insight

3 August 2009

A brave new world?

Interview with ipac's Chief Investment Officer

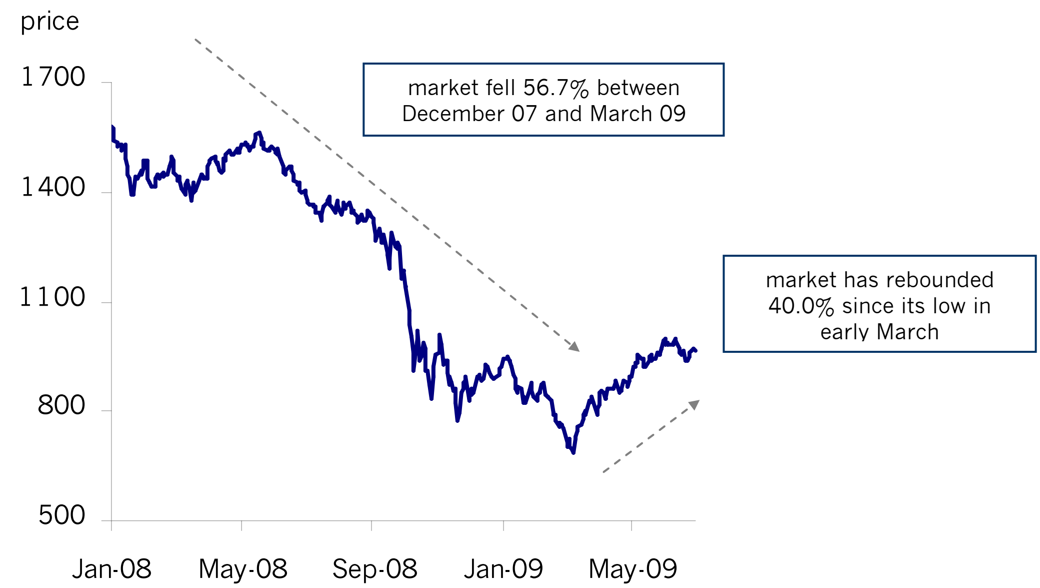
The past 18 months have been among the most challenging any of us have ever faced in financial markets. In 2008 international share prices fell 42.1 per cent, the most drastic fall across a calendar year in decades. International share markets continued to fall in the early part of 2009, before rebounding 40 per cent between March and June.

The turmoil of the past 18 months has driven the investment industry to do a lot of soul searching, and led market participants to consider the lessons learnt from the Global Financial Crisis. We interviewed ipac's Chief Investment Officer, Jeff Rogers, to hear his thoughts about what the future holds for markets, and to learn more about what ipac is doing to position portfolios to take advantage of emerging opportunities.

The turmoil of the past 18 months has driven much soul searching and led the industry to consider the lessons learnt from the GFC.

Markets have been rising recently – does this mean the GFC is over?

It is encouraging to see share markets rise 40 per cent over the past four months, however it is important to remember that this rally has come from very low price levels. We need to remember that the GFC has been the most serious financial crisis since the Great Depression. It has been met with an unprecedented response from policymakers around the world. Given the scale of these developments it makes sense that we should require considerable confirmation before we can argue that the crisis is over.



source: Bloomberg. MSCI World ex-Australia Index. Data as of 30 June 2009.

What evidence do we need to see before we can call the end of the GFC?

We anticipate that over the next year we will be able to put the GFC, as an event, behind us.

We will need to see evidence of reduced financial stress in capital markets, less rapid economic deterioration, and evidence that banks are in a healthier position. Six months ago liquidity had dried up, economic activity was in free-fall and there were serious questions about the solvency of the global banking system. The table below, which is our checklist of conditions, would have been awash with red crosses. As a result of the aggressive and unconventional actions by global policymakers a number of favourable developments have occurred. Our current assessment is presented in this table. While a number of positive developments still need to take place in the economy and markets, we anticipate that over the next year we will be able to put the GFC, as an event, behind us.

How the evidence stacks up so far:

evidence of reduced financial stress	
lower mortgage rates	✓
lower corporate borrowing costs	✗
lower LIBOR spreads	✓
greater credit availability	✗
equity markets stable/up	✓
evidence of less rapid economic deterioration	
rate of increases in unemployment peaks	✗
some healing in housing market	?
trade stabilisation	?
evidence of healing banks	
'ring fencing' toxic assets	?
regulatory forbearance	✓
adequate capitalisation	?

source: Wellington Management and ipac.

Value still exists at today's prices, and shares remain an attractive place to be invested.

What does this mean for markets in the short-term?

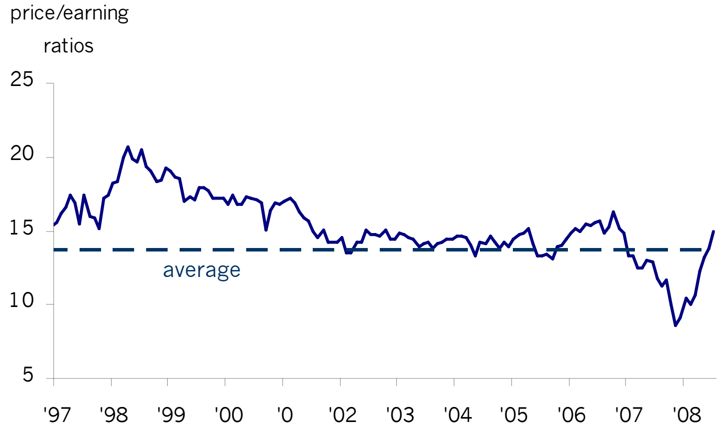
Over the next few years, investors should remain vigilant for unexpected after-shocks from the GFC. Policy makers will need to remove their monetary and fiscal stimulus when they believe economies are on a self-sustaining path. Timing their exit will be quite tricky because they have never faced a set of conditions quite like this before. Until market participants have a better understanding of how economic conditions will unfold, any hint of unexpected developments is likely to lead to a period of market volatility.

