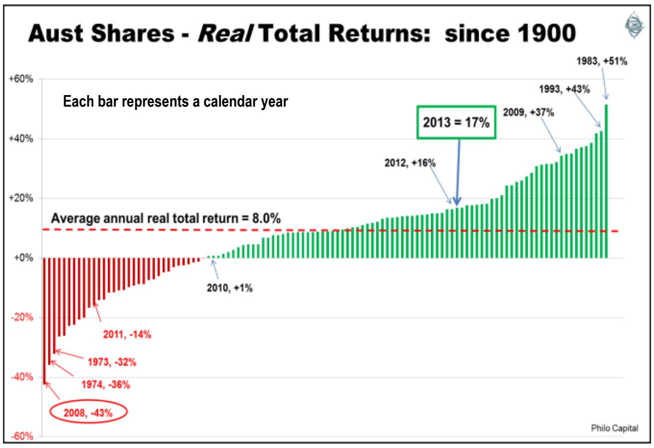


Another Great Year for Shares

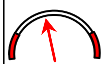
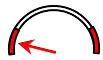
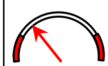
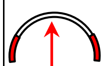
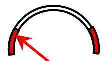
2013 was another good year for Australian shares on the whole. The broad market index returned 17% in real terms after consumer price inflation. This puts it into the top one third of annual returns historically (real total returns including dividends have averaged 8% per year above inflation since 1900).

This month's chart shows real total returns from the broad Australian share market index for each calendar year since 1900, ranked from the lowest real return (-43% loss in 2008) on the left, to highest (+51% in 1983) on the right.

Share price volatility was also much lower than average in 2013, so it was another year of smooth, high returns from Australian shares - like 2012.

We have been over-weight Australian shares in portfolios in 2012 and 2013, but we were under-weight in the second half of 2011 when the market fell heavily during the European debt crisis and US credit rating downgrade crisis.

We are currently assessing the outlook for the year ahead and will make our quarterly asset allocation changes during January.

Major Markets		Current position	Direction / Trend	Pace of growth
Australia	Australian economic growth in 2013 remained weak and is being kept alive mainly by government deficit spending. 2013 saw the end of the mining construction boom, while resource production volumes rose. Commodities prices fell in the first half but remained relatively strong for the rest of the year as Chinese growth stabilised. The unemployment rate continued to drift upward during the year and the outlook for jobs remains relatively weak. Removalists were busy in Canberra as The Lodge saw three PMs in residence in 2013 - Gillard, Rudd and then Abbott following the September federal elections. After six years of budget deficits and rising debt under Labor, the new Abbott government quickly reversed its election promise of balanced budgets and is now proceeding to spend up big and borrow even more. It is even foreshadowing budget deficits for another decade. Apart from running up deficits and debt, the government has essentially promised to make no big policy changes during its first term, leaving many voters wondering why they elected them in the first place.	Below average growth rate	Growth slowing	 current speed
Europe	Europe emerged from recession in late 2013 but growth remains very weak, with high unemployment rates, rising extremism and political unrest, and a relatively strong Euro. The major risk for global markets emanating from Europe remains its prolonged bank & government debt crisis. Progress toward a banking and fiscal union is slow but positive, continuing the policy and institutional changes that emerged in the second half of 2012. At the centre of this is Germany, which shifted further away from its initial hard-line austerity stance against the PIIGS. The key player, German Chancellor Angela Merkel, was re-elected in September but her new coalition partner, the Social Democrats, promise to raise wages and pensions and wind back labour market reforms, dampening hopes of an economic revival in Germany. There were a couple of minor banking crises in 2013 - Cyprus in March and Slovenia in September, but much larger risks remain. Portugal and Spain remain very unstable, and even larger potential risks are Italy and France. In Italy voters rejected the reformist PM Mario Monti in favour of comedian Beppe Grillo before settling for Enrico Letta, with continual destabilising efforts from Berlusconi. Across the border in France, the new socialist PM Francois Hollande also faces severe challenges in reviving the economy with stimulus spending while limiting deficits and debts.	Still virtually Stagnant	Recovering very slowly	 current speed
