

economic & investment horizons

Grant Thornton 

Is the trend really your friend?

Reading the papers, we hear that banks are boring and any cyclical stocks tied into Chinese growth are a must-have in a portfolio. Turning to another page, we are told that investors should be getting out of cyclical stocks, out of small-caps and into large caps.

Whilst these shifts in market sentiment keep stock-brokers in business, Grant Thornton Investment Management (GTIM) maintain one consistent approach to investment year-on-year, regardless of the short-term trends. We invest in businesses, rather than shares, and if we like the business's strategy and management and the company figures illustrate their operational strength, we commit to an investment for at least five years, irrespective of whether the share is "popular" in the market at that time.

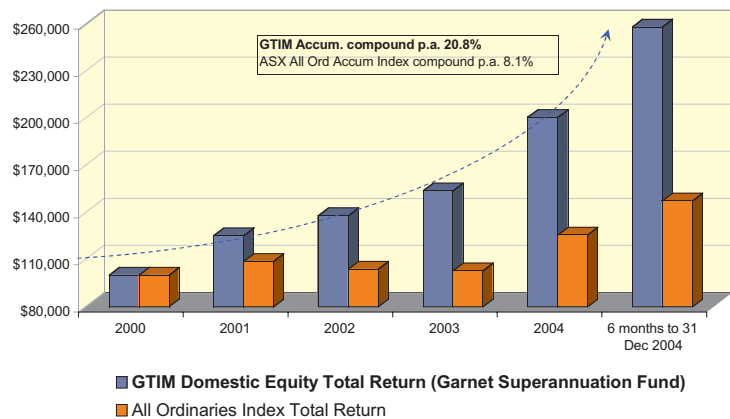
The accompanying graph (Graph A) outlines the total return (capital growth and income) generated from the domestic equity section of Garnet Superannuation Fund (a fund managed by GTIM that represents our model portfolio) as against the total return generated from the All Ordinaries Index. The results from the graph clearly vindicate our long-term approach to investing - GTIM has significantly outperformed the overall

market on a consistent year-on-year basis. This consistency and our commitment to never producing a negative return in any year has seen GTIM's equity portfolio produce a

strong cumulative total return of 158% over the last four and a half years, versus the All Ordinaries' total return of 47%, illustrated in Graph B.

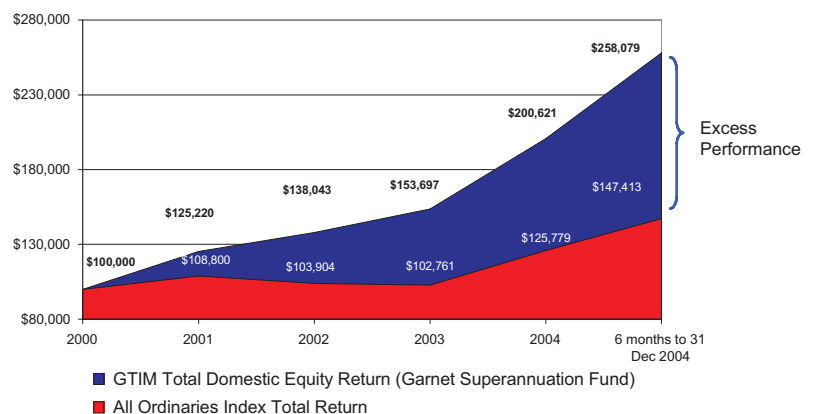
Graph A

GTIM DOMESTIC EQUITY RETURNS (GARNET SUPERANNUATION FUND)



Graph B

GTIM DOMESTIC EQUITY RETURNS (GARNET SUPERANNUATION FUND)



National Foods Limited

National Foods Limited (NFD) is one of Australia's largest food companies and has been a key contributor to the outperformance of GTIM's equity portfolio.

