ISSUE ONE CHANGE

IS VOLATILITY THE PRICE OF LIQUIDITY AND IF SO, CAN YOU AFFORD IT?

THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

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THOUGHT PIECE

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THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

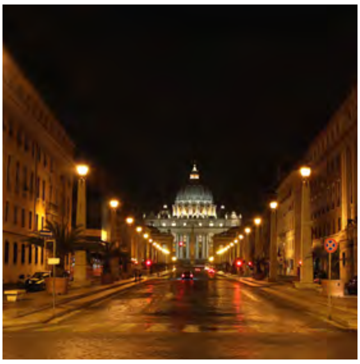
GLOBALISATION

NEW INVESTMENTS & INVESTMENT STRATEGIES

GLOBAL FINANCIAL CRISIS

SOVEREIGN RISK AND DEBT

CHANGE



WE BELIEVE THAT ALL ROADS LEAD TO INCOME!

At the end of the day, regardless of gender, age, relative financial security, employment or retirement, we all seek the same thing as the product of our investment strategy: income.

Put more simply the reason we invest is so that we can have sufficient income to live and hopefully live well at the time when we choose, or someone else chooses that we no longer will receive income from employment.

Balmain Funds over the period ahead will make available a series of "thought pieces" designed to provoke new thinking on why we invest the way we do, challenge investment orthodoxy, such as "modern portfolio theory", posit and in some cases guess at future risks and opportunities. The overall aim however is to help you create a better future for you and the ones you love.

We have identified five themes that we believe will impact your ability to achieve the income you want. These are:

1. The Global Financial Crisis
2. Sovereign Risk(s)
3. Change
4. Globalisation, and
5. New Investments and investment strategies

We will over time populate these themes with "thought pieces" that are designed to inform you, challenge and provoke your investment thinking and from that hopefully assist you in making better investment decisions.

ABOUT BALMAIN

Using our staff of 140 located in 8 offices in Australia and New Zealand we arrange and deliver financing solutions to Australian and New Zealand commercial property developers and investors. Balmain originates between $2b and $4b p.a in transactions ranging from senior debt to mezzanine and preferred equity.

Over the years Balmain has arranged commercial loans to over 140 lenders, banks, institutions, managed investment schemes and high net worth individuals / family offices. It currently manages over $8b of ongoing loan relationships with over 100 of these organisations.

Balmain is Australia's 5th largest commercial mortgage fund manager, who on behalf of over 8000 Australian investors, we manage over $800m in commercial mortgage loans.

Balmain in its own name and via AMAL (in which Balmain has a substantial shareholding) provides special servicing skills to loan portfolio owners covering both residential and commercial loans.

IS VOLATILITY THE PRICE OF LIQUIDITY AND IF SO CAN YOU AFFORD IT?

For quite some years, it has been common investment orthodoxy that investments need to be liquid. But as the GFC painfully revealed, liquidity, for all its good, comes with a high price ....volatility.

What may not be recognised by some investors is that volatility has risen sharply since mid 2007. This fact, when combined with a recent trend for investment platforms to demand liquid investments at the expense of illiquid investments, – poses the question – is the price of liquidity too high?

What is volatility? Simplistically, it is a measure of dispersion (ie variance) in price over a specific period of time. This measure is the standard deviation and is expressed as an annualised percentage. The higher the percentage, the higher the volatility or, the higher the probability of returns being much more, or much less, than expected.

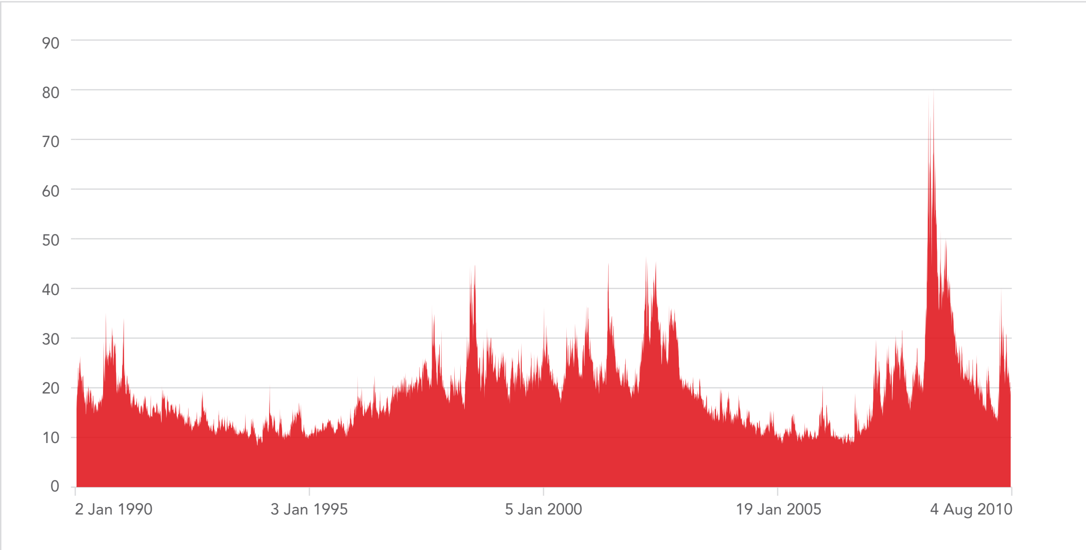
For example, from 1981-2010, the annualised return of the ASX 300 Share Accumulation Index (dividends included) was 11.72% pa and the standard deviation 17.78% pa. That means that 68% (one standard deviation) of the time, the share markets returns were 17.78% above and below the mean return of 11.72% pa. That is, +29.50% to -6.06%. Great new if you are retiring when volatility allows you to cash –in when returns are above the mean, but not so great when volatility drives returns below the mean!

