



*"Be Prepared."*

Robert Baden-Powell

At the end of the September quarter dark storm clouds seem to be gathering on the financial horizon. Chinese growth is stalling, the price of iron ore, which has already halved since 2011, fell a further 20% just in the month of September. The Australian dollar has fallen by almost 7% in the last three weeks, as foreign institutions, keen to repatriate funds in anticipation of rising US interest rates, sell holdings in Australian securities, depressing the prices of both these shares and our currency.

There is good reason to believe that these forces will gather further momentum and lead to higher local unemployment and falling property prices. This in turn will put pressure on our banks (as mortgages default and the demand for credit declines) and on our discretionary retailers (as consumers keep their wallets shut). All of the knock on effects, if this scenario plays out, will be unpredictable but they will be severe. Government tax receipts will also likely fall, as they did in 2008/09 and 2009/10 when we were relatively insulated by our resources sector, leaving less opportunity for government fiscal stimulus.

So should we panic? Go to cash and wait for the storm to pass? I don't think so. There are no surprises in any of this. The signs have been there for anyone who has cared to look. But managing a portfolio is not about predicting a particular outcome and betting everything on it coming to pass. Sometimes these things play out over a much longer time frame than you thought they would. Sometimes you're just wrong. More things can happen than will happen. It is important to prepare your portfolio for any number of outcomes and protect it from the direct effects of any of them. This is a very dynamic process.

Over the past four or five years we have been gradually increasing our exposure to currencies other than the Australian dollar, by investing directly in global companies, in listed investment companies and unit trusts that have an unhedged exposure to global equities and in Australian companies that earn a large part of their earnings in other currencies. We have virtually no remaining exposure to the resource or the resource services sector and have been taking profits from the banking and discretionary retail sectors, as well as some of the "yield plays", over the past year. Consequently our portfolios have very healthy balances of cash and will be able to take great advantage of opportunities that are likely to emerge if this bleak scenario does play out. These are the rewards for being prepared.

September 2014