

Money Matters

La Trobe
financial

how investing should be™

Newsletter Summer 07-08

What can we expect in 2008



La Trobe Financial CEO,
Greg O'Neill

As we reflect upon the year past and some of the events that have occurred in the world of investments, we look forward into 2008, and anticipate what are the key

investment drivers for the next twelve months.

In June 2007, with the economy strong, a low unemployment rate and a one off tax free component capped at \$1 million, Australians poured contributions into their superannuation causing an all time high for superannuation funds at \$1 trillion.

We saw the collapse of Westpoint (late in 2006) followed closely in early May 2007 by failures of other debenture companies such as Fincorp, Australian Capital Reserve (ACR) and Bridgecorp in July. Whilst the number of investors affected in the last two debenture company collapses were not as significant as Westpoint and Fincorp, it certainly left debenture and promissory note operators floundering and many investors sensibly shied away from debenture investments. Additionally, ASIC has demanded all debenture fund operators obtain two external ratings of their operations from 1 March 2008 if they wish to continue.

In August 2007 we read about the first wave of losses affecting many investment markets across the world from the US sub prime mortgage market crisis; this again caused investors to rethink where to invest their hard earned money. This was also reflected in the sentiment of corporate investors and subsequently corporations and banks tightened their lending and investment procedures. This 'herd' like behaviour significantly impacted economies around the world, causing a wholesale market liquidity crisis, where no wholesale funds were available for a period of up to 3 days in August. Economies are still in a 'credit crisis' phase and this is particularly relevant for our outlook in 2008.

Come November 2007, the Australian economy had survived the debenture company collapses, and to date survived the first wave of US sub-prime and credit crisis in the wholesale financial markets. Despite these experiences, Australians contributed more than ever to superannuation and many Australian states are experiencing a housing 'boom' where properties are reaching prices as have never been seen before, despite interest rate rises, and threats of further increases.



La Trobe Financial takes a long term perspective when looking into the future.

So what can we expect in 2008?

- More big gains in house prices?
- A steady year?
- A down year?
- A correction?
- A crash?
- None of the above?
- Some of the above?
- All of the above?

We're putting the La Trobe crystal ball to the test and are confidently predicting...

item g. Some of the above.

Which some? Now that's the \$64,000 question.

Let's get the bad stuff out of the way first. **We think a total collapse is highly unlikely.** Corrections or periodic stock and financial market wobbles happen most years. Usually we view those times as opportunities, even though interest rates may rise further during 2008. Now let's get onto the good stuff... **There is no doubt in our minds that the world is in the midst of a resources boom that will last for decades to come.**

What we can be sure of in this environment is to learn from the lessons of the past:

- arm ourselves with the knowledge of who we invest with;
- what we invest in; and
- how secure our investments are.

We hope that 2008 is a prosperous year for all our customers and investing clients.

Know who you invest with

What are La Trobe's differences from the likes of Westpoint, Fincorp, Australian Capital Reserve and Bridgecorp that keep your investment secured? Why is La Trobe's business model unique compared to other non bank lenders?

The La Trobe Australian Mortgage Fund ("the Fund") is a regulated and complying managed investment scheme; we are not a debenture company or promissory note operator. Our Fund was established to provide a wider range of services and products for our customers, to diversify funding lines, and to widen product offerings to include funds management in La Trobe's chosen area of expertise – specialist mortgage management. The Fund has now evolved into one of Australia's largest mortgage funds.

Receiving over \$2 billion in loan applications annually and being a balance sheet lender, to the best of our knowledge the nature and size of La Trobe's business model is unique in Australia. We raise funds directly from institutional and private retail investors. Our institutional investors include a number of major banks, both local and international, second tier banks, insurance and other financial organisations, all investing for periods of up to 40 years at a time. We also hold an Australian Financial Services Licence ("AFSL"), so private retail investors can also invest in our Mortgage Fund, providing tailored investment options. Combine this with a total menu of loan products to suit the varying needs of our borrowers, such as commercial loans, and an investment management process which allows direct contact for borrowers with key decision makers at La Trobe, we stand out as a lender with unique capabilities. Our long term funding structure differentiates us from other non bank lenders as our peers rely heavily on wholesale capital markets for funding, which is short term in nature.

Therefore La Trobe's model and our operations are transparent and built on long term sustainability.

The list below highlights some unique features that keep your Fund investments secure and have been the basis of La Trobe's 55 year history:

- La Trobe does not permit lending of your investments to related entities, or to directors or staff of La Trobe.
- We are not a development company masquerading as a mortgage trust – our shareholders do not have any interest in any loan funded and are not property developers.

- La Trobe has very low exposure to construction and development loans and we have a tightly managed approach to development projects, with the percentage of the Fund exposed to property development projects currently standing at only 12.00%.
- The La Trobe Fund rarely exceeds a Loan to Value Ratio ("LVR") of 66% and the average LVR for all loans across the Fund is 60.36%.

