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Fourth Quarter (Q4)
2020 Edition

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Diamonds: January 2013 Recirculation

With special thanks to Mr Philippe Mellier (CEO), Ms Esther Oberbeck (Head of Strategy) and Mrs Lynette Gould (Head of Media Relations) of the De Beers Group



A recirculation of our January 2013 Circular, which is as timely today as it was then. With special thanks to Mr Philippe Mellier (CEO), Ms Esther Oberbeck (Head of Strategy) and Mrs Lynette Gould (Head of Media Relations) of the De Beers Group for their generous contribution towards this piece.

Find all previous circulars at our [Global Investing For Australians](#) archive, hosting over 894 original contributions since 2012.

The 1947 N.W.Sayers advertising agency slogan, “A Diamond is Forever” could easily be regarded as the single most successful advertising campaign of all time. It lodged in our collective psyche a relationship between tangible value, love and security and by doing so set its place at the centre of our personal lives, relationships and investment decisions.

As an UHNW investment, unlike in Europe and North America, this commodity receives little airplay in our region, even in light of the fact that the reestablishment of greater China is already presenting unprecedented levels of consumption, investment and interest, both in the gem-stone consumer markets and in the industrial applications of both mined and synthetic stones. Not only are the spending patterns of consumers changing but the cultures too, shifting in China for example from the traditional preferences of Jade and Silver towards those of Diamonds, Platinum and White Gold.

We are very fortunate this month (*January 2013*) to have a Q&A with the Head of Strategy at the De Beers Group, which can be found at the conclusion of this circular. A quintessential pioneer of this market throughout the entire value chain, the De Beers group enjoys a unique perspective and insight into the machinations, trends and perceptions of this commodity, throughout the world, going back to 1888.

We will briefly look at the significant changes in dynamics of this industry over the past ten years which are worth being cognisant of, the role and applications of this commodity in the consumer and industrial markets and the considerations required as an investments decision.





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Mined 'Natural' Diamonds

As a natural resource and investment asset, diamonds are not unique. The diamond-mining industry is part of the global mining sector and subject to the same business and market dynamics as other extractive industries. The diamond industry is not as idiosyncratic as outsiders have generally thought.

Diamonds have several appealing characteristics as a potential investment tool. Investors often consider them to be a "safe haven" as a portable, physical asset whose value remains uncorrelated to the stock market's volatility. Diamonds also offer a way to balance portfolios, since their prices do not correspond with the performance of other investments. Classically they would be referred to as relatively price inelastic investments.

Diamonds also carry an additional association with security, above all, economic security, in the developing markets of China, India and Russia. Because women in those countries perceive diamonds, in part, as a store of value, it is possible that a market for investment diamonds could develop in those countries. This perception however is not only limited to the **BRIC (Brazil, Russia, India and China)** economies, it could be argued it remains in western economies too. In the United States for example, annual revenues and total private consumption levels for luxury consumer diamonds still remain double those of the US mobile phone market. Notwithstanding, qualitative research by the Antwerp World Diamond Centre (AWDC), et al notes that consumption preferences of 'Gen-Y' female consumers are shifting with stronger inclinations towards electronics (i.e. mobile phones, I pads, etc) in both the developed markets of Europe and North America and those of the developing economies too.

At a macro level, the geopolitics, economics and national interests of the Diamond value chain has also shifted, particularly over the past decade. Traditionally for example, rough diamond cutting and polishing was primarily undertaken in London, Antwerp in Belgium, Mumbai in India, Ramat Gan in Israel and Johannesburg in South Africa but that is now changing with a shift towards India and China. Almost all diamonds are now cut and polished in India or China.

Origins Of The Modern Industry

The 1870 discovery of massive diamond deposits near the confluence of the Vaal and Orange rivers in South Africa was a watershed moment, igniting a diamond rush. British-born politician and businessman Cecil Rhodes began buying up the claims of small mining operations, including the farm of two brothers, Diederik and Johannes de Beer.

Rhodes founded the De Beers commercial mining company, which eventually consolidated all the South African mines after it bought out Barnato Diamond Mining, the company owned by his main rival, Barney Barnato, in 1888. By the time Rhodes died, in 1902, De Beers accounted for 90 percent of the world's rough diamond production and distribution.

