05

ISSUE FIVE NEW INVESTMENTS & INVESTMENT STRATEGIES

NON BANK INCOME INVESTMENTS STARTING TO SHINE AS BANK TERM DEPOSIT RATES DECLINE

THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

10 DECEMBER 2010

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THOUGHT PIECE

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THINKING OUTSIDE THE SQUARE

FIVE THEMES TO HELP YOU CREATE A BETTER FUTURE

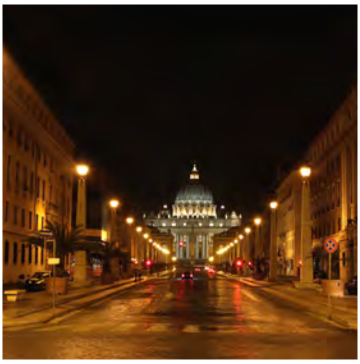
GLOBALISATION

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.

NON BANK INCOME INVESTMENTS STARTING TO SHINE AS BANK TERM DEPOSIT RATES DECLINE

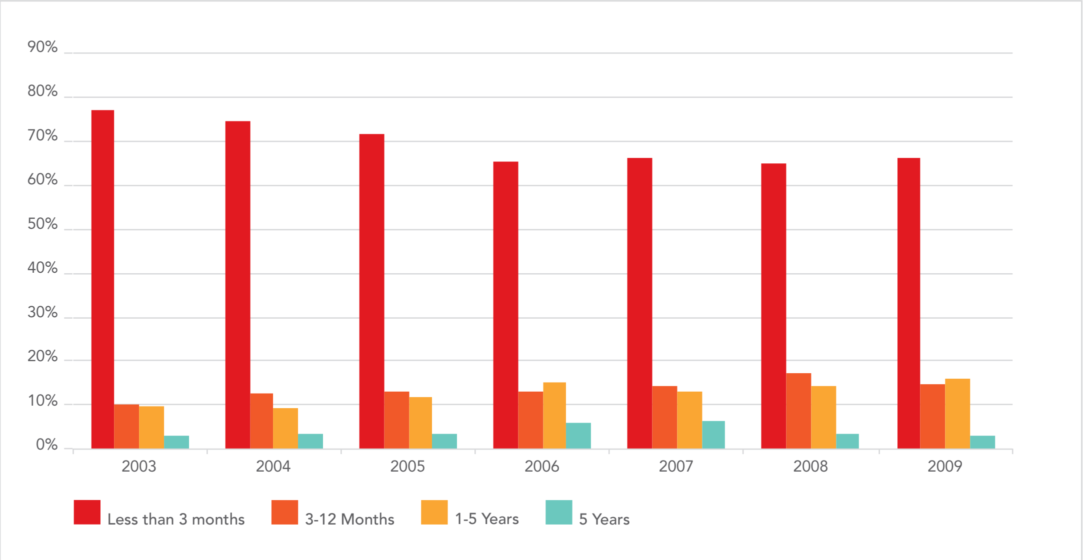
Following the Global Financial Crisis (GFC) the major Australian banks have tightened their control over the Australian financial economy. In 2009 fixed interest rates offered by banks on Australian term deposits rose significantly as banks both in Australia and globally competed to refinance debt. The increase in term deposit rates, compounded by the Australian Government Bank Deposit Guarantee, reduced the competitiveness of non bank income investments. Clearly the increased cost of capital puts pressure on bank profits which logically flows through to interest margins charged to borrowers and paid to depositors. The Big 4 (ANZ, CBA, WBC & NAB) have commenced reducing interest rates offered on longer term deposits, whilst increasing mortgage rates in the short term. This could set the stage for the comeback of non bank income investments.

Bank Funding

Today around 55% of the Big 4 banks' funding comes from their Australian deposit base[1]. Between January 2007 and September 2010 Australian deposits at the Big 4 increased 89% to $977 billion[2]. The bulk of bank funding remains short term, as can be seen in Chart 1.

