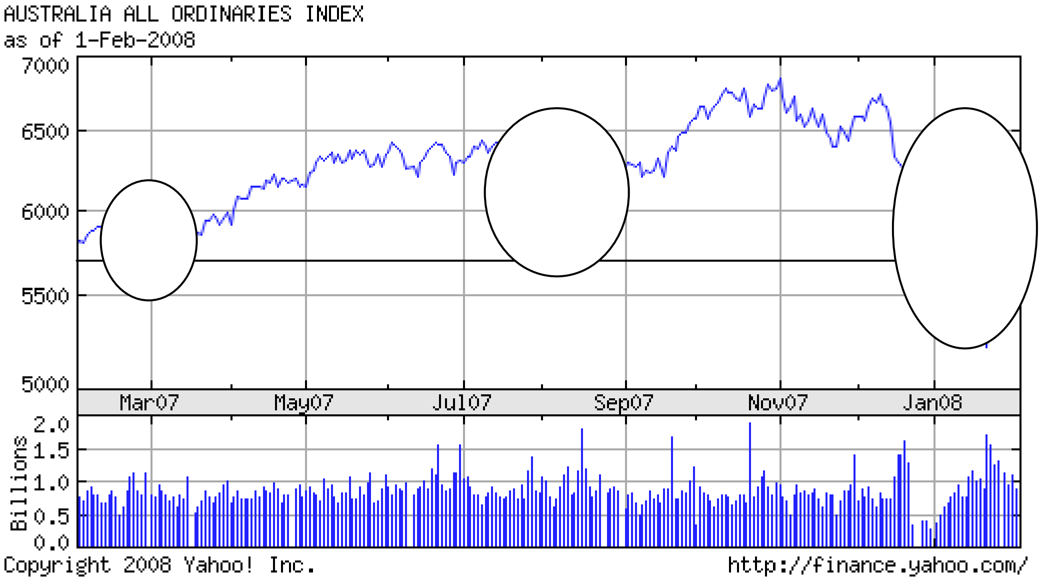
- Far lower fees, both up-front and ongoing
- No deleverage risk – the Hour-Glass participates fully in market movements, both up and down. (By contrast, an equity linked note can partially or fully reduce exposure to the market after a serious fall.)
- Income continues to be paid based on the underlying income of the portfolio. (Capital-protected notes can suspend dividends to rectify or avoid a partial deleverage event; in a full deleverage they will generally not pay any dividends at all.)

Timing

Timing equity investments is always a dangerous business. However, we do make the following observations:

The Australian stockmarket has suffered a significant retracement of recent strong gains and is now at levels at which investors appear to be happy to buy during recent events:

Chart 6



Circled events are:

- the Shanghai market correction, accompanied by Alan Greenspan's speculation about US recession
- sub-prime, and the collapse of two German banks
- adverse global reaction to US central banks, aggravated by Centro fallout and then by the unwind of a EUR50bn equity futures "rogue trade" by Société Generale.

The market may also be supported by the change in focus by the US Federal Reserve to defending the economy from recession, effectively abandoning inflation targeting for the time being.

In previous financial crises, the US Fed has been able to use monetary policy to defend both economic and financial conditions. We believe they will ultimately be successful again, and consider the massive interest rate cuts in January a potential market turning point. Easy policy could well trigger a new round of asset price growth:

- directly (through comparison with cash yields);
- through the impact on corporate earnings (with companies paying lower interest rates for their borrowing); and
- by re-activating a takeover and acquisition boom (corporate mergers, or private equity leveraged buyouts) – already we have seen Microsoft move on Yahoo! in the largest tech merger ever proposed.

The experience of the 1990s and 2000s suggest an asset price bubble is likely to form in an environment of easy money. US housing is likely to be the weakest asset sector. If the intention is to reflate housing to defend the banking system then other, stronger, sectors are likely to perform well over the medium term.

Should you have any further queries, please do not hesitate in contacting our office on 9264-0001.

Yours sincerely,

Brett Sanders / Andrew Vallner

Encl:

- Grove research profile on TCorp Hour-Glass Long-Term Facility
- ANZ securities offers

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Further to our discussion on Friday, we provide additional comment about the recent returns from the BlackRock Diversified Credit Fund, and the implications for that investment.