"...we stand out as a lender with unique capabilities..."

- La Trobe has successfully managed mortgages since 1952 and through many economic cycles such as post war, the 1980s – 'recession we had to have', the early 1990s and now the 2007 international wholesale market liquidity squeeze.
- La Trobe neither accepts nor pays hidden fees and commissions. All fees charged to investors are fully disclosed in the Fund's Product Disclosure Statement and Supplementary Product Disclosure Statements.

Risk comparison of Cash & Mortgages, Pooled Mortgages, Select and Special Situation Options



Over the past year avid readers of our weekly Wednesday Investor News email updates will have noticed a few recurring themes. We make no apology for this repetition, for one sure way to lose money is to continually chop and change investment strategies and direction.

We have a fundamental belief in Fixed Interest investments for all investors as a safeguard or defensive strategy against share market volatilities, and as a source of regular investment income.

La Trobe Pooled Mortgages Option wins awards

In June 2007 Property Investment Research Pty Ltd (PIR) awarded the Fund four stars out of a possible five stars for the Pooled Mortgages Option and Standard & Poor's (S&P)

first rating, awarding 3 out of a possible 5 stars. Please contact us if you would like a copy of either PIR's report or S&P's report, or download them at our website.



The US Sub-Prime Mess

You have probably heard of Warren Buffett. He is the 3rd richest person in the world, sporting a net wealth of over US\$50 billion. One of our favourite Buffett quotes is... “Risk comes from not knowing what you’re doing.” Trust Mr. Buffett to make things simple. The rest of the investing world make risk sound highly complicated. They talk about alphas, betas, risk adjusted returns and the like. Put another way ... **“If you don’t know jewellery, know the jeweller”** ... keep it simple!

The “US sub-prime lending market”, whilst only a part of the total residential mortgage market in the US, is characterised by lending to low income borrowers who have a bad credit history in servicing their home loans. In 2005, the United States real estate market experienced an all time high as funding became more available and financing became more creative to make owning a home more accessible to a wider US population - in particular, to those who may not have otherwise been able to afford to do so.

Characteristics of the changes in lending practices included:

- Credit became available to low income members of the community and those with a poor credit history, who are known as ‘sub-prime borrowers’.
- Low-start and teaser rate loans – the ‘catch’ to these types of loans was that they included an interest rate reset condition that doubled the initial loan rate after a short period of time.
- Honeymoon rates – some initial interest rates were as low as 1% to 2% for the first two years then they increased to the standard rate of 7% p.a. This caused sub-prime borrowers to default as they could not keep up with the repayments on their loans.
- High Loan to Value Ratios (“LVRs”) – some as high as 140%. Traditionally, LVRs do not usually exceed 80%. As property prices

began to fall, this made the position of the sub-prime borrower even worse.

Therefore, as the interest rates increased on these types of loans, many sub-prime borrowers could not meet their repayments, and so defaulted on their loans. It is now believed that up to 7 million people in the US have taken out sub-prime mortgages totalling some \$1.5 trillion US dollars, and that losses will total some \$300 million US dollars.

“...the sub-prime crisis is far from over, predicting more top heads to roll...”

How did this economic issue in the US spread to other economies around the world?

The crisis spread because many sub-prime mortgages in the US have been “packaged” by lenders with the

and we suffered as a result of an unprecedented liquidity squeeze and deterioration in that market. No one, no one is more disappointed than I am in that result.” The quote comes from the retired CEO of Merrill Lynch, after posting an unprecedented \$US8.4 billion quarterly loss. On Monday September 27th, the US sub-prime crisis claimed yet another victim. Charles Prince, the boss of the world’s largest bank Citigroup, left after the company revealed it was facing losses of up to \$16 billion due to its sub-prime exposure. And some crystal ballers say the sub-prime crisis is far from over, predicting more top heads to roll as further hefty losses emerge.

Why does the US housing market matter to us here in Australia? It’s a good question. Here are some possible answers:

- Fear has spread into worldwide corporate debt & wholesale markets, which has lifted the cost of debt across the board and has had an impact on the cost of money.



help of investment banks and sold around the world to other, or ironically often the same, financial institutions including some hedge fund managers. These packages are often referred to as ‘Collateralised Debt Obligations’ (“CDOs”). In basic terms, as the value in the US real estate market began to decrease, and the level of defaults began to increase, the investments in these CDOs became non viable to the point where many major investors lost substantial amounts of money.

“The bottom line is we got it wrong by being overexposed to sub-prime,

- It appears that investors are taking profits and demanding higher returns for the risk profile of certain investment assets. The simple law of supply and demand.
- The world has experienced a massive growth in credit availability in the last few years and the very threat of that unwinding has a big impact on the investment markets.
- In a nutshell, the US sub-prime crisis has effectively put a global end to cheap and easy credit.