Another key figure in the history of the diamond trade was German-born businessman and financier Ernest Oppenheimer. After he established the Anglo American Corporation, he bought De Beers shares whenever they came up for sale. By 1927 he was one of the most significant shareholders of the company; he was later named chairman. Under his leadership De Beers evolved into a global diamond empire. Led by Oppenheimer and his descendants, an interrelated group of companies emerged that dominated the mining, trading, marketing and industrial manufacturing sectors of the diamond business for the majority of the twentieth century.





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Soon after Oppenheimer took control of De Beers, he established a central selling organisation (CSO) known as The Diamond Corporation. This organisation sought to make outside competition irksome, due to the fact that diamond producers had to sign exclusivity agreements with the CSO.

Up until the 1970s, the central selling organisation remained unchallenged. This, combined with De Beers' mine acquisitions, contributed to De Beers' enjoying approximately 80% control of the global diamond market.

In the 1970s and 1980s, a number of events threatened De Beers' CSO. In the 1970s for example, whilst Israel was experiencing high inflation, diamonds were seen as an investment that would hold their value. Seeing the threat posed by a number of investors selling diamonds at once, De Beers created a temporary mark-up for all diamonds sold through the CSO. They also threatened dealers in Israel with supply cuts should they continue to hoard diamonds. In the end, this proved effective and by the late 1970s, the Israeli diamond industry was severely damaged by these events.

It wasn't until the turn of this century (~2,000) however that the industry, throughout the entire value chain, experienced a quantum shift and a permanent change in whom and how it did business.

What Changed?

For over a century, the De Beers Group undertook the market leader role and in doing so, also accepted tacit responsibility for the generic promotion of diamonds (both for consumer and industrial consumption). By doing so they not only promoted their own and affiliated products but that of their (then smaller) peers alike. The brand De Beers wasn't explicitly marketed, the commodity was. The preeminent position of De Beers meant that their role as steward of the entire industry would be known by all parts of the value chain, in effect, from the mine up and until the retailer.

What changed was the introduction of new sources of diamonds, new players in new countries that in economic terms meant that a monopoly market now became an oligopoly.

Commercial production of diamonds started in South Africa in 1870 and had expanded to four continents by the early 2,000s, with 133 million carats produced globally in 2010. Today most commercially viable deposits are found in Australia, Botswana, Canada, Russia and South Africa. Russia produces nearly one quarter of global diamond output by volume, followed closely by Botswana.

Along with these new deposits came new competitors, some of which had either explicit or tacit sovereign backing. One of the new majors is Alrosa, a Russian diamond conglomerate. Alrosa retains complete ownership rights to all its projects at every stage of development namely because of the classification of diamonds as a strategic national resource in Russia. Any diamond-producing company operating in Russia must by law be majority Russian-owned, which makes it difficult for international exploration players to conduct business there.





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In the 1930s Russian explorers recognised geological similarities between the ancient bedrock in Siberia and some diamond-rich parts of southern Africa.

They began prospecting in the Sakha region and in 1954 discovered the first kimberlite pipe in the region, called Zarnitsa (Dawn); more than 500 additional kimberlites were discovered during the next two years.

Mines were gradually developed and by the 1970's Russia had become the world's third largest diamond producer by volume, following Congo and South Africa. This major discovery increased the overall supply of rough diamonds on the market.

At the same time, the Soviet Union made a deal with De Beers to sell its rough diamonds through the single channel of the CSO in order to better respond to global supply fluctuations. However, since the 1980s Alrosa has been circumventing the CSO system and pioneered their own distribution channels globally.

Another interesting story lies in Australia. In 1979 geologists discovered the largest diamond deposit in the world by volume, the Argyle pipe, in Western Australia. This marked the world's first discovery of economically viable lamproite deposits. In 1994, its peak production year, the Argyle mine produced 43 million carats of diamonds, which at the time represented 40 percent of world production.

Canada has become the most recent major region of new diamond discoveries. Significant deposits were found in 1992 at Point Lake in the Northwest Territories. Several major Canadian mines have since opened, among them Ekati and Diavik.