Are share markets likely to deliver over the longer-term?

The key ingredients in our assessment of return potential in share markets are valuations and company earnings prospects. The chart below provides a perspective on valuations. It indicates that valuations have normalised over the past quarter, after having appeared unusually attractive earlier in the year. This suggests that share markets are close to fair value and therefore priced to deliver normal long-term returns. However shares prices today reflect a good deal of uncertainty about company profits in the near-term. As economic conditions improve it may well become clear that analysts have been too pessimistic. Such an upgrade of expectations would support above-average returns in the market for several years.

In summary, we think it is realistic to expect long-term returns of high single digit figures with the prospects for somewhat higher returns over the next few years.

Value still exists today in shares:



source: Bloomberg. 12 month forward price/earning ratios. MSCI Australian Index. Data as of 30 June 2009.

Financial markets have become increasingly complex – it is crucial to understand the risks of what you are investing in.

What lessons have been learnt from the GFC?

Financial markets are extremely complex
The GFC has reminded us that global economies are increasingly inter-linked and financial markets have become ever more complex. While globalisation is a positive economic force, investment markets have become more integrated which makes risks harder to measure and manage. Investment decisions need to account for these linkages and the related complexity.

In the years preceding the GFC, many market participants did not adequately assess the risks inherent in the products in which they were investing. It may sound like simple advice, but it pays to understand what you are investing in. A guiding principle at ipac is to only invest in areas of the market that have fundamental underpinnings.

Counterparty risk needs to be actively managed
The failure of several large scale financial institutions over the past 18 months demonstrates the importance of having robust governance procedures in place to manage counterparty risk. That is, the risk that a financial institution is not capable of settling its financial obligations to us in a full and timely fashion. It is simply not enough to rely on a counterparty firm's reputation or credit rating.

Government involvement can have an important influence on capital markets
The government intervention we have seen over the past 18 months is indicative of the fact that markets are now more influenced by governments than they have been in the past. This is likely to stay the case as the regulatory environment will be tightened even as government stimulus programs are gradually unwound. As a consequence, it will be important that investment managers are able to incorporate the impact of the government footprint in their analysis of market opportunities.

Diversification doesn't always show up in short-term price movements….but will win out over the medium-term

The drastic falls in most investment markets over 2008 have also taught us that in some rare circumstances, the benefits of diversification may not be evident in short-term price movements. Last year, there was nowhere to hide from the collapse in investor confidence. In these rare circumstances, investors need to stay focussed on their long-term objectives, as we are confident that the benefits of diversification will become evident as time progresses.

The lessons we have learnt, or re-learnt, from the GFC will help us build better portfolios for our clients.

What is ipac doing in response to these learnings?

We have learnt, or re-learnt, a number of lessons from the GFC that are helping us build more robust portfolios to improve investment outcomes for our clients. We have acted to markedly reduce counterparty risk by enforcing improved collateral management processes. We are also targeting liquidity levels in portfolios to ensure we have the flexibility to pro-actively manage client assets. At the strategy level we are increasingly open to new opportunities as they arise, and are focussed on identifying risks that might have a large impact on portfolio outcomes. Finally, we are continuing to assess the skill of our investment managers and their prospects for adding value in the post-GFC environment. For example, we have recently implemented changes within the Australian listed property sector aimed at capturing active returns more efficiently.

Looking forward, what is ipac's investment strategy?

Consistent with our assessment of return prospects for share markets, ipac's investment strategy is to be fully exposed to core markets. With the direct impact of the GFC subsiding there is little reason for investors to hold unusually high levels of "precautionary" liquidity. At the same time, the GFC has created a number of interesting new opportunities which we are looking to take advantage of.

What sort of interesting opportunities are you seeing in the current environment?

Market dislocation has created opportunities to buy good quality assets that are temporarily available at "marked-down" prices.

One of the areas where we are currently seeing opportunities is the alternative investments sector of the market. Past overuse of leverage has led to forced selling by a number of global financial institutions. This has created opportunities for ipac's managers to buy good quality assets at "marked-down" prices. Unlike many others in the market, we have the liquidity to buy these assets at price levels which support solid medium-term returns without the use of leverage.

One such interesting area is corporate loans where market dislocation has created opportunities to buy the secured debt of companies at price levels which support returns in excess of those available in the general share market. Interestingly, at times we invest in the shares of these companies within our international share portfolios. ipac is devoting considerable resources to validate the opportunity and identify superior managers in this area.

Finally, how confident should investors be that they can meet their investment objectives?

While the GFC has been a painful experience for all participants, investors should remain confident that they are still positioned to achieve their long-term investment objectives. To paraphrase Rudyard Kipling "it is difficult to hold your nerve as all about you lose theirs" especially when there are so many conflicting opinions in the media about the best place to invest your money. At ipac, we still hold firm to the belief that a well diversified portfolio invested in quality assets aligned with an appropriate financial plan will continue to reward investors over the long-term.

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