Authorised Representative of Hudson Gore Pty Ltd

Winter Newsletter 2013

Introduction

Paul Hudson Managing Director

Happy NFY!

Welcome to the new financial year which will herald a time of change for Australia and the world. In politics we have started the year with a new (yet old) Prime Minister in Kevin Rudd who is battling hard for his political life. Surprisingly if the polls are correct, he has made some progress. I have the feeling that Mr Rudd's scout leader's features will be appearing everywhere for the next few months. Overseas the US has signalled a recovery that looks sustainable with jobs and housing starts both improving. In Europe we have witnessed slow improvement, the Middle East continues to be problematic and China has slowed to a snail like GDP growth rate of only 7.5%!

As per previous correspondence the ticking over of the new financial year has brought with it a ream of important legislative changes:

- higher tax on concessional contributions for very high income earners (effective 1 July 2012)
- a higher concessional contributions cap of $35,000 for clients aged 60 or over (effective 1 July 2013)
- excess concessional contributions taxed at a client's marginal tax rate and refundable (effective 1 July 2013)
- reduction in maximum co-contribution to $500 from 1 July 2012
- abolishing the Baby Bonus from 1 March 2014
- significant aged care reforms have been legislated.

Drilling to the small world of Hudson Gore, we enter the new world with our own Australian Financial Services License (AFSL). Our fully owned subsidiary Bay Finance had already obtained a Credit Licence. Our AFSL is just in time to meet the governments Future of Financial Advice (FoFA) reforms. The FoFA reforms have been enacted by parliament but there are a number of uncertainties still. Our view is that most of the FoFA reforms are commonsense and involve clients receiving advice that is not conflicted i.e. service and products that are in **your** best interest not the advisers'. Hudson Gore has spent most of our financial life as part of an independently owned AFSL until the buyout of IFA by the ING/ANZ owned Millennium3 in 2009. The culture of the bank owned organisation was not consistent with our culture. We see ourselves as service providers, the banks call advisers "distribution networks". Going forward, as per our preference we will not have any licensing or ownership alignment with any product producer.

The year that was:

Despite the late sell off growth, investors were well rewarded in the last financial year as the graph below shows. You will note the selloff in Aussie growth assets in June related to our slowing economy and the purported end of the commodity boom.

The Resources Boom:- Final Curtain?

The papers have been flooded with headlines, the RBA have issued statements saying that we have passed the peak of the cycle and importantly the miners themselves are rationalising spending. Certainly in my mind we are through the first phase of the mining boom.

The Demand Equation

China's production output has slowed and its demand for our key commodities has abated as a result. China and other developing economies demand have been the driver of commodity prices and mining investment spending. The rapid growth of China has resulted in some credit bubbles that have concerned investors. The Chinese government have moved to ease these concerns. The restrictions on lending may restrict future growth forming a nasty cycle. I believe these market concerns have been overstated for the following reasons:

- The Chinese banking system is not as complex as Western Banking systems. If we think back to the GFC and the reasons behind it, it was all about the leverage of credit instruments. These types of sophisticated vehicles are virtually non-existent in the Chinese Banking system.
- If the worst came to worst and Chinese banks needed to be bailed out it would be a much simpler situation then in the GFC. China has very little Government debt, the banks are already state owned and it is a communist state.
- The urbanisation of China and many of its neighbours continues and will continue for many years to come.
- Importantly everyone is talking about demand but no one is discussing the other side of the equation:- SUPPLY.

The supply side of the equation

CFS has recently produced a paper quoting what it sees as a number of factors that may possibly result in tight markets and sustained strong prices over the long term. In summary:

- Cost curves are rising and steepening, which is pushing up the marginal price required to incentivise new production;
- Resource companies are scaling back investments in new projects;
- Equity markets are far less supportive of new, independent mining companies with single projects;
- Declining exploration success, despite record spending; and
- A host of 'soft' risks (political, social and environmental) are creating substantial headwinds for new projects.

