

don't miss out on the rebound

While 2008 has been an incredibly difficult year for investors, we do see light at the end of the tunnel. Investment markets present unusual value as high quality assets are being sold at prices well below their fundamental value. Indeed, the huge price falls we've experienced allow scope for a rally, supported by the unprecedented action by governments and central banks to support global economic growth.

We are confident our portfolios are well positioned to take advantage of the opportunities we see in the current environment. The following 'insight' highlights some of the reasons to be positive, and why we believe the future looks promising for long-term investment returns.

government intervention has been without precedent

The size of the financial crisis and its impact on markets has been historic. Equally though, government intervention has been without precedent. It may take a little time to work through, but eventually we expect these measures to stimulate economies and support investment markets.

Although the International Monetary Fund has recently talked about a "great recession", at the same time, Ben Bernanke as head of the Federal Reserve has expressed some optimism that the US can recover before the end of this year.

No-one can be certain when the recovery will take place, however the early implementation of global economic stimulus is history in the making. Signs of economic recovery could start emerging as early as the second half of 2009. Powerful contributors to eventual recovery include the lowering of interest rates by central banks around the world, as well as co-ordinated responses from governments to implement stimulus packages.

So, what does this mean for markets and the future? Where should you be investing?

1

cash has had its time in the sun

In times of uncertainty, it is natural for many investors to feel they should be in cash. If you could predict 2008 with perfect foresight, then it made some sense to be in cash as it was one of the few asset classes to generate a positive return (+7.6%)². But does moving to cash make sense for investors now?

Official interest rates across the globe have been cut in response to the financial crisis. Returns on cash are at a generational low. In fact, the last time the cash rate in Australia was this low (3.25%) was 1964. In the US and UK, rates are barely above zero.³ Interest rates are likely to remain low for some time.

At ipac, we base our investments on four sound and enduring principles: Quality, Value, Diversity, Time™. That means we aim to provide investors with a wide range of quality investments, bought at reasonable prices and given time to perform well. These principles have ensured our portfolios have recovered from all previous downturns.

² source: UBSA 90 Day Bank Bill Index. 12 month return to 31 December 2008.

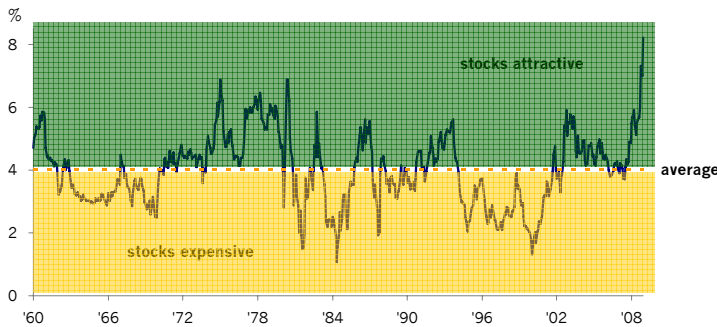
³ source: ipac. Data as of 18 March 2009.

extraordinary value exists in markets

As longer-term investors, we are confident that ipac portfolios will reward investors over time. Severe market dislocation has created compelling buying opportunities, and there are significant signs that value exists in most asset classes.

If we start with equities, the chart on the following page shows the equity risk premium of US shares. The equity risk premium is one research firm's estimate of the return equities have offered over the last 40 years relative to the prevailing bond rate. At present, the risk premium is at an unprecedented high, meaning investors can expect to receive a considerable premium for holding shares once the market normalises and volatility subsides.

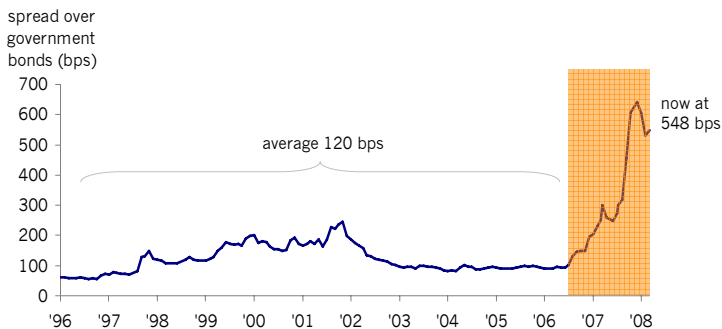
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source: S&P, Global Financial Data and AllianceBernstein. Data as of 20 November 2008. Equity risk premium is the difference between expected return on the S&P 500, as calculated by the Bernstein expected return model, and 10-year US Treasuries.

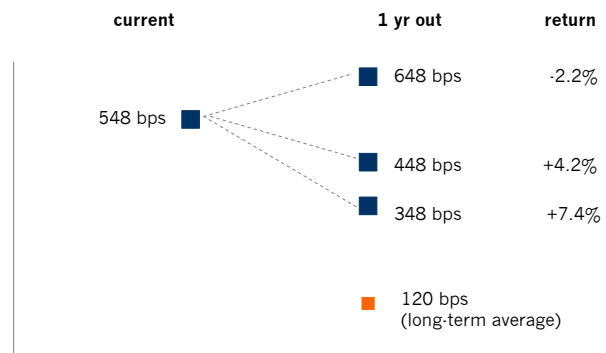
Within the bond market there is also evidence of compelling value – namely within corporate debt, which are bonds issued by highly rated companies. Market distortions have caused extraordinarily low prices to be set for high quality corporate bonds. The following chart shows that between December 1996 and February 2007 the additional return investors received on average for high quality US corporate bonds was 1.2 per cent above US government bonds. Since then, however, the additional yield has risen to 5.5 per cent above US government bonds. Bond yields and prices have an inverse relationship, meaning that as the yield rises, the price of the bond falls. The current high yields mean that prices for US corporate bonds have fallen to historic lows. The same trend is evident in Australia.