US	Economic recovery in the US edged ahead in 2013, led by extraordinarily loose fiscal and monetary policies, together with declining costs of energy, labour and commodities inputs, lower debt levels and low interest rates for businesses and consumers. Congress and the White House spent all year bickering over the on-going fiscal crisis, starting with the past-midnight deal on New Year's Day 2013, the "fiscal cliff", the automatic "sequester" cuts, the government shut-down in October, and a series of last-minute deals on the deficit and debt ceiling issues right up until December. On the monetary front, the biggest single impact on global markets during the year was Fed Chairman Ben Bernanke's stop-start efforts to begin the winding back of the Fed's $85 billion per month bond buying program, starting with the "QE taper scare" in May-June, and finally announcing a taper plan in December.	Below average growth rate	Recovery remaining slow	 current speed
Asia	2013 was a major turning point for Japan, following the LDP's return to power in the December 2012 elections. Two former LDP PMs returned - Shinzo Abe as PM and Taro Aso as Finance Minister, and they installed pro-inflation Haruhiko Kuroda to head the Bank of Japan. The year may well go down in history as the start of an era even more significant than the revivals under Nakasone (1982-7) and Koizumi (2001-6). There are four "arrows" in the attack on deflation and stagnation - fiscal stimulus, monetary stimulus, structural reforms, and nationalism as a powerful uniting force to galvanise national action. So far the plan is bearing fruit in the form of a much lower yen, higher levels of business and consumer confidence, spending and investment, rising industrial production and exports, the first signs of inflation, and rising nationalism against China as a motivating force for action. It was also a critical year for China, with the stabilisation of economic growth and the leadership transition from Hu Jintao and Wen Jiabao to Xi Jinping and Li Keqiang. In November the landmark Third Plenum meeting of the Communist Party leadership resulted in the announcement of major reforms to a number of policies including the one-child policy in urban areas; rural land sales; the "hukou" system of residency and access to welfare; allowing competition in markets currently dominated by state-owned enterprises; and acceleration of financial market reforms. Also, in a Deng Xiaoping-like move the new President Xi Jinping also consolidated and centralized executive power in the hands of a small group at the top of the Party at the expense of state owned enterprises and local government leaders. This dramatic shift in power may be enough to see the reforms through to fruition, where previous leadership struggled. A 'hard landing' has been averted but inflation is rising.	China: Cyclical slowdown Japan: Early recovery	China: Lower structural growth trend Japan: Stimulus improving exports, production & growth	 current speed  current speed