Elephants don't gallop

The US sub-prime crisis well and truly entered our shores in August 2007 when three Australian fund managers — Basis Capital, Grange Securities, and Macquarie Bank through its Fortress Products were affected. Also RAMS Home Loans Group firstly warned profits would be severely hurt by the escalating cost of providing loans, quickly followed up by news that they were having trouble finding buyers to enable it to rollover \$6 billion of its US short term funding and was subsequently sold to Westpac Bank. The potential ramifications from the US sub-prime losses are endless:

- Local house prices might slump.
- The US economy might enter a recession.
- Australian lenders may sharply increase the interest rates they charge end consumers.
- The Aussie dollar might slump even further.
- Makybe Diva's newly-born colt might only fetch \$50,000.
- Kevin Rudd may stop visiting seedy nightclubs.
- The stock market volatility might continue for the next 12-18 months.
- The US Federal Reserve may cut interest rates again, while Australian rates may soar.
- Cash might be king, and Debt might be the devil.
- China may host the 2008, 2012, 2016 and 2020 Olympic Games.
- The resources boom might run for another 15¾ years.

It's about there that our crystal ball starts to blur. We could go on and on, pontificating and frankly guessing about some of the ramifications of the US sub-prime crisis. The biggest worry today is the global liquidity crisis in wholesale financial markets, the fallout of which is being felt across the globe. Perhaps the old saying "Money Makes The World Go Round" is never truer. The biggest worry tomorrow however will be something completely different, something that we're not even worrying about today.

Ex-US Defence Secretary Donald Rumsfeld could easily have been talking about the world money markets when he uttered these now infamous words ... *"There are known knowns. These are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know."*

The sight of large queues outside British bank Northern Rock as savers rushed to withdraw all their savings in September was a sobering scene. In three (3) days during



September 2007, \$A4.8 billion was withdrawn by savers. Once seen as the darling of UK banks, with a market capitalisation of A\$12.6 billion at its peak, Northern Rock today is only being kept afloat due to it being bailed-out by the Bank of England. Depositors are being told by the Bank of England that they will not lose any of their money.

"The biggest worry today is the global liquidity crisis in wholesale financial markets..."

The markets will correct themselves

The bottom line however is that, over time, the financial markets, with or without help from central banks, will correct themselves. How do we know this? **We've been here before.**

- In 1989 we had the collapse of several banks like State Bank Victoria, Tricontinental, as well as Pyramid Building Society and Estate Mortgage. The Australian market recovered and grew.
- In 1997, we had the Asian financial crisis. The markets recovered.
- In 1998, we had the Long Term Capital Management collapse and Russian bond crisis. The markets recovered.
- In 2001, we had the US terrorist attacks. The markets recovered.
- In 2003, the markets plunged heavily amidst a liquidity and forced selling crisis in the insurance and banking systems, also signalling the absolute bottom of the dot com crash. The markets recovered.
- In 2007, the US sub-prime crisis is resulting in a global liquidity squeeze. The markets will recover but not in time to save some. The days of cheap and easy credit are gone, for the time being at least. Any company who relied on such easy pickings to fuel their growth will now struggle, and rightly so.

Three reasons why economic growth will continue

Notwithstanding the clouds on the global investment horizon, emanating from the US and wholesale financial markets around the world, we believe there are three main reasons as to why growth in the Australian economy will, after a period of moderation in the first half of 2008, continue to push higher and higher in the months and years ahead.

Reason #1 - There is a veritable wall of money sloshing around the financial services and banking industry. Every day, millions more compulsory superannuation dollars enter the market; it must find a home and invest somewhere.

Reason #2 - The insatiable private equity appetite for acquisitions, whatever the company, whatever the size. It seems no company is safe, even companies as big as

Telstra or Rio Tinto. Forget footy tipping - picking the next takeover target is almost becoming the truly national pastime.

Reason #3 - The resources boom is just beginning as our Asian neighbours each experience their own industrial revolutions in modernising their respective economies. Chinese demand for resources such as iron ore, copper and oil is strong and growing. Middle Eastern political instability is sadly a fact of life, and since most of the proven oil reserves in the world are also in that region, oil prices are likely to stay high and go even higher. If all that isn't enough, a recent report on Bloomberg quoted prominent investor Marc Faber as saying, "The up wave of the (current commodities) cycle is likely to last another 15 to 20 years."

More interest rate pain on the way, figures say

Mortgage holders should brace themselves for further interest rate pain in 2008, new figures on economic growth suggest. The only thing saving them from another hit - immediately following November's 0.25 per cent hike - is the continued pressure on global credit markets due to the US mortgage crisis.