UNDERLYING ASSETS

BlackRock invests in the same assets as other credit funds, although their fund is more heavily tilted to major global banks and financial institutions.

A more detailed list of exposures is as follows (managers prefer their detailed allocations to be kept in confidence, but they are listed highest to lowest):

- Banks (senior, subordinated debt and "Tier 1" capital *i.e.* hybrids);
- Corporate debt;
- Residential mortgage-backed securities (Australian only – no U.S.);
- Major insurers;
- Cash;
- Listed property trust debt, and commercial mortgage-backed securities;
- Asset-backed (*e.g.* short dated CDOs; car lease and medical equipment securitisations)

BlackRock maintains an unusually high allocation to overseas credits (just over 50%) – given the objectives of the fund is to be overweight major money-centre banks and financial institutions, there are very few in Australia matching this description. All assets, of course, are either issued in $A or completely hedged to $A, and are floating rate.

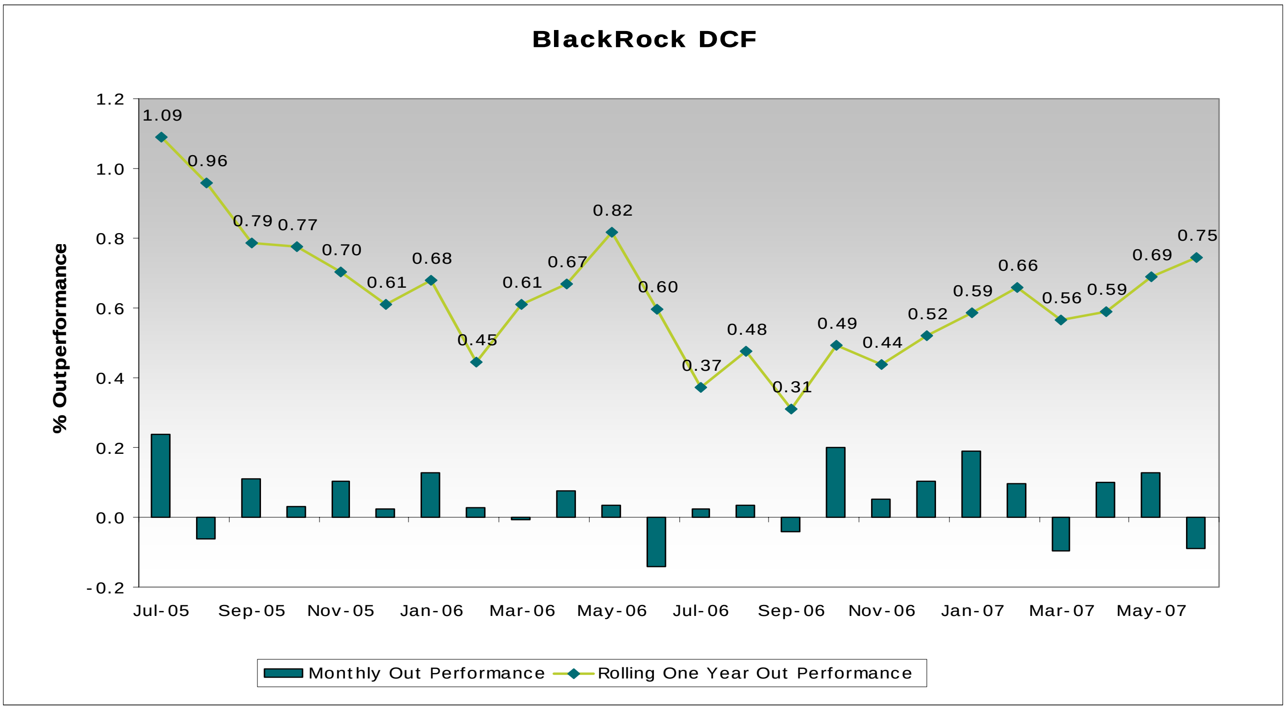
Less than 1% of the fund is invested in low risk CDOs nearing maturity – these assets have had no material effect (up or down) on performance.

WHY BLACKROCK?

