Stonehouse Core Value Portfolio

Monthly Update - September 2013

During September the Stonehouse Core Value Portfolio was in the black contributing to a solid +3.25% performance for the quarter. From an asset allocation perspective we have retained our fairly defensive positioning - with some of the benefits of this cautious stance coming to pass through September. For the moment though we're keeping our powder dry with the aim of opportunistically positioning in oversold assets in order to seek value - potentially post some resolution to the present fiscal impasse in the United States.

In the interim, the investment committee is ensuring our 'insurance policy' positions (i.e. volatility traders, long/short equity managers and CTA's) are being topped up so that should equity markets slide into substantive negatives the downside risk to the portfolio would be limited.

We have also been reviewing our fixed income positions in light of the recent bond market sell off to ensure that we are getting the best returns from active management in this asset class.

Finally, as emerging markets sold off earlier in the month we increased our exposure to this segment of the market as we saw the oversold opportunity as a good chance to gain entry at favourable prices.

Market Performance:
Equity markets rallied over the month of September as fears of an imminent US Federal Reserve tapering dissipated. The US Federal Reserve surprised most in the market by opting at its September meeting not to reduce its commitment to a monthly bond purchase program of $85billion - as part of its efforts to reinvigorate the US economy. Hindsight is a wonderful thing and it appears the US Fed's reluctance to alter its bond purchase program was in response to fears of a fiscal standoff in the US Congress – a fear that soon became reality in early October.

Domestic equity markets moved in lockstep with their offshore counterparts over the month of September – at first falling pre the Fed meeting but then rallying hard post the Fed's surprise result. Over the quarter however domestic equity markets considerably outperformed relative to offshore exposures. Some of this rally appears to have been a form of catch-up after the domestic equity market underperformed considerably over the June quarter.

Longer term we anticipate offshore equity exposures should perform relatively better than domestic equities. This is simply because the Australian economy is slowing while the US, UK, Japan and even Europe are all in expansion mode (albeit in some instances off a very low base). This relative economic performance will have a telling effect on the earnings potential of equities and will therefore influence the disparity of relative performances within this asset class.

As for the Australian Dollar, it continues to astound many by recording modest rallies. Much of this has to do with $US weakness rather than $A strength. One would anticipate that as our economies diverge in relative performance over 2014 the prospects of the $A remaining in the mid $US0.90 range looks unlikely. Therefore in the interim, we continue to maintain the bulk of our overseas exposure as 'unhedged' which would further benefit the Portoflio should the $A move down against the $US over the medium term.

Asset class ranges & current allocations[2]	Range	Current exposure
Cash & Fixed Int.	15% – 60%	46.6%
Property	5% – 25%	8.7%
Equities	25% – 65%	29.3%
Alternatives	5% – 35%	15.4%

Top 10 investment holdings (ex cash)

1. DFA 5 year Diversified Fixed Interest Trust
2. Kapstream Absolute Return Fund
3. Ardea Australian Inflation Linked Bond Fund
4. Payden & Rygel Global Income Opportunities Fund
5. 36 South Kohinoor Core Fund
6. Lazard Global Listed Infrastructure Fund
7. AQR DELTA Fund
8. Gold Bullion ETF
9. Northcape Global Emerging Markets Fund
10. S&P/ASX 200 Index ETF

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Individual Country Macro Views:

US: Forget about the economics, it's all about politics in the US at present. In fact, even if you wanted to concentrate on the economics it's getting difficult as the US government shutdown has forced the delay of several key economic releases. All the political angst aside, a resolution is likely to be reached simply because the prospects of not forming an agreement are so dire (much like debate about opting/not opting for nuclear war). The question for the US economy (and the global markets for that matter) is how long all the US political posturing pre the inevitable 11th hour agreement will take and what will be the economic/market damage in the interim. US politicians have approached this cliff plenty of times before and as yet haven't stepped over the edge – at least in terms of a technical default by the US government lasting for a substantive period of time. At each juncture when they've finally reached a resolution, it has cost both the market and the economy in terms of performance. This time will be no different – the only question is the quantum of the damage.

Australia: Now that the election fever is over, we're back to the boring old economics as a driver for market performance. And the news here is pretty much the same – the $A is still too high for the 'rebalancing' of Australia's growth drivers and the economy is commensurately slowing from a 'super-cycle' commodity fuelled economic performance back to a more urbane/moderate GDP growth pace. In the middle stands the RBA, looking to get the $A down but also not wanting to fuel the fires of a housing bubble. What to do? Going by the fact that domestic economic releases appear to be getting worse rather than better the odds appear that the RBA will lower the cash rate from its present 2.5% level at some juncture in the near future.

EMU: The EMU economy still appears to be eking out a slightly positive GDP growth tone. This is certainly refreshing after years of negative GDP performance. In short, 2014 is looking to be a demonstrably better year for Europe than experienced for some time. Still, this needs to be put in perspective. The Eurozone remains the weak man of the developed world – and by a substantive margin – but it is not as weak as it once was.

Japan: Japan's CPI remains the focus of whether the Abenomics experiment is working. To date, the evidence has been extremely positive. August CPI recorded a strong yearly performance – up from a substantively negative outcome in April when the Abenomics experiment first started. It may seem odd that a country is wishing for higher inflation outcomes but after years of deflation Japan is only too happy to see annual price growth once more. This is good news not just for Japan's economy but the world economy as well.

UK: If Europe is the weak man of the developed world, then the UK certainly qualifies as the strong man. Key economic indicators – such as the PMI - continue to run hot. We remain of the view that the Bank of England is likely to be the first of the major developed world's central banks to raise cash rates – most likely in late 2014.

China: The goldilocks 'not too hot / not too cold' economy for China continues. Economic indicators are indicative of an economy just toddling along at a moderate pace. This is exactly what the ruling elite in China want. Indeed, unless there is a notable change in rhetoric out of Beijing in the near term, this is exactly the type of GDP growth pulse we should come to expect for much of 2014.