Both the Australian and Canadian deposits are predominantly owned and mined by the two big Australian mining conglomerates BHP Billiton and Rio Tinto.

Because of the change in marketplace dynamics, in effect a shift from monopoly to oligopoly, as the former De Beers Managing Director, Mr Gareth Penny put it, the group has changed *"from a supply-controlled business to a demand-driven one."*

In all likelihood two developments drove that change. First, category marketing made sense for De Beers when the company was able to channel the vast majority of rough-diamond sales to the market. But when the company relinquished that role, generic marketing that benefited the entire industry became harder to justify to shareholders. Second, the returns on category marketing became harder to quantify. While diamond sales were exploding in the mid-twentieth century, far outpacing GDP growth, the *"A Diamond is Forever"* campaign was considered a huge success. However from 1979 to 2000, even as industry marketing spend significantly increased, overall diamond sales grew much more slowly, barely keeping pace with GDP.

In De Beers' absence retailers and jewellery manufacturers are now stepping up their efforts to boost consumer demand. Major players such as Tiffany and Cartier each spend about US\$50 million a year marketing their own brands of jewellery; an effort that partly compensates for the absence of a generic marketing campaign.

So far no other diamond-producing player has stepped in to drive a generic marketing program - the jury is still out on how this absence will affect consumer demand, especially in fast-growth markets with relatively low per capita diamond penetration such as India and China.





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Natural *Vis-à-Vis* Synthetic Diamonds

Most manufacturers of industrial synthetic diamonds are in China, with a handful in other places.

Synthetic diamonds are created by a technological process that takes place in a laboratory, in contrast to natural diamonds that are created through a geological process that takes place deep within the earth.

Synthetic diamonds have been around since the 1950s. About five billion carats of synthetic diamonds are manufactured and used for industrial purposes, a sector in which they dominate the total volume of diamonds used.

In the world of jewellery, the only inexpensive alternatives to natural diamonds until synthetic alternatives emerged were cubic zirconium and moissanite, which bear some visual resemblance to diamonds.

But these stones have a molecular structure completely different from that of diamonds and the visual differences between the two types are easily detected. Only in the past decade has technology allowed the manufacturing of synthetic diamonds of high quality.

Today it is possible to make colourless synthetic gemstones that, on a molecular level, are identical to natural stones and so visually similar that only a gemmologist with special equipment can tell the difference.

Perhaps more worrisome than any actual or potential change in corporate control was the appearance in 2011 of a large batch of synthetic diamonds believed by their dealer to be natural.

An analysis by a grading lab revealed that the entire batch was synthetic. The event was unsettling, raising concerns that high-quality counterfeit diamonds had slipped into the market.

The batch in question was created through a process known as chemical vapour deposition (CVD), which produces stones that a diamond dealer cannot distinguish from natural diamonds without special equipment.

The event highlighted the importance of diamond certificates to ensure the authenticity of purchased stones.

Two methods are used to produce synthetic diamonds. Diamonds produced through either method can be cut into gemstones suitable for the jewellery market.

The high-pressure, high-temperature (HPHT) method is the older approach. General Electric used HPHT to achieve its breakthrough 1954 commercial production of industrial diamonds at the company's research facility in Schenectady, New York.

HPHT replicates the natural geologic process. Small seed diamonds are placed into a machine, covered with a mixture of catalyst metal and graphite powders and subjected to temperatures up to 2,500 degrees centigrade and pressure up to 60,000 atmospheres. HPHT remains the major method for producing diamonds suitable for industrial purposes.

The downside of HPHT is that most of the diamonds emerge in shades of yellow and brown because of the presence of nitrogen in the manufacturing process. Manufacturers can produce diamonds of other colours as well by introducing various gases into the reactor chamber.

It is also possible to introduce chemicals that will produce the highly desirable colourless diamonds, but the cost of doing so is far greater.





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In the second method, chemical vapour deposition (CVD), manufacturers create diamond crystals in a low-pressure environment using carbon-bearing gases. The process involves depositing a carbon vapour onto a substrate to grow the stones. Manufacturers can precisely control the diamond composition and create either a single crystal or a polycrystalline form. The ability to do so has wide potential for industrial uses. Using the CVD method manufacturers can produce colourless gem-quality diamonds up to two carats in size more economically than with the HPHT method.