We have, of course, met regularly with BlackRock's managers and qualitatively assessed their capability in terms of personnel and experience, technology, access to a global credit research network, and reputation.

The BlackRock fund has had, for a number of years, a sound performance history and was consistently either first, second or third on the Grove Performance Survey. At June 30, it was equal first over 1 year (at more than 100bp, or 1%, over bills), and second over longer terms to the traditionally more volatile Colonial First State Global Credit Income Fund. Volatility had been very modest – the worst month in the fund's history returned +33bp (14bp below bills).

Chart 7



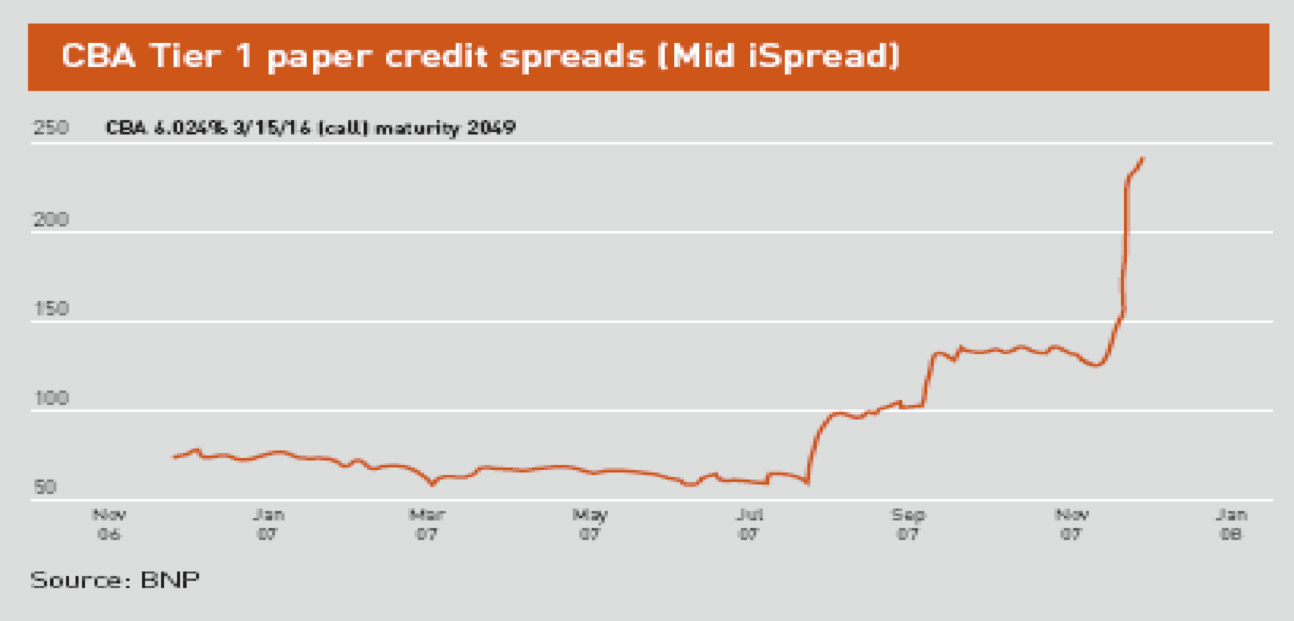
We saw BlackRock as bringing near CDO-like returns with superior credit quality. We considered a top-performing fund that was heavily invested in major bank debt would represent a defensive investment, for a number of reasons:

- Major money-centre banks are very large, profitable and highly rated – before (and even during) the credit crisis they were regularly receiving credit rating upgrades, as did the 4 Australian major banks from AA- to AA during 2007.
- Banks are not subject to the debt-funded leveraged buyouts that regularly saw corporates downgraded from BBB range to B range – a B rated bank is not a competitive entity, so acquisitions are almost always by a larger bank (thereby improving credit quality and producing capital gains to credit investors).
- When a corporate (or for that matter a CDO) suffers credit distress or default, it is highly unlikely that there will be a bailout package. However, when the stability of the financial system is threatened, it is in the interest of all parties to protect the weak. Witness the recapitalisation and central bank support now given to groups such as Northern Rock, Countrywide, E*Trade and even Citi, as well as the $100bn "M-LEC" fund mooted in consultation with the US Treasury (not to mention the 32-bank syndicate set up after the collapse of Long Term Capital Management in 1998).
- In previous periods of credit losses, major banks had readily attracted capital (for example, the Saudi royal family previously invested in Citigroup, and recently increased their investment).