Standard deviations move up and down over time, driven by fear and greed, or to paraphrase former US Defence Secretary Donald Rumsfeld, they are impacted by 'known knowns, known unknowns and unknown unknowns!'

Some readers may have heard of the VIX (or 'fear') index. Figure 1 the CBOE Volatility Index® (VIX®) - a key measure of market expectations of near-term volatility (as conveyed by S&P 500 stock index option prices.) Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility for the US equity market.

FIGURE 1: CBOE VOLITIITY INDEX® (VIX®)

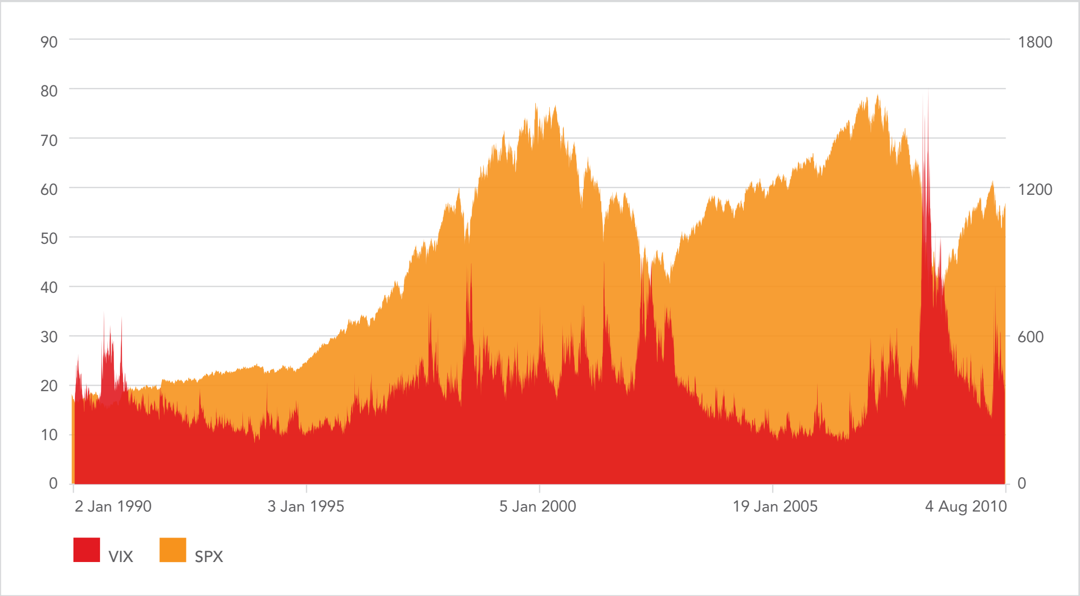
Sources: Bloomberg and CBOE



In figure 2, notice in 2004 to 2007, while the stock market was gradually rising, the VIX (volatility) fell to record lows. Then the GFC hit, volatility rocketed and liquidity disappeared as asset prices fluctuated wildly (down!) due to uncertainty, fear and panic. And because liquidity disappeared, institutions that needed cash (to repay investors who clamoured to get their money back) were forced to sell 'liquid' assets such as blue chip stocks and bonds, causing these assets to fall further. Thus liquidity begot volatility!

