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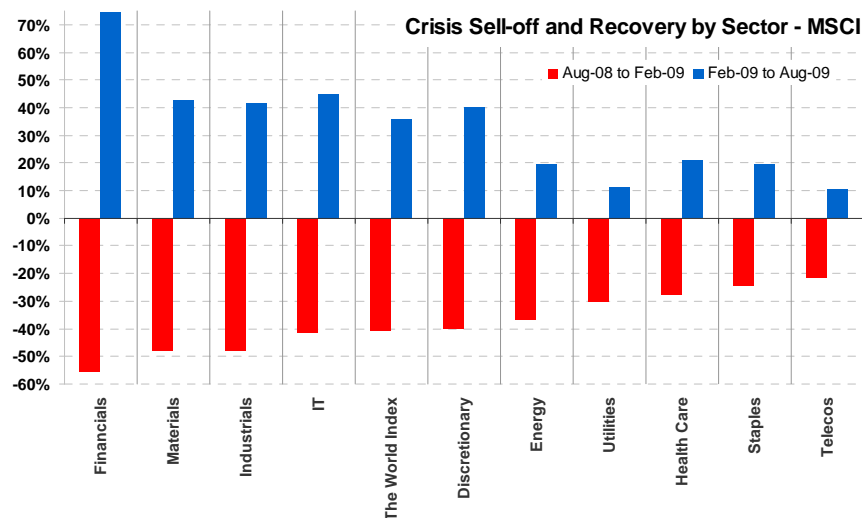
Time for fundamentals to matter

As we pass the second anniversary of the commencement of the global financial crisis (the US sub-prime issues emerging in August 2007), markets have become somewhat jittery in recent weeks while poised between the belief of an economic rebound and valuations that could be pricing in an overly optimistic view of corporate earnings recovery. Calendar year to date (30 September 2009), world equity markets as represented by the MSCI World Index (in local currency terms) have risen 21% and from the low on 9th March 09, 55%. One could be easily mistaken for feeling that we are heading back to more “normal”, pre crisis conditions. However, the financial and economic environment has changed profoundly and after such a significant rebound rally which has had very little to do with logic or fundamentals, the question of when fundamentals will matter again seems appropriate at this time.

Last twelve months – a tale of two halves

The rally on world markets has been the steepest since the 1930's. We have seen a huge shift in sentiment in response to record levels of government stimulus, improving growth estimates and positive earnings momentum. Fundamentals have taken a back seat as stocks have rallied even though missing estimates, as investors set aside 2009 earnings and look beyond into 2010/2011. There is growing momentum in markets as investors are looking for reasons to buy stocks and are often selling the more defensive businesses in order to participate in the rally of higher beta stocks (especially banks and cyclical).

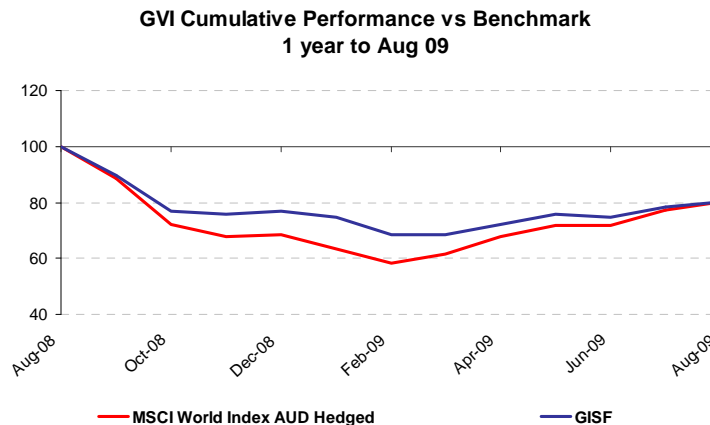
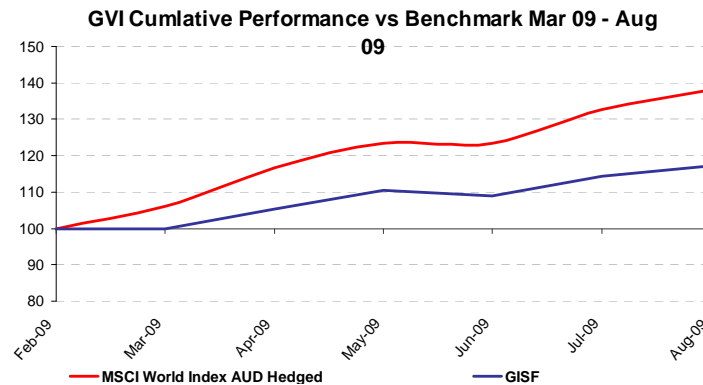
If we dissect the last twelve month's performance at a sector level to the end of August 2009, we can clearly see a tale of two halves. The red columns in the chart below show that the most distressed stocks (banks) and those heavily geared to economic activity (miners, industrial, IT and discretionary) were those that experienced the sharpest falls. The more defensive type of businesses did not fall as much in a period noted for its indiscriminate and panic-selling. Since March the 9th however, the chart also shows in blue, that the same distressed assets were dramatically re-rated by the market on the back of improved sentiment with the more defensive sectors lagging.