Chart 1 – Aggregated bank funding maturity analysis from 2003 to 2009 for consolidated banking groups: Australia and New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Bank, Westpac Banking Corporation.

Data Source: Big 4 Banks Annual Reports



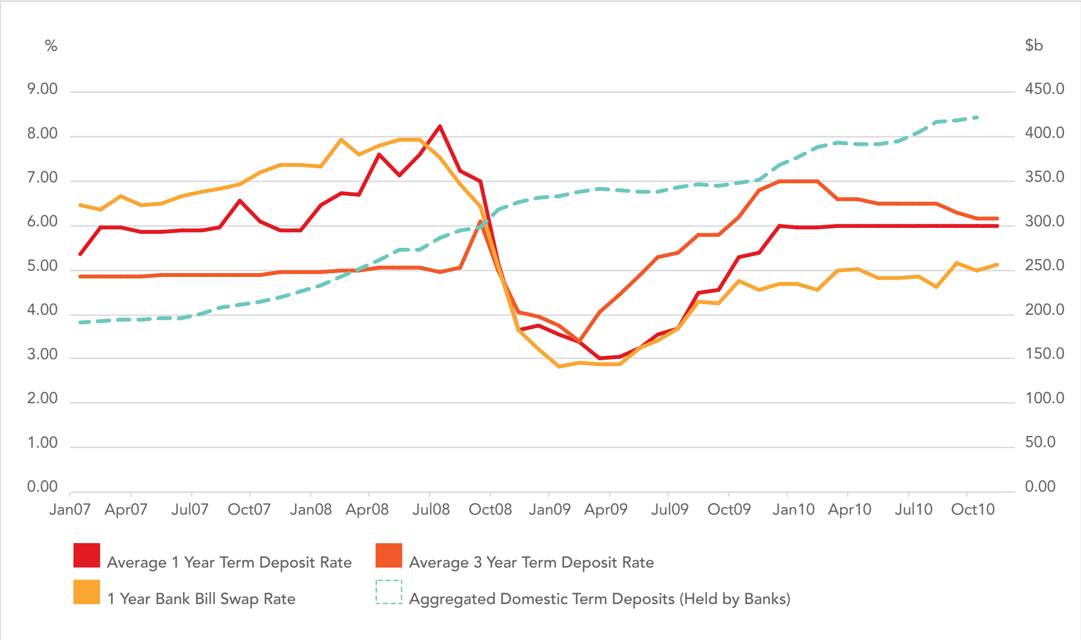
Post the GFC, wholesale funding became more expensive as banks reduced their interbank lending volumes and kept this lending at short duration. In July 2009 Commonwealth Bank of Australia (CBA) raised $1 billion, via unguaranteed 5 year floating rate notes, at a margin of 145 basis points over the 90 day bank bill swap rate (BBSW). Debt capital markets' confidence has improved since then, as evidenced by CBA raising $1.5 billion, at an 85 basis points margin over the 90 day BBSW in September 2010[3]. This is much lower than the average 100 and 115 basis point premiums (over 90 day BBSW) the Big 4 banks are currently paying on 1 and 3 year term deposits respectively[4]. Of concern to fixed term investors, is the possibility that the banks may look to further reduce term deposit rates if they can raise funds less expensively with equal reliability elsewhere.

Term Deposits

During the GFC Australian banks focused on raising deposits as a stable source of funding. By increasing domestic deposit funding Australian banks insulated themselves from volatile global money markets. Post GFC the average Australian 1 year and 3 year bank term deposit rates peaked at 6.0%pa and 7.0%pa respectively in December 2009[5]. Between September 2009 and August 2010 the aggregated term deposit base grew a whopping 20.6% to $416 billion[6]. Whist the average 1 year term deposit rate remains 6.00%pa, the average 3 year term deposit rate has gradually fallen to 6.15%pa by October 2010[7].

