Stonehouse Core Value Portfolio
Monthly Update - July 2013

Financial markets experienced a significant pullback in June 2013 and then recovered a large portion of this negative performance by the end of July 2013. From a relative standpoint the Core Value Portfolio performed well, falling only 0.53% in June 2013 before rebounding with a rise of 2.7% for the month of July 2013. This is exactly what the Core Value Portfolio is designed to do – protect capital by substantively reducing the order of magnitude of the negative months but still participate in the upside performance over the stronger months.

From an asset allocation perspective we remain cautious on the outlook for financial markets overall and expect volatility in the coming months. This is in response to greater uncertainty in the global economic environment and the level of monetary stimulus central banks are willing to provide. A possible 'witching hour' for this nervousness to crystallise could be the traditionally volatile September / October period. Our response is that we have been building a defensive cash reserve buffer in anticipation of a potential pullback in global equity markets. Should this occur, we may look to put some of this cash reserve to work in asset classes that already appear 'unloved', such as emerging market equities. Valuations in this asset class are nowhere near as stretched as those in developed markets which could represent a good buying opportunity in the near future.

In July 2013 the Portfolio also increased exposure in what we label as 'insurance' asset classes; those that traditionally perform well when other areas of financial markets falter. Long / short equity managers that have displayed a talent to return positive results when the overall equity market declines, such as Bennelong, and volatility traders that generate returns as financial markets gyrate, such as 36 South. These investments have recently been added to the Core Value Portfolio with an overall target allocation of 5%.

Furthermore, we have removed exposures to some asset classes that have proven highly volatile in recent months, for example a small holding of gold mining stocks that struggled in June 2013 but performed strongly in July 2013 and some of our energy exposures. We took advantage of the July 2013 market rally to sell down these positions as they moved back into the black.

As for the Australian dollar, we continue to hold a significant unhedged exposure on our international holdings. Our expectation remains one of Australian dollar weakness over the medium term, although this downward trend may be punctuated at times with the odd short covering rally. As the Australian dollar tracks lower we will actively seek to hedge some of this exposure at favourable levels.

Asset class ranges & current allocations[2]			Current exposure
Cash & Fixed Int.	15%	60%	49.4%
Property	5%	25%	8.2%
Equities	25%	65%	31.2%
Alternatives	5%	35%	11.2%

0% 20% 40% 60% 80% 100%

Top 10 investment holdings (ex cash)

1. Kapstream Absolute Return Fund
2. DFA 5 year Diversified Fixed Interest Trust
3. Payden & Rygel Global Income Opportunities Fund
4. Ardea Australian Inflation Linked Bond Fund
5. Wingate Global Equity Income Fund
6. Platinum International Fund
7. Perpetual SHARE-PLUS Long Short Fund
8. Denning Pryce Equity Income Fund
9. Allan Gray Australia Equity Fund
10. Vanguard Australian Share High Yield ETF

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Individual Country Macro Views:

US: There were some surprisingly stronger numbers out of the US last month, particularly the all-important ISM series. This is encouraging, but unfortunately the labour market continues to drag its feet. Non-farm payrolls continue to underwhelm and it will be the outcome of this key indicator that will dictate terms to the markets over coming months. Achieving the Fed's US unemployment target of 7.2 – 7.3% by end 2013 will be difficult. Will Bernanke continue to taper (as much of the market expects) come mid-September or will he acknowledge defeat in terms of the employment forecast and back away? Already the market is debating this issue and it is injecting its fair share of concerns (and volatility). In short, our concerns about an apparent disconnect between recent US equity market performance and the underlying performance of the US economy continues. We anticipate some form of realisation for markets that their overly optimistic expectations will not be met before year end (possibly around the traditionally volatile September / October period). Add into the mix a looming German election around the time that tapering is set to take place and there is little surprise that we expect greater volatility going forward.

Australia: The RBA cut the cash rate, largely as expected, by 25bpts to bring the official cash rate to a historic low of 2.5%. Deciding on where the RBA goes from here will be much more difficult. Two factors loom large in this decision, the $A and fiscal austerity. The $A is largely supportive of yet another cut simply because at this stage it has not developed a 'mind of its own' and has not continued to step down without RBA assistance. To keep the downward momentum happening, it seems the RBA needs to continue to ease; this is supportive of a 2.25% cash rate before year end. Next comes fiscal austerity. Irrespective of promises presently made and who wins the Federal election, the first Budget will be tough. Ergo, there will be not much support for an already weakening Australian economy from the fiscal side. If anything, the government sector looks set to detract from the national accounts going forward. This too is supportive of yet further cuts to the cash rate but that said, an improving US (see above) and world economic outlook in 2014 tells us that the bottom of the cash rate is nearing. Perhaps it's time to think about hedging up your international equity exposure (and fixing your mortgage)?

EMU: The big surprise out of the Eurozone last month was Manufacturing ISM, it actually slipped into expansion mode. That said, overall the European economy continues to look resoundingly weak. The best that can be said is that at least it is not going backwards as fast as it was this time last year. Indeed, if the US continues to recover and the UK and Japan start to accelerate (see below) it could be that Europe might actually manage a weak / mild expansion in 2014. It is this prospect that has set European equity markets ablaze in recent weeks. Still, one must counsel caution. The European workout from recession will be long and arduous. An overshooting European equity market is a real prospect, as has been the case in the US for some time, and an inevitable day of reckoning will come.

Japan: After a very strong set of numbers last month, the results backed off a little in Japan for the June 2013 reporting period. Are we worried? No. The push toward the end 2014 2% inflation / reflation target still looks in place. Over the past three monthly readings, yoy CPI figures have gone from substantively negative (-0.7% yoy April) to slightly negative (-0.3% yoy May) and now (+0.2% yoy June), slightly positive. This is a good sign and illustrates the much vaunted 'monetary experiment' appears to be working.

UK: It seems that in not only cycling, cricket and rugby, the British are doing well. At this pace, especially looking at the Manufacturing (54.6), Construction (59.0) and Services (60.2) PMI's, the BoE may be the first developed world bank to set a decidedly hawkish tone for 2014. This should prove a formidable task for the new Bank of England Governor Mark Carney.

China: Authorities continue to print results consistent with a 'not too hot / not too cold' flavour. We have continually expected China's GDP to settle into a 7 – 8% range for 2013. This appears to be happening. The big question is what to make of 2014. For now a 7 – 8% GDP range looks commensurately fine but as we approach the calendar year end we will undoubtedly need to sharpen our pencils a little further. Without question, guidance from key policy-makers will be important in framing China's 2014 outlook.