Source FactSet

Our internal research shows that a vast majority of the top 20 stocks in each sector involved in the snap-back rally neither made it through our initial screening for the GVI universe (interest cover, dividend yield, FCFY et al) nor satisfied the strict GVI qualitative investment criteria. In our view, it is important not be to drawn into short-term sentiment shifts or trends but rather, to maintain a strict focus on what is compelling value and quality over the long term in adherence to a proven investment process.

Looking at the performance of the GVI Global Industrial Share Fund during this interesting period, we see it mimics the sector performance charts above. That is, if one looks at performance over the short term during this risk rally only, one misses the bigger picture facts in terms of the year to year and longer periods, where the Fund outperforms the benchmark. The defensive qualities shown on the way down have been overtaken in the last 6 months with the rapid re-rating of stocks that were heavily sold down. In our view, comparing the Fund over the last 6 months is not instructive for longer term investment considerations.



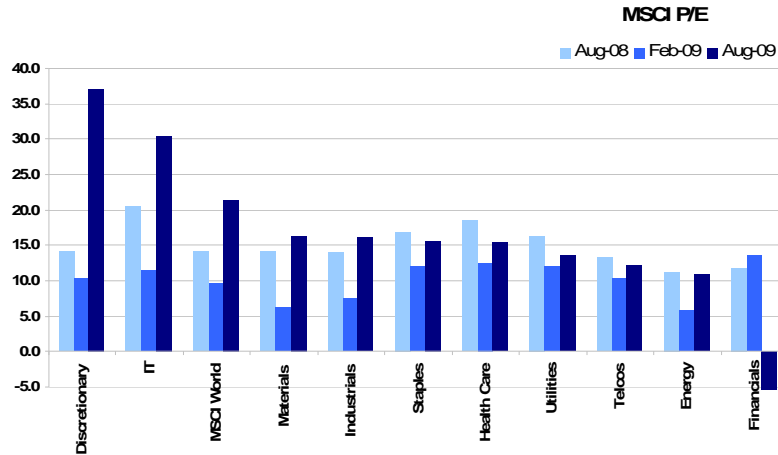
Source: GVI and MSCI

Current earnings estimates overly optimistic

We have also seen a significant rise in the PE multiples. For example, on a trailing earnings basis, the S&P 500 has moved from 10.4x in February this year to over 30.2x (a rise of over 190%) which is a record rise (in both speed and magnitude) when compared to previous periods of expansion. For example, the next most significant expansion period was in 1984-87 (128%) but this took place over three years not seven months. Similarly, in terms of speed, the closest

comparison is with the 2001 period when the multiple expanded by over 66% over a period of nine months.