Chart 2 – Term deposit rates correlation to banks aggregated term deposit base

Data Source: Reserve Bank of Australia



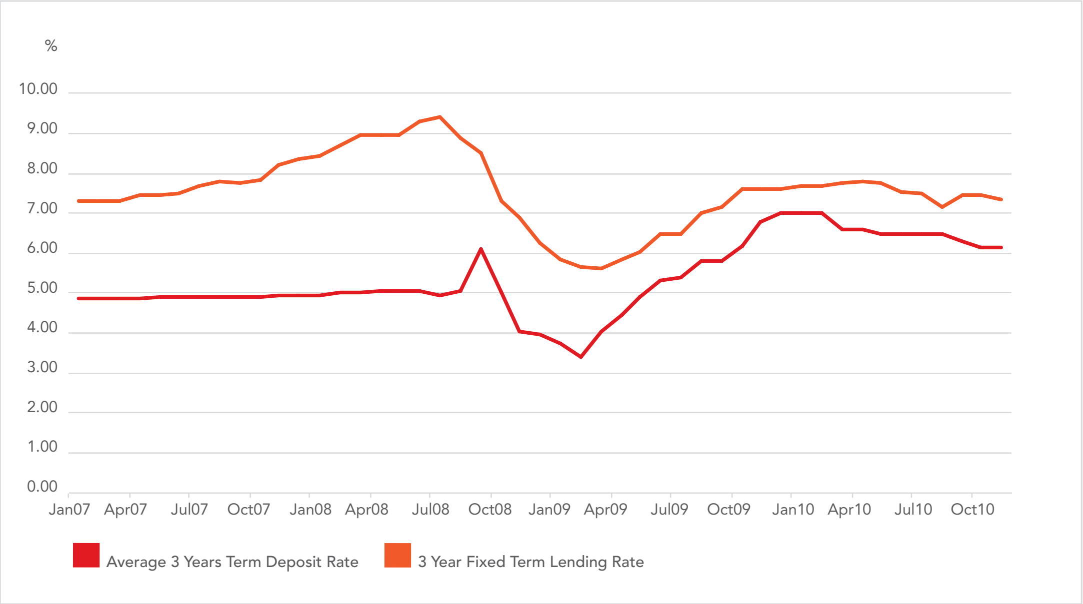
The lack of competition in the fixed income sector

Any increase in costs such as the rise in term deposit rates has a negative impact on bank profit margins. As chart 3 shows, the differential between the average 3 year term deposit rate and 3 year fixed residential mortgage rate has fallen from around 4.00%pa in July 2008 to 0.65%pa in August 2010. Since then that margin has increased to over 1.20%[8]. Is this a sign that the banks are looking to reverse their margin squeeze?

Today the average 3 year fixed term lending rate is around 7.35%pa whilst the average term deposit rate for the same period has fallen to 6.15%. Again this is evidence of loan margins increasing and term deposit rates reducing as banks move to maintain or increase their typical 2% plus net interest margins.

Chart 3 – Profit margin 3 year fixed interest loan

Data Source: Reserve Bank of Australia



At the same time there is evidence that the banks are also offering high interest rates on at-call funds held in online savings accounts, typically for set short promotional periods. Interestingly after the November 3, 2010 RBA Official Cash Rate 0.25%pa rise, some banks increased their promotional rates, whilst holding term deposit rates on terms 12 months and longer. It may be that the motivation behind this is to roll-over longer term investors to shorter term deposits. If so, it is probable that once these promotional periods end, the banks may further reduce the deposit interest rates. Whilst some investors will move their money elsewhere, inertia amongst customers should result in a slow attrition and a greater profit margin for the banks.

Bank Deposit Guarantee ends soon

The Australian Government Bank Deposit Guarantee reduced the risk of bank deposit investments. This guarantee is scheduled to be reviewed in October 2011, however there are many who believe that it should be removed sooner as the increased risk the banks faced in 2008 is largely gone. An effect of this guarantee was the reduced competitiveness of mortgage trusts and other fixed income investments not guaranteed by the Australian government. This resulted in the banks currently facing very limited competition both in terms of fixed income investments and in the commercial mortgage lending sector. However there are glimpses that this period may be coming to an end.