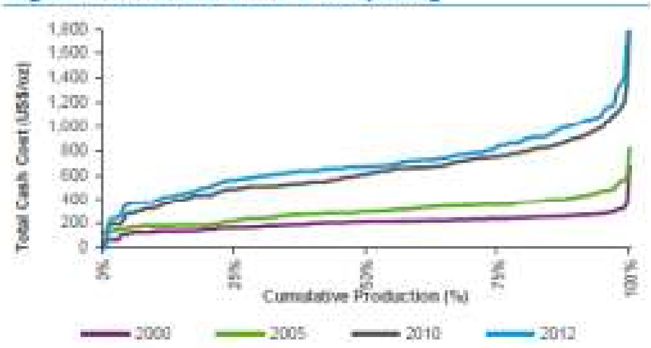
CFS believes that in an environment of steadily growing long-term demand combined with the growing probability of under-delivery on planned projects, that on a multi-decade view, commodity prices are likely to stay higher for longer than consensus.

Consequently, world class assets with low operating costs and the potential for future expansion will generate superior shareholder returns.

CFS produced a number of graphs across a series of commodities showing exponentially increased costs. (I have shown gold and copper as an example below)

CFS argue industry specific factors are causing cost curves to rise and steepen, thereby supporting long-term commodity prices. In simple terms, a 'cost curve' is a chart which shows the competitive position of different mines or companies within a particular commodity. The Y-axis measures the production cost per unit. The X-axis then reflects how much of global supply is produced for that cost or below. By showing several cost curves of different time periods on one chart, you get a visual representation of how the industry's cost structure is evolving.

Figure 1: Gold cost curve is steepening



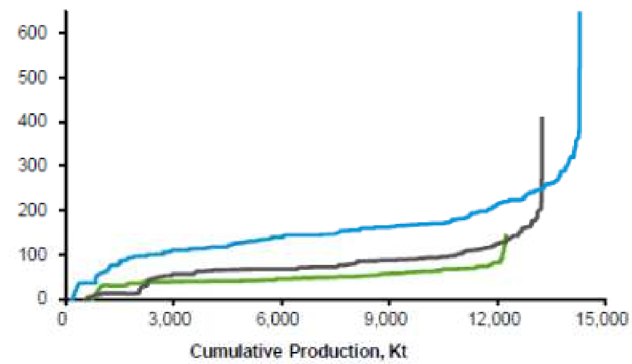
Source: BMO Capital Markets Research
Notes: "Total Cash Cost" reflects Gold Institute Standard of operating costs excluding DDA

The difference between the production cost and the commodity price is the operating profit margin that a particular mine or company makes. Therefore, the mines on the left hand side of the chart have the highest profit margins and enjoy the best industry positioning, whilst the mines on the right hand side have the thinnest margins and in some cases may be unprofitable. As a commodity price declines, more mines on the right hand side will become unprofitable. If these high cost operations cease to produce positive cashflow for a sustained period they are likely to be shut down, helping to restore the supply/demand balance. Obviously in a time of rationalisation, it is essential to be invested in mines on the left hand side of the chart (i.e., the low cost producers). These are the companies that can ride out a short term downturn in the commodity cycle; remaining viable in tough times and positioned to prosper when conditions improve.

As you can see in Figures 1, and 2 respectively, the gold, copper cost curves are all rising and the steepness of these cost curves has increased over the last 10 years.

Figure 2 shows how the copper cost curve has steepened over the last decade. We are now in an environment where approximately 10% of copper production requires $3.00/lb costs to break even.

Figure 2: Global copper total cash cost curve
(including sustaining capital)

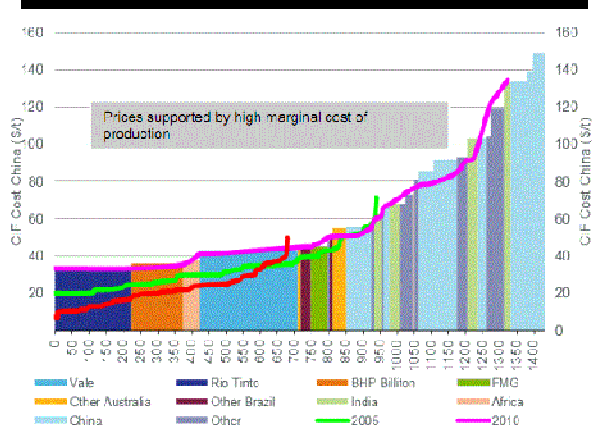


Source: WSA, CRU, Bernstein analysis (and estimates)