Overall, the HPHT method is better suited than the CVD method for industrial diamond production, because HPHT has the advantage of using fewer ingredients and producing more diamonds more quickly. CVD is more suitable for manufacturing stones of higher quality because this process permits growth of diamonds over larger areas and on various substrates and more-refined control over the chemical properties.

Consumer acceptance of synthetic gem-quality diamonds could negatively affect the market for natural stones. But for that to happen the price of synthetic diamonds would have to drop considerably, which would be feasible if a technological breakthrough permitted lower manufacturing costs. Although such a possibility exists, it is not likely to present a significant threat to the diamond industry in the next decade. Yet it is worth considering the experience of the sapphire, a gemstone also highly prized but less valuable than the diamond. The technology to produce synthetic sapphires that are nearly indistinguishable from natural sapphires emerged in the early twentieth century.

Synthetic sapphires have been produced artificially for a century, but their availability has not dampened the demand for natural sapphires, which are still mined in about the same quantity as diamonds. The price of a one-carat natural sapphire has been growing at about seven percent per year for the past 35 years.

Despite the emergence of synthetic diamonds, no substantial changes in the supply or demand for natural diamonds are expected in the next decade. It would take substantial shifts in manufacturing, the supply chain, marketing campaigns and consumer attitudes for synthetic diamonds to pose a threat to naturally mined diamonds.

DE BEERS

A DIAMOND IS FOREVER

To: Australian Standfirst

From: Esther Oberbeck

31 January 2013

Dear Australian Standfirst,

Below are some statements related to your questions of January 27, 2013 on the topic of diamonds for investment. Before reading said statements, please note this disclaimer.

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Question One: Diamond products have been considered a way of protecting existing wealth for millennia. In light of the significant broader gamut of investment options now available to high net worth individuals and families in the twentieth and twenty first centuries, how popular have you seen diamond investments continue to be within these portfolios?

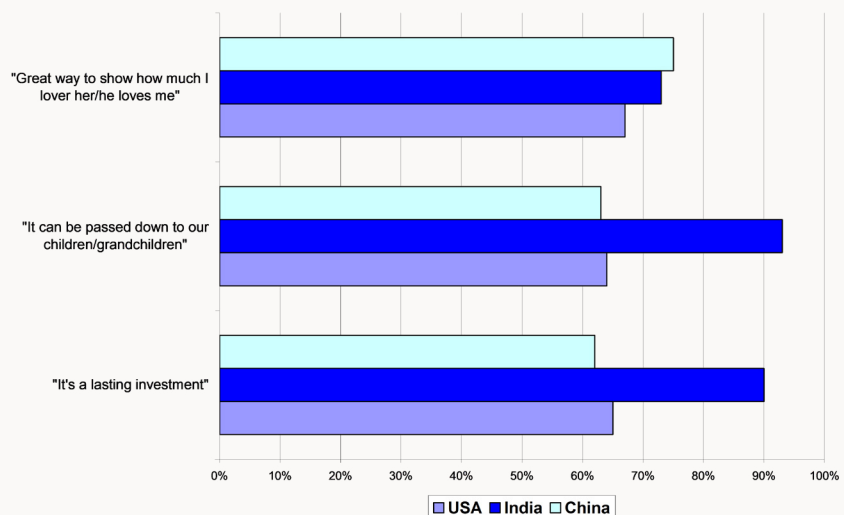
Answer One: Diamonds are a unique scarce natural resource. As such, diamonds have been perceived as a store of value throughout the ages. In recent years, De Beers has been approached by representatives of high net worth individuals and proposed investment funds interested in the concept of a collection of diamonds as an asset class.

De Beers, as the industry's leading diamond mining and distribution company, sells rough (i.e. uncut) diamonds through term contracts and spot auctions. Term contract clients are objectively selected according to their ability to drive demand for diamonds. These are leading diamantaires (independent of De Beers) with a global distribution reach who trade rough diamonds or supply polished diamonds to jewellery manufacturers and retailers. De Beers does not supply rough diamonds to end-consumers or investors.