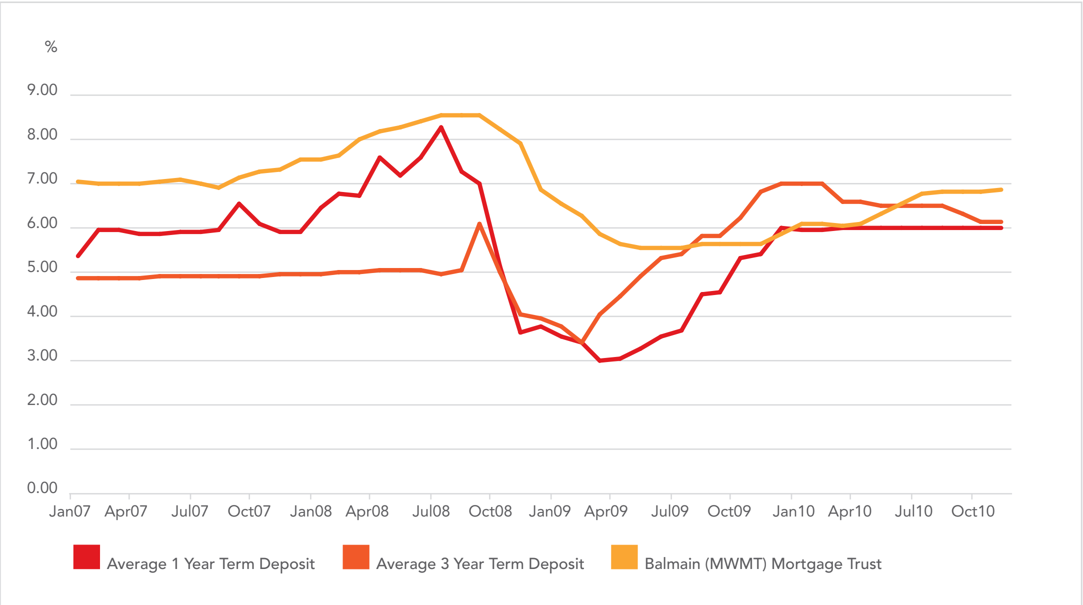
It is likely that non bank mortgage investments will be more attractive to investors at the expiry of the deposit guarantee in 2011, if not before, as banks reduce term deposit rates to improve lending margins. By way of example we can already see how the returns from mortgage trusts are becoming attractive once again when we contrast the results of Balmain Wholesale Mortgage Trust against average 3 year bank term deposit rates (Chart 4).

The Balmain Wholesale Mortgage Trust 3 year yield surpassed average bank term deposit rates in August 2010 reaching 6.80%pa. In November 2010 the yield reached 6.84%.

Today both mortgage trusts and banks are able to write higher margin commercial mortgages than those written pre GFC. Loan-to-value ratios have reduced and interest servicing capacity has increased on new loans being written. These reduced risk and higher reward direct mortgage investments are likely to again become an attractive option to income seeking investors. Commercial mortgage trust investments perform best when investors commit to a term that is equivalent to the term of the underlying securities. As expiry of the deposit guarantee draws closer and bank term deposit rates reduce, non bank income investments should become more competitive.

Chart 4 – Balmain MWMT Vs 1 & 3 Year term deposit rates

Data Source: Reserve Bank of Australia, Balmain Funds



Conclusion

The banks' desire to drive shareholder profits and limit capital funding costs is seeing them reduce interest rates on longer term deposits. At the same time they have increased mortgage interest rates beyond the increase of the RBA official cash rate.

Investors that require high income returns might start to consider non-bank alternatives for income investments, and also accept that high income yielding investments will not necessarily be liquid. In this situation, liquidity needs to occur from a financial planning/portfolio perspective rather than only considering investments that offer immediate or shorter term liquidity.

Importantly investors should recognise that inertia comes at a cost (to them) and might start considering alternate income investments (either directly or via their financial adviser), sooner rather than later.

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BMT 4557 - 31 July 2011