COMPARISON TO COMPETING INVESTMENTS

BlackRock's underperformance has been in line with that of bank paper globally – what was previously priced at a level reflecting the outstanding global economic environment, it is now priced for the depths of recession. For example, few investors would have any fears for the solvency of the Commonwealth Bank of Australia, but this is how their Tier 1 debt is trading:

Chart 2



CBA Tier 1 paper credit spreads (Mid iSpread)

Source: BNP

(Note: As spreads rise, values fall – obviously, investors will pay less for an existing credit instrument if they can earn better spreads from new ones.)

The same equation applies equally to Deutsche Bank, Bank of America, Barclays and the other global peers of CBA.

While BlackRock also holds a small allocation to smaller institutions such as the major investment banks (including Merrill Lynch), for such institutions only senior debt is held.

Overall, the BlackRock fund is yielding around 8.5%, which (as they point out) is vastly higher than the term deposit rates of the same institutions. However, the yield has obviously been swamped by movements in capital values, and will likely continue to be (in both directions) until markets return to normal liquidity. It has certainly been less volatile than other medium-term investments, even ones as conservative as bank sub-debt.

Arguments for Retention

BlackRock have displayed faith in the strategy with their own money going forward.

- They have offered to rebate management fees if returns over the coming 6 months do not cover bank bills net of their fees.
- BlackRock have used their balanced funds to increase allocation to credit – switching from the Diversified Credit Fund to the more aggressive and therefore unrated, Monthly Income Fund. This fund carries roughly double the credit allocation of the DCF (and the November result has been roughly twice as extreme).

Also, there are macro reasons to believe that the credit event may be ending:

- From September 19, when the US Federal Reserve first cut interest rates, BlackRock returned around 2% in the next 4 weeks (i.e. nearly 4 times the cash rate). The extreme underperformance of November followed market disappointment when the Fed implied the rate cutting cycle may be over. The last week of November saw statements from Fed officials, including Chairman Bernanke, implying that they understand the gravity of the situation and that rates will be cut again. They went on to cut by an unprecedented 1.25% in January.
- Successful implementation of the M-LEC would remove a major source of selling pressure of quality assets at these distressed levels, taking pressure off bank paper and prime mortgage-backed securities. (It cannot protect institutions from sub-prime losses they have already incurred, but with sub-prime paper trading near zero anyway it is difficult to imagine material further losses there.)

- Many new sub-prime loss announcements have been met with stock prices rising as the market took comfort that losses were immaterial to solvency (of the order of one quarter's profits) and that the was not a previously-undiscovered catastrophe revealed.
- Likelihood of specific action to help sub-prime borrowers directly – Federal loan insurance enabling refinance, freezing rates, cutting loan margins to affordable levels, partial forbearance (rather than foreclosure), and potentially Federal subsidy programmes.

Given the unique circumstances surrounding the current market conditions, the normal buy / sell spread is not nearly adequate to cover transaction charges to the fund. Accordingly, BlackRock has instituted a change whereby redeeming investors will bear the full cost to the fund of any redemption they make. For redeeming investors, this passing on of transactions charges can be significant. Charges are not fixed in advance as they are a function of bid / offer spreads in the credit markets on a given day (again see our note below for more explanation of that). However, BlackRock's best estimate of that in current market conditions is transaction charges have ranged as high as 1 – 2%. In 2008, a modest improvement in liquidity offshore has seen this fall below ½% on most days.

Whilst introduction of this process is disappointing for redeeming investors, it is actually good news for continuing investors in that it ensures that they are not bearing the transaction costs of others. Grove has reviewed the Product Disclosure Statement for the BlackRock Diversified Credit Fund and confirmed that BlackRock's actions are in accordance with the disclosure document. We support the steps they have taken as being consistent with equitable treatment of investors. At these prices we find it impossible to recommend paying an additional charge to redeem.