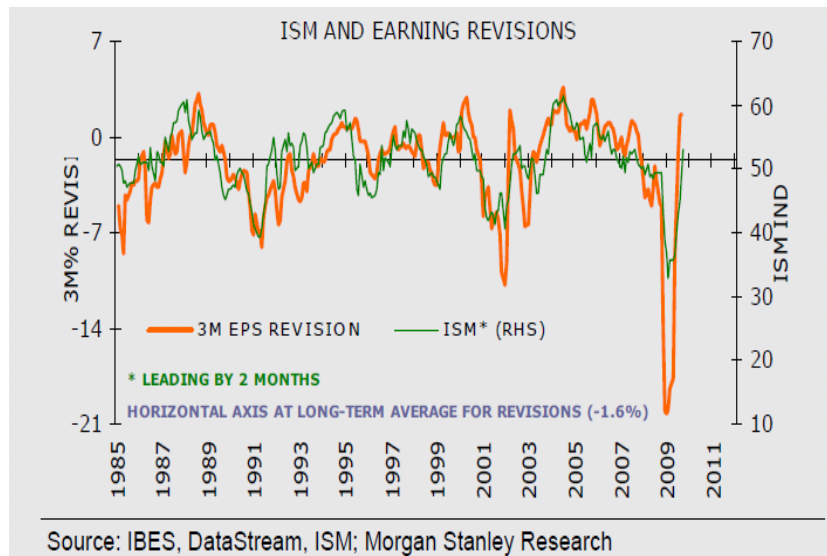
The PE expansion from market lows earlier this year is also vividly depicted in the changes on a sector basis in the chart below. The 2010 consensus earnings expectations appear optimistic and imply a return to peak ROE from the bottom in just 6 months. We believe that the period of PE re-rating is largely over and the market will increasingly depend on earnings to justify and underpin current levels.



Source: FactSet

While equity markets have gathered enormous momentum and rising confidence in a V-shaped recovery, we believe that the expectations appear overly optimistic and significant risks doubts remain as to the underlying demand of the consumer when fiscal and monetary support by governments and central banks is ultimately removed.

In our view, the equity markets have run way ahead of fundamentals and leaving the real economy too far behind in what may be described as a strong speculative snap-back rally that typically follows from such severe declines. Currently the MSCI World index is trading at over 19x forward earnings which from our perspective, is a source of concern and will be difficult to maintain as we face the prospects of a drawn-out period of economic recovery.



The current level of earnings revisions represents the highest level for over 30 years. As evidenced by previous recessions in the US (1981 and 2001), revisions can turn sharply lower during a recovery phase when actual earnings do not meet with increasing expectations. That is, just because the economy is recovering there is no guarantee that estimates will be met or exceeded.

If we look at the chart above, it shows both the increase in the Industry Supply Management (ISM) numbers (ISM above 50 shows expansion, or below 50 a contraction, in US manufacturing) and how consensus earnings revisions have strongly followed ISM's lead. Clearly, earnings forecasts earlier in the year were far too pessimistic, enhancing the subsequent rebound. However, it appears that the ISM is out of kilter with broader macro economic indicators which are much weaker than usual when the ISM breaks through 50. Weak unemployment, industrial production, year-on-year retail sales and non-farm payrolls figures, suggest that the ISM is not representative of the broader recovery and may be unduly influenced by the cash for clunkers initiative, recent stockpiling and seasonal factors. If the ISM is providing a misleading signal to markets as to the strength of the recovery, investors face risks of a set-back, if the broader economy does not follow the ISM lead.

In the first half of 2009, top line revenue and sales growth was actually worse than expected by the market but overall earnings were better than expected, largely due to effective cost-cutting. The market will need to see some top-line revenue coming through to continue to justify current PE levels which, in our view, are overly optimistic. In fact, given overly optimistic earnings revisions (especially for banks and cyclicals) and our outlook for a sluggish recovery in the US, there will be growing downside risk to earnings expectations.

Based on our analysis, we are starting to see a bottom in earnings growth which is supportive of the consensus view that the worst of the recession is behind us. The severity of the current recession globally has meant that it has taken over 20 months to reach a bottom in earnings growth and we would expect market multiples to begin contracting from current levels. As earnings stabilise and multiples contract, we expect fundamentals to have a greater say in the direction of markets which poses interesting risks for those investors who have chased market momentum or bid up earnings multiples by looking past 2009 and into 2010 and beyond.

Our research shows that our holdings in healthcare, integrated energy, utilities and consumer staples have not significantly expanded their multiples, have a high return on equity (ROE), low beta and are trading at attractive valuations. These sectors also typically outperform during periods where market multiples contract.

Summary

While emotions can run high in the volatile conditions that we have experienced over the last 18 months, we continue to be driven and motivated by the opportunities presented to us that make sense based on fundamentals and a strong investment case. A shift in risk and momentum has driven a very sharp and fast rebound but we believe it is important to maintain focus on those businesses that generate revenues and free cash flow throughout the cycle and market volatility, rewarding shareholders with growth in earnings and dividends over the longer term.

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