De Beers estimates that the investment market in diamonds – that is, diamonds held exclusively in expectation of financial gain – accounts for only a small proportion of the total annual polished diamond demand.

At the same time, De Beers-commissioned research shows that consumers worldwide are drawn to diamonds for both emotional as well as store of value benefits. They see diamond jewellery as a gift that will last forever, will hold its value and can be passed on to the next generation (see chart below).

Motivation for DJ Choice as Gift (USA, India and China) - % Very Important/Somewhat Important



One of the reasons for the underdevelopment of diamonds as an asset class are the intrinsic barriers to developing a widely adopted trading platform for diamonds. As a so called non-fungible product, each diamond is totally unique and thus also has a price point unique to them. This is quite unlike precious metals or other widely traded commodities such as oil, gold and platinum.

Historic attempts to create diamond contracts to be traded have not met with success. In the 1970s and 1980s, the Chicago Board of Trade (CBOT) and the London Commodity Exchange, separately, looked at diamond futures and rejected the idea. In 1982, Martin Rapaport submitted an investment contract to the then Commodity Exchange, Inc (COMEX, now NYMEX) but it was rejected on account of lack of price transparency and the difficulties of standardising a contract for a non-fungible product. Today, the financial industry continues to attempt to develop standardised instruments for trading (For a recent example, see <http://monediaminc.info/investment.html>) but none has yet been widely adopted by the industry.





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As a result, investors looking to benefit from the potential appreciation of the value of diamonds have mainly three choices: 1. Hold the actual polished diamonds themselves; 2. Invest in closed-end funds that buy and hold physical diamonds for investment; or 3. Buy shares of publicly traded diamond exploration and mining companies.

Question Two: What differentiates De Beers diamonds from others?

Answer Two: De Beers, established in 1888, is the world's leading diamond company with unrivalled expertise in the exploration, mining, sorting and marketing of diamonds. Together with its joint venture partners, De Beers employs approximately 16,000 people in operations around the world.

The people of De Beers are committed to "*Living up to Diamonds*" by making a lasting contribution to the communities in which the company operates. In the countries in which De Beers has mining operations, this means carrying out profitable business, while simultaneously helping host governments achieve their aspirations of turning natural resources into shared national wealth. For Africa alone, this means returning more than US\$3.0 billion to the continent every year.

The Diamond Trading Company (or DTC, now in the process of being re-named De Beers Global Sightholder Sales) hosts rough diamond sales ten times a year. The sales are known as "Sights" because, during the sales period, customers are able to physically inspect the stones on offer before deciding whether to purchase. Since these customers (all of whom have been selected according to the stringent legal and commercial criteria) literally have Sight of the diamonds, they are known as "Sightholders". The DTC only sells rough diamonds during Sights and only to Sightholders.

Sightholders have been required to comply with the company's Best Practice Principles (BPPs) since 2005. The BPPs are a continually evolving standard intended to ensure that consumers buying diamond jewellery can rely on the professional, ethical and technical standards of the gem diamond industry. Supported by an external assurance programme, the BPPs are a mandatory code of ethical business conduct that the Family of Companies, our joint venture partners, contractors and Sightholders all subscribe to.

De Beers has two consumer-facing brands: the Forevermark and De Beers Diamond Jewellers.

Forevermark is the diamond brand from the De Beers Group of Companies. Forevermark appoints expert diamantaires (that adhere to stringent ethical and pipeline integrity requirements) who are able to submit their eligible polished diamonds (which may have been cut and polished from De Beers or non-De Beers rough from eligible sources) to be inscribed with the Forevermark icon and a unique serial number. These diamantaires are licensed to sell their diamonds incorporating the Forevermark brand to authorised Forevermark Jewellers.

Each Forevermark diamond carries a promise: that it is beautiful, rare and responsibly sourced. Selected for their exceptional qualities, only 1% of the world's polished diamonds are eligible to be inscribed with the Forevermark icon. Forevermark diamonds are widely available at retail level in China, Hong Kong, Japan, India, the USA, as well as in eight other markets.