Arguments against Retention

Other concerns include the possibility that conditions could deteriorate further – no matter how weak the pricing of credit assets currently, there is always the possibility that they could trade even wider. Possible triggers include:

- A decision by the US Federal Reserve to tolerate a recession rather than cut rates excessively – reasons might include fear of the "moral hazard" perception in which risk-takers are rewarded, worry about a plunging $US, and wanting to avoid a surge in inflation.
- New, undiscovered losses bringing down a substantial institution, for example the inability to recapitalise the bond and mortgage insurers.
- An extreme housing collapse leading to similar problems in prime mortgages (which would certainly threaten the amount of free capital available to the financial system).
- With the M-LEC now unlikely to be established (as banks preferred to raise capital and take the assets back onto their balance sheets), evidence that selling of credit assets continues unabated.
- US slowdown turning into a major recession.

Recommendation

We have not lost faith in the capabilities of the manager, and we consider the underlying assets' yield is highly attractive relative to their credit quality. This is not a situation where a manager has lost money on defaults or inappropriate trades. On that basis, we would not downgrade the fund to "Sell" at what is an historically extreme point in asset values.

Indeed, an extreme point roughly equal to that reached in the deep global recession 2002, despite a diametrically opposed economic environment.

Referring to Chart 2, we believe that a decision about a fund should be regarded as a **decision about the underlying assets** – the holding should be sold if the investor would make the same decision about a direct investment. If Council had bought the CBA investment shown above, would you now sell it at the current price? You would only do so if:

- You were concerned about the solvency of the bank;
- You felt the environment for credit will deteriorate further, to an extent not factored in the current price and that the price will fall further (which is of course possible); or
- That the risks in their totality (both the risk of price movements tomorrow, and the risks of bonds not being repaid at maturity) exceed the reward available from the investment.

We note that falling asset prices do not appear to have led to any significant selling of FRNs and CDOs held directly and in fact investors are happy to buy them at what they consider very attractive yields.

Having said that, we acknowledge that the decision to hold or divest is solely that of the investor, who may have considerations other than simply asset valuation.

Retaining any assets would involve some investment risk, and it is very easy to take the view that "There is going to be more bad news to come" – particularly in relation to sub-prime and its fallout on financial institutions. There certainly will be more negative announcements, but for spreads to go wider still would require news that is unexpected, not priced into the market (which in financials is already pricing for a 2002-style disaster), and without offsetting good news. Credit investors do not need any recovery – simply maintaining the status quo would result in a favourable outcome going forward given the very high yield of the fund's assets.