Asset Classes			Current position	Long term returns (1)
Shares	Australian shares	The local stock market was up a fraction in December after a very strong July-October rebound. The broad market index ended the year up 15% in price terms, and up 20% including dividends, virtually a repeat of 2012. The share price gains were recorded in the face of a slowing local economy, a spate of earnings downgrades and rising bond yields. We have been overweight Australian shares in portfolios all year (since early 2012, near the start of the 2012-3 rally), and our internal and external portfolios also added value above the index during the 2012-3 rally. The banks were very strong this year while the big miners ended up flat, assisted by big volume gains albeit on lower commodities prices (The exceptions once again were gold miners, down 60%+ as the gold price continued to collapse). The star among the big stocks was News (in our portfolios), up 77%, which split into two parts during the year - Fox (media and entertainment) and "New" News (the old print business).	Around fair value	Around average long run returns
	Developed markets shares	December saw nearly all global stock markets end flat for the month, after recovering from the mid-month dip once the US Fed announced its plan to scale back QE. For the full year all of the major developed markets were up by double digits. Japan led the way with a gain of 57%, its best year since the 1972 Tanaka boom. The US was next best of the big markets for the year, with the S&P500 index up 30%, the Dow Jones Industrial Average up 27%, and the NASDAQ up 38%. Overall it was the best year for US stocks since 1997. These strong results were achieved in the face of rising bond yields, slow economic growth, high unemployment, soaring government debt, draconian budget cuts, the government shutdown and the debt ceiling crises. Stock markets in recession-ridden Europe were also up strongly. UK, Germany, France, Italy and Spain were up by 15-20% for the year, with cyclical stocks and banks leading the charge. Our portfolios have benefited from being over-weight global equities since early 2012, and un-hedged on the currency as the AUD has fallen.	Mixed – US is moderately over-priced on long term measures, but most other markets are under- priced to fairly priced	Around average long run returns, but currency gains expected (2)
	Emerging markets shares	The big BRIC markets had another poor year. Only India was up (+9%), while China, Russia and Brazil were down again. The BRIC markets were adversely affect by slow demand for exports from the developed markets, and slowing growth at home. Unlike last year, when almost all of the smaller markets were up strongly, this year the picture was mixed due to local conditions. The best results were from Pakistan, Vietnam, Argentina, Egypt, Nigeria, Romania and Finland. Ireland, Greece and Portugal also rebounded strongly during their deep recessions.	Difficult to value. Many appear inexpensive to fair value, but are reliant on fickle global sentiment	Above average long run returns, but high volatility (2)
Fixed Income	Australian Fixed Income	Australian bond markets had a poor year in 2013 as yields rose and the yield curve steepened. The broad composite index returned just 2% for the year (including interest payments), coming after three years of good returns in 2010, 2011 and 2012. Returns on Commonwealth bonds ended the year flat, interest income was wiped out by capital losses. Corporate bonds returned 4% as credit spreads contracted back to boom-time levels, and semi-government returned 2%. Inflation linked bonds had a bad year, down 2% as investors fled for higher yields elsewhere. We have been under-weight bonds in portfolios in 2013, reducing to zero weighting for bond funds during the year, benefitting investors.	Yields below (prices above) long run average level	Below average long run returns
	Bank Term Deposits	Bank TD rates fell during the year despite rising underlying market yields. The lower rates are finally enticing retail investors out of bank deposits and into shares and property, helping push up prices there. However there is still more than $1.4 trillion dollars in bank deposits in Australia. Banks have no incentive to increase interest rates to attract deposits while lending growth remains slow, especially business lending which has been dormant since the 2007 boom.	Rates below long run average	Below average long run returns
	Global Bonds	While 2012 was a year of declining bond yields generating good returns from bonds, in 2013 the market was split in two. Yields in the developed western markets rose in expectation of scaling back of QE, while yields on PIIGS bonds declined as the Eurozone debt crisis eased. Japanese yields fell further thanks to accelerated bond buying under the "Abenomics" plan. As a result the overall global government bond index had a flat year, returning just 3%, which was made up entirely by returns on currency hedges back into Australian dollars. We remain under-weight global bonds, as they have virtually no credit risk or inflation risk built into their pricing.	Yields below long run average level	Below average long run returns (2)
Cash	Australian target cash rate	The RBA cut its target cash rate twice in 2013 - in May and August, making a total of eight rate cuts since November 2011, bringing rates down from 4.75% to the record low of 2.5%. The dollar is still too high but the RBA is reluctant to cut rates further for fear of sending house prices and housing debt levels even higher, although higher house prices are likely to stimulate new housing construction, leading to higher employment and retail sales.	Cash rates below long run average level	Variable, rising over medium term
Real Estate	Australian commercial property	The listed property market ran up strongly with shares in the first part of the year but fell on the first QE taper scare in late May. Unlike shares, LPTs never recovered, ending the year virtually unchanged. The unlisted direct property market did better this year as yields were compressed by foreign buying despite rising vacancy rates and falling net effective rents. We were over-weight listed property in portfolios during much of the 2012 when the LPT market index returned 33%, but we have been neutral during 2013 while returns have been very modest.	Over-valued on long run measures	Around average to below average long run returns
	Australian residential property	Housing prices rose in 2013 as Australia participated belatedly in the global housing surge created by artificially low global interest rates. Renewed buying interest in Australia was driven primarily by investors and foreigners. While prices rose in 2012 and 2013, price medians across the main cities are only just back up to their 2004-7 pre-GFC levels in real terms after inflation. The current minor price rally may peter out if interest rates and unemployment rates keep rising next year, as household debt levels in Australia remain at elevated levels.	Varies by market and by property	Varies by market and by property
	Australian dollar	The Aussie dollar fell by 1% in December and ended down more than 10% for 2013, including a decline of 14% against the stronger US dollar. Of the major currencies, the US dollar had a strong year but the Euro was even stronger (kept strong by deflationary forces there), while the Yen was weakest, marginally weaker than the AUD. Our portfolios benefited significantly from our un-hedged stance during 2013 as the AUD fell, and it is still over-valued on fundamentals.	AUD above fair value	Currency gains for Australian investors as the AUD falls

(1) Expected "long term" returns refers to periods of 10+ years (looking through economic cycles) starting from the current position
(2) Returns for non-Australian assets are in AUD terms – ie including any profits/losses from hedging or currency movements