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# Financial *focus*

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## MARKET WATCH

### WHAT HAS CAUSED THE VOLATILITY ON FINANCIAL MARKETS?

Global financial markets have been extremely volatile over recent weeks as the stresses in the US financial system have increased. The continued decline in US house prices saw US mortgage giants Fannie Mae and Freddie Mac become insolvent and seized by the US Government in early September.

A week later the 150 year-old US investment bank, Lehman Brothers, filed for bankruptcy protection and subsequently Merrill Lynch agreed to be bought out by the Bank of America. Meanwhile, the largest US insurer, AIG, had difficulties raising funds after suffering from liquidity shortages and was also bailed out by the US Federal Reserve to the tune of US\$85 billion in mid-September.

### DEVELOPMENTS SINCE MID-SEPTEMBER

Over the past weeks, the US Treasury and Federal Reserve have formulated a broad-based solution (known as TARP) by proposing the creation of a government agency to purchase and manage up to US\$700 billion of illiquid mortgage and commercial-related financial assets. These assets have been handicapping bank balance sheets and the lending capacity of US financial institutions.

The passing of the associated legislation by the US Congress expectations are that the package would enhance market liquidity, restore confidence in the US financial system, reduce the 'forced' selling of housing assets and free up the capital on bank balance sheets. These would all be very positive developments.

Earlier this month to the surprise to most observers, the RBA announced a dramatic 1.00% cut to the official interest rate. This is the first cut to interest rates by a full percentage point since May 1992.

## MARKET WATCH

### HOW DID THE GLOBAL SHAREMARKETS REACT?

Given that it has yet to be implemented, the markets to this point have been thoroughly underwhelming in response to the passage of the US Treasury's bail-out package.

This is evidence that a number of things needed to happen, and still need to happen in order for markets to believe that the light at the end of the tunnel is not an oncoming train.

In early and mid-September and now early October there have been large-scale share price losses in all regional markets, led by the financial sector. The share markets have been driven by the primal fear of loss – that more financial institutions may be contaminated by exposure to either troubled US mortgage loans or failing financial institutions, or both.

This has prompted many investors to sell banking and financial stocks displaying to some degree loose faith in the financial system.

Importantly, heightened investor fear over the past year has meant that the global financial system problems were not limited to the financial sector alone. In fact, all global share market sub-sectors have now recorded significant negative returns to date in 2008, in line with softer earnings, weaker growth and investor sentiment.

Over the weekend of 11<sup>th</sup>/12<sup>th</sup> October, in a further attempt to instil investor confidence in Australia's somewhat robust financial system, the Prime Minister, Mr Rudd announced a similar strategy to other global governments, in that the Australian Government will now provide a guarantee (for the next three years) to all depositors' funds held in Australian financial institutions, including our Banks, Credit Co-Operatives and Building societies.

The "G20" countries meeting in the US have also agreed upon and announced an extensive five point plan designed to restore confidence in the global financial systems. Their main objective is to encourage the current liquidity squeeze to be quickly loosened, and to encourage the Global banking systems to begin lending money again to each other, and consequently on to individuals and business in their broader economies.

Just as investors were impatient to buy during the Bull Run, now seemingly they can not wait to sell their holdings. While financial and economic downturns are painful - as we are all experiencing now, they are a healing process. When we eat or drink too much, our body gets sick in order to rid it of the toxins that has built up during our splurge. So it is for the financial system. It is sick. But at the same time it is healing.

The excesses of debt and leverage are being corrected. Balance sheets are being strengthened. The savings rate will improve providing ammunition for renewed consumer spending later. Mortgage defaults will decline and housing will be more affordable. Restructuring and cost cutting will increase productivity, competitiveness improves and profitability returns. Weak companies disappear, and the strong remain. This will create a virtuous cycle and provide a sturdier springboard for the next Bull Run.

## MARKET WATCH

### HOW DID THE GLOBAL SHAREMARKETS REACT?

Ultimately, these rescue measures will work. But they won't happen overnight.

Finally, a sustained recovery in financial markets – in equity and credit markets – probably needs to start from a point when valuations look genuinely cheap. In credit markets, where corporate debt spreads have blown out dramatically, value does seem to be on offer. In equity markets, in spite of future short term volatility, value is also clearly emerging.

### WHERE TO NOW?

While every investor's situation is different, we believe investors should try and maintain composure and stay invested. Here's why:

- Economic research into the relationship between recessions, share slumps and share recoveries reveals that in the past seven recessions the US share market has risen by an average of 33% in the following year.
- On the five occasions since 1985 that the Australian market has suffered a negative return, it has generated an average rise of 28% in the following year! So history tells us that the share market generally bounces back sharply after a period of negative returns. Missing that bounce can be very expensive.
- The Australian financial system is one of the best placed in the world, with the recent announcement by the Government to guarantee all bank deposits an additional safety net for all Australians.

Markets are now valuing balance sheet strength and earnings certainty more than anything else. Given the heightened level of uncertainty, it would be foolish to predict what markets will do from here. What we can say is that those companies with high cash and low debt, sustainable business models and sustainable cashflows are likely to be viewed favourably by risk-weary investors in the period ahead. These companies will be able to fund their growth, be less reliant on external funding sources and be in a strong position to purchase assets which are at distressed prices.

In every bear market in history, and there are no exceptions, there are great buying opportunities, so long as you never lose sight of the fact that you are in a bear market.

While there is no doubt that the economic climate will be very tough over the next 12-24 months, we don't think we are in for a sustained economic downturn. The Australian economy is in good shape and there is plenty of scope for the Government to continue to cut interest rates to ensure that consumer spending doesn't dry up completely.

## SECURITY NATIONAL'S NEWS

### WHAT'S NEW AT SECURITY NATIONAL?

- We want to welcome two new advisers joining Security National's team. With more than 20 years' experience in the financial planning industry, David Gumley and Peter Budge have joined Security National from Primeplan Securities. They both hold the highest possible designation of Certified Financial Planner (CFP) as issued by the Financial Planning Association of Australia. Welcome to the team!
- With Christmas almost here, it is important to remind you that our offices will be closed over the Christmas break from midday on the 24<sup>th</sup> December, 2008 and operations will resume on the 12<sup>th</sup> January, 2009.



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