Chart 3

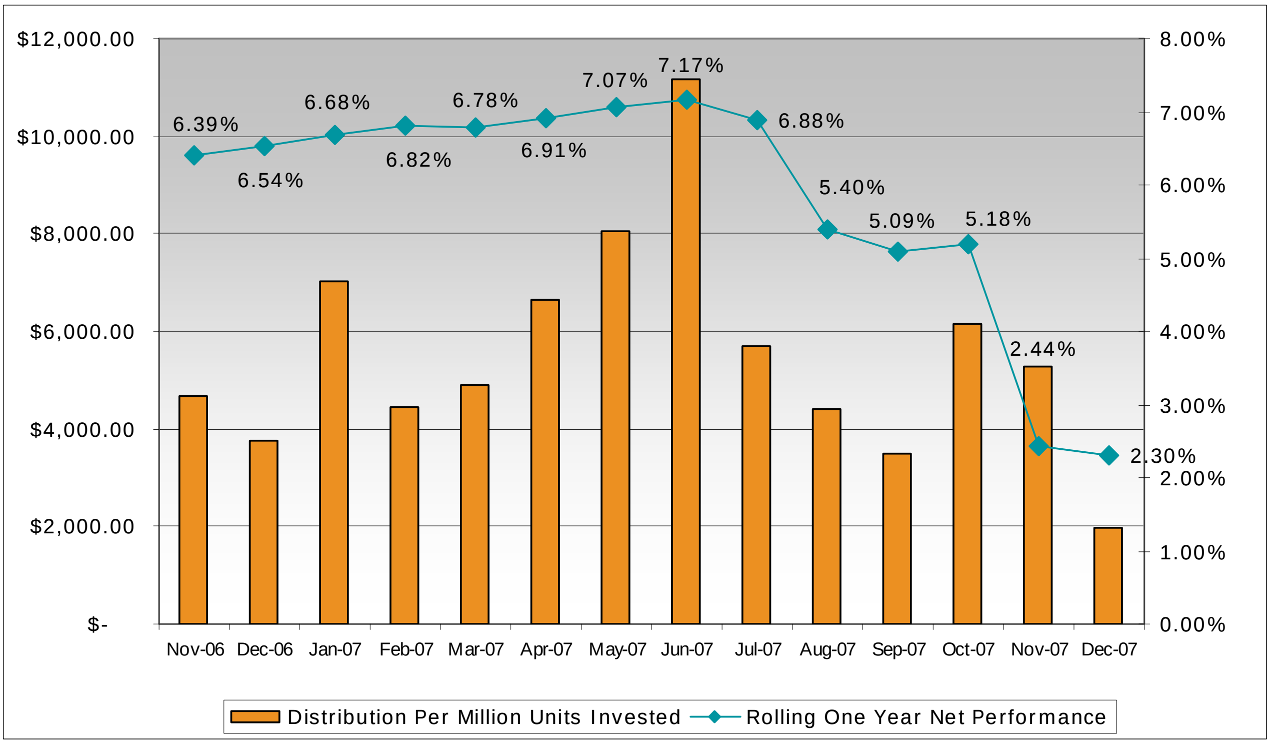


Table 1

Date	Distribution (cents per unit)	Distribution ($ per unit)	Distribution Per Million Units Invested	Cum-Price	Exit Price	Net Return*	Rolling One Year Net Performance	Rolling One Year UBSA Bank Bill Index
30/11/2006	0.4670	0.0047	$ 4,670.00	1.0053	1.0006	0.56%	6.39%	5.96%
31/12/2006	0.3760	0.0038	$ 3,760.00	1.0069	1.0031	0.63%	6.54%	6.02%
31/01/2007	0.7020	0.0070	$ 7,020.00	1.0104	1.0034	0.72%	6.68%	6.09%
28/02/2007	0.4460	0.0045	$ 4,460.00	1.0093	1.0048	0.59%	6.82%	6.16%
31/03/2007	0.4880	0.0049	$ 4,880.00	1.0092	1.0043	0.43%	6.78%	6.21%
30/04/2007	0.6650	0.0067	$ 6,650.00	1.0107	1.0041	0.64%	6.91%	6.32%
31/05/2007	0.8040	0.0080	$ 8,040.00	1.0106	1.0026	0.65%	7.07%	6.38%
30/06/2007	1.1150	0.0112	$ 11,150.00	1.0070	0.9959	0.44%	7.17%	6.42%
31/07/2007	0.5690	0.0057	$ 5,690.00	0.9980	0.9923	0.22%	6.88%	6.47%
31/08/2007	0.4420	0.0044	$ 4,420.00	0.9838	0.9794	-0.86%	5.40%	6.48%
30/09/2007	0.3500	0.0035	$ 3,500.00	0.9809	0.9774	0.16%	5.09%	6.54%
31/10/2007	0.6140	0.0061	$ 6,140.00	0.9851	0.9790	0.79%	5.18%	6.61%
30/11/2007	0.5260	0.0053	$ 5,260.00	0.9589	0.9536	-2.05%	2.44%	6.66%
31/12/2007	0.1970	0.0020	$ 1,970.00	0.9587	0.9567	0.53%	2.30%	6.73%

** Based on unit prices sourced from manager's website and not Council's actual return. Returns above are unadjusted for any capital cash flows during the period.*

As can be seen from Chart 3, the “income” distributions paid by BlackRock have been relatively stable. It has been the “growth” component of the fund which has contributed to the underperformance relative to the Index - particularly for the period in financial year to date. This has been due to the re-valuation of the underlying securities in the funds that has resulted in the poor performance. We do think that these re-valuations have been severely dealt with as the repricing of risk and general widening of credit spreads mainly as a result of forced de-leveraging of positions rather than any fundamental weakness.

Should you have any further queries, please do not hesitate in contacting our office on 9264-0001.

Yours sincerely,

AVallner

Brett Sanders / Andrew Vallner

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