Note: "Cash Cost" reflects C1 cash costs, Brook Hunt, as reported

One of the reasons to like robust operations with large margins is that they are not under acute financial pressure and can run on a sustainable basis over the long term. This will benefit holdings in the low cost producers Rio Tinto & BHP Billiton. With Rio producing iron ore for less than $40/t (including freight), their Pilbara operations make a 70% EBITDA margin at the current price ($130/t) and the sustainability of these prices and margins is well supported by the cost curve as demonstrated in figure 3 below.

Supply curve to Chinese market for iron ore fines



Source: Macquarie, Bloomberg, October 2011

Conclusion

I have no doubt that high cost producers will come under pressure over the near term, but best of breed low cost producers offer an opportunity for long term investors. Inevitably these producers will gain some pricing ability as competition declines.

Beware:- Are you being told the full story?

Ian Cameron

The internet is an ever expanding "store" selling products and services of all kinds! I never cease to be amazed what I can buy on the 'net, from all kinds of suppliers around planet earth!

This works well for me as long as I know exactly what I want. Consider when I am buying joggers; am I a US or European or UK sizing? If I get something wrong with my order; can I return the item? Do I need to pay extra postage etc?

You might be reading this thinking "and the relevance to financial services here is ...?". To be plain, the number of online providers of insurances has flourished over recent times. That may be a good thing if you know exactly what you need ... and herein is the issue! What IS trauma insurance? How much do you need? Is death cover really necessary? How do all the types of insurances "fit" together? Do I need Total and Permanent Disability insurance? Should I put any or all of these insurances inside superannuation? Can I put them inside superannuation?

Online policies to protect your income may be "indemnity" policies. This means that the amount you will be paid is what you are earning when you claim. This is very bad luck if you are a small business operator and trade has been down for the last quarter or more – OR if you have recently had a demotion at work and not on the same level of pay. "Agreed value" polices will verify your earnings on application and 'lock' amount that in, which can also be indexed with inflation. Some online policies will assess IF you can claim WHEN you claim; some policies simply won't cover you for any illnesses that you had when you applied. You will only find this out when you claim. With more robust policies offered by Hudson Gore, determining what you can claim for is part of the 'underwriting' process and will be done when you first apply so you know what you are and are not covered for.

Whilst online websites may provide information on personal insurances, if you don't know exactly what you need then when you claim on your policy you can't 'exchange' your insurance if you have made an incorrect choice! With personal insurances, sitting down with an experienced advisor and talking through your current position and your needs is invaluable. Not only are you being looked after by someone who has spent many hours assessing people's needs and requirements, you also have an informed sounding board for the "what if" questions. Can you even do this online?

Another concern is the "it all seems too hard" factor! Wouldn't it be easier simply to login, buy my insurance and just 'get it done?' Here again, does your income protection need to be indemnity or agreed value, is a 14 day waiting period ok, or should I have 90 days? Are level or stepped premiums better for me? What is the quality of the policy I am buying online; can I get independent research to assess it and tell me what it is like compared to other policies in the market?

Hudson Gore prides itself on being a service business that is family owned; our focus is on you! We will sit with you and research your current position and discuss what insurances would be appropriate. At claim time, we will also work with the insurer and yourself to expedite your claim.

We do all of this because you may not know exactly what you need; we have the specialist knowledge to help!

Photos from the Hudson Gore Annual Golf Day 2013

Disclaimer: This information is general in nature and does not consider your individual circumstances or needs. Do not act until you seek professional advice and consider a Product Disclosure Statement. The views and opinions expressed within this letter are those of the author and do not necessarily reflect those of Hudson Gore Pty Ltd.