De Beers Diamond Jewellers (DBDJ) is an independently managed and operated 50/50 retail joint venture with LVMH Moët Hennessy Louis Vuitton.

DBDJ sources polished diamonds for sale at retail level from rough diamond manufacturers (cutters and polishers) and polished traders (i.e. it does not purchase rough diamonds from De Beers).





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DBDJ expresses the Art of Diamond Jewellery, through the elegance and timelessness of its own inspiring designs, its impeccable craftsmanship as well as its unrivalled expertise in selecting only the most beautiful diamonds that display Fire, Life and Brilliance.

In both cases, these diamonds are put through the industry's most rigorous testing and grading process in order to give the customer absolute confidence in the integrity and precise quality of the diamonds they are buying. This is very important to their future value.

Question Three: With scenario planning, asset allocation and strategic capital deployment at front of mind, what does your office believe are the benefits of holding diamond products within a portfolio?

Answer Three: Diamond mines are difficult to find and take a long time and are expensive to develop. Of almost 7000 kimberlites sampled in the last 140 years, only approx. 60 have been turned into economic mines. No major finds have taken place in the last decade, leading industry experts to believe that growing consumer demand for diamond jewellery, driven by the emergence of large middle classes in China and India, coupled with flat to declining diamond production in the short to medium term, will result in a structural supply deficit that should yield price upside for the industry.

As mentioned earlier, consumers have a choice of De Beers linked brands when buying diamond jewellery:

- a. Forevermark diamonds come with a special promise of beauty, rarity and integrity, captured forever in the inscription on each Forevermark diamond, giving consumers confidence and peace of mind in their purchases;
- b. As the quintessential diamond jeweller, De Beers Diamond Jewellers create high quality jewellery which reveals the natural beauty of its especially selected, exquisitely polished diamonds.

Question Four: Continuing on from the previous question and answer, the devil's advocate counterargument for holding diamonds and gold bullion within a portfolio has been that they yield no interest, yield or distribution – above and beyond strategic, defensive and scenario planning considerations, why would investors choose diamonds over an alternative that delivers them interest on their investment?

Answer Four: The diamond market is not dissimilar to the art market. It provides the potential for long-term price appreciation, a finite (decreasing) supply, safety and the benefit of owning and wearing that financial investments do not.

Question Five: Has your office noticed positive or negative effects on diamond purchases due to recent events such as the GFC, Euro Crisis, Chinese leader hand-over, US recession or the like?

Answer Five: Overall, 2010 and 2011 were strong years for diamond jewellery sales world-wide, driven by economic recovery and in particular by the strength of the expansion of the Chinese and Indian economies. With the slowdown of economic growth experienced in China and India in 2012, growth in consumer demand for diamond jewellery has moderated in 2012 but was still positive overall. Growth in China, Japan and the USA in particular contributed to another record demand year for diamond jewellery.





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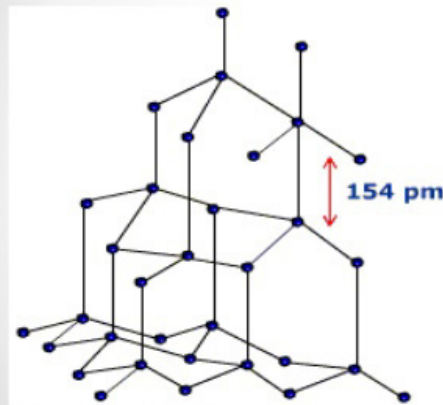
PHILANTHROPY

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Question Six: Why should a girl insist on a DeBeers diamond from their fiancé?
(this answer may get me in trouble with my wife)

Answer Six: Because it's one they will always be proud of. It will be a truly beautiful diamond with all the fire, sparkle and life a polished diamond should have, it will be the precise quality it claims to be and it will have made a positive contribution to the community from which it has originated.

Structure Of Diamond



- In diamond, the carbon atoms are arranged tetrahedrally (sp^3 hybridisation of C): each C atom is linked to its neighbours by four single covalent bonds. This leads to a three-dimensional network of covalent bonds.

Yours,
Michael N. Barnes
CEO, Australian Standfirst Asset Management



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