But, according to Westpac chief economist Bill Evans, it will only be a short-term reprieve given Australia's upbeat economic outlook and growing inflation concerns.

"All signs are that the Reserve Bank of Australia ("RBA") has more work to do in the battle against inflation," Mr Evans said. "Accordingly, we expect the RBA to lift

interest rates by 0.5 per cent over the first half of 2008." Mr Evan's comments came after the release of the latest Westpac-Melbourne Institute leading index of economic activity, which showed the Australian economy continues to surge.

Thanks to consumer spending, employment growth and business investment, the index - which indicates the likely pace of economic activity three to nine months into the future - increased 1.9 points (or 0.8 per cent) in September, taking the index's annualised growth rate to 5.8 per cent.

All four components of the leading index increased in August - dwelling approvals rose 6.8 per cent, share prices were up 5.1 per cent, real money supply was 1.3 per cent stronger and US industrial production was 0.2 per cent higher. "The leading index is pointing to strong, sustained economic growth in Australia," Mr Evans said. "This picture is in line with Westpac's forecasts for GDP growth to be 4.5 per cent in 2007 and to at least hold that solid pace in 2008." The annualised growth rate of the coincident index was 4.4 per cent - above its long term trend of 3.7 per cent, but off its peak of 6.3 per cent in January this year.

While the numbers show Australia's economy continuing to motor along and the outlook for growth in the Asia-Pacific region remaining robust, the index suggested sluggish conditions in all G-7 countries except Canada.

The financial turmoil arising out of the US sub-prime housing market has seen about \$US36 billion (\$A40.41 billion) in writedowns booked or already announced. The RBA's official cash rate has increased twice in 2007 to sit at 6.75 per cent, its highest level since July 1996. Also, the central bank last week said inflation will remain at the top of its two to three per cent target range for the next two years and underlying inflation will rise to 3.25 per cent by end of the December quarter.

2008 Scenario 1. Mortgage rates Up, House Prices Down

We're not going to have a Northern Rock UK Bank type run on a large bank here in Australia, because unlike Northern Rock, our banks have very high level of savings versus mortgages ratios. But what is entirely plausible is that, because of the global banking liquidity crisis, Australian banks continue to raise interest rates to their customers, meaning mortgages will ultimately become more expensive. That could impact on banks in a multitude of ways, the most obvious being a slow-down in them generating new mortgages as Australian consumers simply can't afford to buy their first home or to move up the property ladder. Whisper the words, but the whole US sub-prime crisis has the potential to cause a house-price correction here in Australia.

2008 Scenario 2. Mortgage rates steady, house prices flat

More likely however is that as a result of \$40 billion having already been written off sub-prime losses in the US, and the November 2007 OECD report confirming one fifth of all sub-prime loans may be 'at risk' totalling future projected losses of some USD \$300 billion, and US housing starts down 48% (the last time this happened was 1996) we believe the US economy now looks softer, and in February 2008 when the RBA has its first meaningful look at official rates again, these impacts will have moderated domestic Australian inflation, and removed the need for the RBA to increase rates in an attempt to dissuade people from spending and over heating the local housing market and economy.

Investment Returns

Our objective for the Fund is to provide investors with regular monthly income with a low level of investment risk and

volatility, and to outperform the UBSA (UBS Australia) Bank Bill Index over one year (after fees and charges) on

all mortgage investments. Please refer to the Chart below for our investment performance.

Investment Performance		Historical Performance (30 June 07)				
current % p.a. return [^]		6 months % p.a. 31 Dec 06	1 year % p.a.	2 years % p.a.	3 years % p.a.	5 years % p.a.
Investment Options in Fund						
1.	Cash & Mortgages	6.55	6.02	5.77	5.56	5.40
2.	Pooled Mortgages	7.50	7.25	7.29	7.40	7.38
3.	Select Mortgages*	9.82	9.85	9.83	9.86	9.94
4.	Special Situation Mortgages*	16.27	16.18	16.33	16.48	16.82
Benchmark UBSA Bill Index		6.61	6.26	6.42	6.09	5.94

Notes: Returns are calculated after fees and expenses. The historical performance of the Special Situation Mortgages Option is based on 2nd mortgages made by the Fund over the past five (5) years. * These rates represent the average rates payable on the mortgage portfolio of each Option and may not be indicative of the returns on the investment selections of individual investors. ^ The rates of return from the Fund are not guaranteed and are determined by future profits of the Fund. La Trobe Capital & Mortgage Corporation Limited ABN 27 007 332 363 & AFS Licence No. 222213 is the issuer and manager of the La Trobe Australian Mortgage Fund. It is important for you to read the Product Disclosure Statement for the Fund before you make an investment decision. You can get a copy of the PDS from our website www.latrobefinancial.com.au or by calling 1800 707 707. You should consider carefully whether or not investing in the Fund is appropriate for you.

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