FIGURE 2: VIX® AND S&P 500 INDEXES

Sources: Bloomberg and CBOE



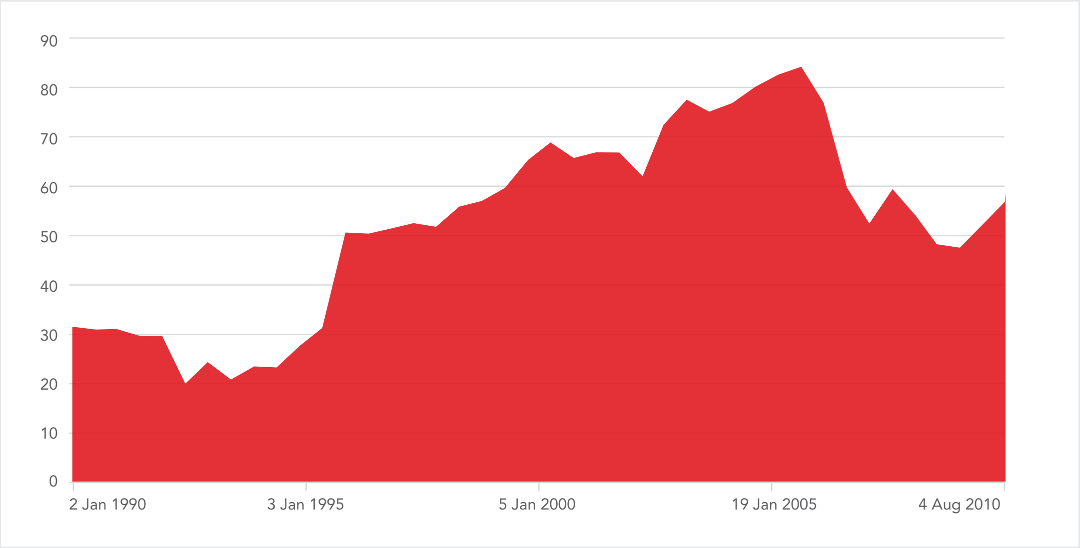
Liquidity, volatility and the issue of administration platforms & exchange-traded investments

It is estimated that around 80% of retail investments (Mum and Dad investors) now pass through Master Trust or WRAP's (platforms). These platforms typically demand that the investment products they include are liquid and able to be liquidated in less than 90 days, regardless of the underlying securities.

As a consequence, more and more investment funds wanting to be included in platforms are now investing in exchange-traded (listed) products in order to be liquid. These include listed property (A-REIT's), listed infrastructure funds, listed investment companies (LICs), listed income funds, listed private equity, and listed hedge funds.

But, note the chart (below) that shows the standard deviation over the past three years for Australian shares. Volatility has been rising at the same time that platforms are demanding that investment products must be liquid (usually meaning listed) before they can be included!

FIGURE 3: ASX 300 SHARE ACCUMULATION INDEX rolling annualised volitility 2007-2010
Sources: Bloomberg and CBOE



Pre-GFC, investment products that contained non-market tradable assets were able to meet liquidity requirements by managing the relationship between cash, investment maturity and net flows. Added to this was that while no formal market may have existed for the underlying investments, demand-driven informal markets provided comfort that assets could be liquidated with ease and therefore the product were considered liquid as defined by the Corporation Act.

Post-GFC, non-market tradable products are typically unable to be included on platforms as they cannot meet the platform's liquidity requirements. As a result, investors that use platforms may be exposed to increasing levels of listed and thus more volatile investments. As well it also means that valid and valuable non-liquid investments are simply not seen by investors for no other reasons that the arbitrary demand of their platform provider.

As we saw during the GFC, in times of crisis, listed investment prices can suffer extreme trading ranges, even for so-called liquid stocks. Discounts to NTA widened dramatically. Even now, many LICs and A-REITs have discounts to NTA in excess of 25 percent.

Consequences

The issue then is the increasing volatility risk when investing (via platforms) in a range of investment products that are themselves investing in exchange-traded products...just to be 'liquid.'

This investment orthodoxy for liquidity has also much to do with the structural issues of managing a platform. Platforms prefer exchange-traded investments because their IT systems are more easily integrated with exchange-related reporting and back-office systems, and because listed investments are more portable between platforms. (Of course, there are also other benefits in exchange-traded investments including more transparency in reporting, and an additional layer of exchange regulations which is now being assumed by the Australian Securities and Investments Commission).

However, before the advent of platforms, investment portfolio construction typically used a mix of non-liquid assets and liquid assets, and planners constructed these in such a way that liquidity was an integral component of portfolio construction, not just an outcome of being listed. Sadly, it appears this will no longer be the case, resulting in lazy portfolio construction where listed is the mantra and volatility could be the price paid.

And volatility becomes an even greater issue as an investor approaches retirement. It would be wonderful if returns are well above 'expected' in a volatile portfolio, but an investor's retirement plans will be dramatically affected if returns are well below what was expected.

Conclusion and Action

Investors, particularly those closest to retirement, are being directed into listed (and 'liquid') investments in an era of rising volatility.

While no one can predict that volatility will keep rising, we can see that it has risen considerably over the last three years. Investors therefore need to be conscious of the link between liquidity and volatility and ensure that they remain comfortable with both the benefits and the risks.

The worst manifestation of volatility could be seen in the recent GFC and also in October 1987, when 'liquidity' disappeared, investment models (such as the much used Efficient Market Hypothesis) melted, and most asset performance correlations moved towards one, skewering assumed portfolio diversification.

For an investor close to retirement, common sense dictates one should aim for low volatility investments, especially as one's ability to replace lost capital diminishes. It stands to reason that leverage raises volatility, so non-leveraged products are important. Investors could do well to consider a range of investment products that do not have exposure to listed markets, in order to lower their volatility risks. These products include income funds, direct property, and fixed income funds and commercial mortgage backed investments as some of these are capable of tracking a rising interest rate market.

We hope this article provides a rethinking of investment strategies and a willingness to challenge the 'liquidity' investment orthodoxy.

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