NFD's core activities in milk (Pura), fresh dairy foods (Yoplait) and specialty cheeses (King Island Dairy) enjoy a strong market presence in Australia and the countries to which it exports. Its market share, together with strong cash flows and low gearing made it an obvious target for takeover activity which began in October 2004:

27 Oct 2004 - Fonterra launches an unsolicited, conditional takeover bid of \$5.45 per share representing an offer premium of 16.7% on the closing price. Fonterra already holds a significant stake in NFD of 19%.

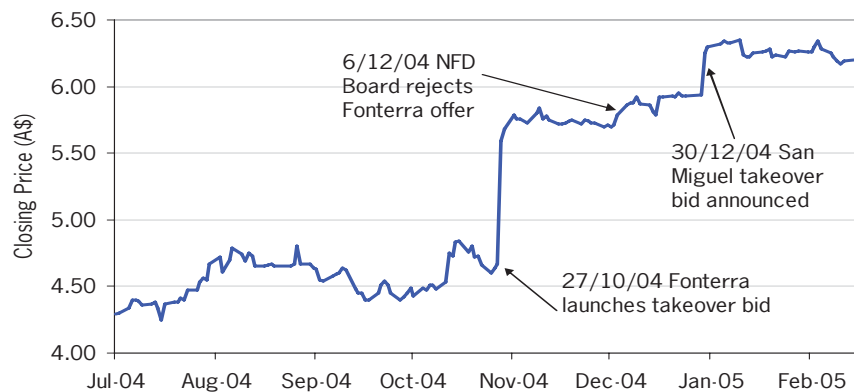
6 Dec 2004 - NFD rejects Fonterra offer as inadequate, valuing itself between \$6.11 and \$ 6.65.

30 Dec 2004 - San Miguel Corp. makes a takeover offer of \$6.00 per share. NFD board unanimously recommends shareholders accept San Miguel offer. NFD announces a 10 cent per share interim dividend.

2 Feb 2005 - NFD provides Fonterra with certain non-public information that will help Fonterra decide whether to revise its takeover bid.

Under its more generous takeover terms San Miguel offers a 28.5% premium on the closing price at 27/10/04. The current stock price, which is in excess of \$6.00, clearly suggests the market is expecting a counter offer. Regardless of the outcome, this is a further example of the importance of holding well run companies that are attractive takeover targets and deliver premium returns to investors.

National Foods Limited - Takeover Price Analysis



Source: Grant Thornton Investment Management

Inflation: not to be taken lightly

In this seemingly virtuous economic and financial environment that Australia is now experiencing, it is vital that inflation (and its benign level) is not taken for granted. Excessive inflation, and more importantly inflationary expectations, cause distortions in economic behaviour which are not economically optimal.

For example, purchasing land where the expectation exists that the general price level and scarce land stock prices will rise. Whilst likely to be profitable in financial terms, in economic terms this is a speculation which will add nil to economic growth. This is unwanted and ultimately a waste of capital resources.

Inflation ended 2004 with an annual rate of increase of 2.6% which is moving towards the upper level of the Reserve Bank of Australia's (RBA) stated band range of 2% to 3% (operating over the cycle). This measure of inflation is the Consumer

Price Index (CPI). As such, the CPI is measuring final prices to consumers.

When considering that most economic commentators were talking about deflation two years ago, and here we are discussing the re-emergence of inflation, we can see that inflation is a difficult economic issue to manage.

Policy makers are in pursuit of the "not too cold, not too hot" balancing act. The problem is, there are no simple water taps. The RBA band of 2% - 3% inflation indicates that a little inflation is desirable, but we are now approaching the level the RBA views as unhealthy. Historically, when this level is breached, it has a "genie out of the bottle" effect and is very difficult to manage.

All indicators in Australia point to upward inflationary pressure. Whilst wage cost pressures increase, productivity growth slows and national income continues to expand, combined

with record high capacity utilisation, inflation above the RBA band is likely. The RBA will have inflation risk as a primary factor in considering whether to increase the cash rate from its current (accommodative) level.

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