The inflated yields in the chart below reflect that corporate bonds are priced for high levels of default and a persistence of difficult business conditions. ipac believes the level of defaults priced into the corporate bond market has been overstated for high quality securities. There is the potential for significant gains in corporate bond markets over the medium-term.



source: PIMCO. US investment grade corporate bond spreads OAS. Data from December 1996 to February 2009.

The chart below considers the return an investor could expect to achieve if the yield on US investment grade corporate bonds changed a year from now. If the yield above government bonds were to contract 100 basis points (1 per cent), investors would record a gain of 4.2%, while a contraction of 200 basis points (2 per cent), would result in a gain of 7.4%. The return is further enhanced by the coupon payment.



source: ipac. Assuming spread duration of 3.2, and yield of 100 bps.

As we can see, the bond markets are currently offering attractive risk-adjusted returns for quality bonds. One example of where we are seeing good value is for Commonwealth Bank subordinated debt. The price of Commonwealth Bank Tier 2 debt callable in 2010 has fallen markedly from its starting price of \$100. The price on 20 January 2009 was \$85.80. Providing the issuer does not default, and the bond is called, the value of the bond will return to \$100 in 2010. This represents a significant price appreciation from current levels, and gives an effective yield, or annual return of 16%. This is in addition to the regular coupon payments investors receive.

quality counts

The prices of many quality investments now represent good long-term value. Nevertheless, active management will remain the key going forward. The managers within ipac portfolios are focussed on identifying opportunities that will add value to portfolios. These include companies with strong market positions within their industries which give them pricing power. Also, companies with a strong financial position and healthy balance sheet should weather the economic downturn better than most.

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A typical company that ipac's managers have recently been invested in is Westfield Group. Westfield owns and manages high grade shopping centres in Australia, New Zealand, the US and the UK. The company has strong management and is best placed in the industry to access capital markets. Weakening retail spending and falling property values have largely been factored into the current share price, that has fallen significantly in the last 12 months.

National Australia Bank (NAB) is another example of a stock that is attractive to ipac's managers. The share price today (\$20.37 on 25 March 2009) is the same as it was in 1997. But the business is much larger. Fund manager, Maple-Brown Abbott say that in 1997, NAB's profit was \$A2.2 billion with total assets of \$A201 billion. In 2008, NAB's profit was \$A3.9 billion and total assets were \$A656 billion, three times the total assets of 1997. ipac's managers are using their skills to take advantage of the price falls to buy into quality businesses they believe have good long-term prospects.

Although many shares represent good long-term value, the road to success could be bumpy. In the short-term, the profit outlook for most companies looks challenging given the current economic climate, and markets are likely to remain volatile. Although the market has seen significant falls, the share prices of some of the more 'defensive' businesses like Woolworths, Lion Nathan and Coca-Cola Amatil have held up relatively well. Some investment managers have suggested that the demand for these 'defensive' stocks may mean that the best medium-term opportunities are in more cyclical areas of the market which investors have recently avoided.

diversify among investments

Although most investment markets perform well over long periods of time, all markets will experience ups and downs along the way. The table opposite shows the annual returns for the main asset classes over the past 20 years, with the green squares highlighting the best performing asset class for that particular year. Most of the time, growth assets such as international and Australian shares and property have been the strongest performers. It is notable that on only one occasion, back in 1994, was cash the strongest performing asset class.

Chasing the best performing markets from one year to another may be a tempting strategy to follow, but since it is impossible to predict which asset class will be the best performer in any given year, it is also a very risky approach.

By diversifying investments across asset classes, investors maximise the opportunity for positive returns, as well as spread the risk of negative returns. ipac's balanced fund, for example, typically provides exposure to 10 asset classes and over 25 managers, providing a plethora of investment ideas.⁴ At ipac, we look at asset allocation in terms of positioning portfolios to achieve long-term investment objectives, and continue to identify opportunities to further diversify portfolios.

⁴ source: ipac Pathways 70 portfolio. Data as of 31 December 2008.

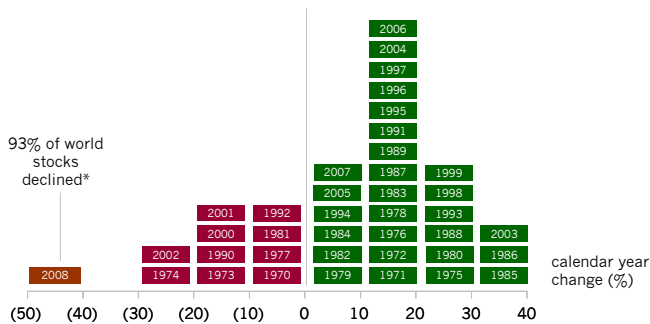
year	Australian shares (%)	Australian bonds (%)	international shares (%)	international bonds (%)	Australian listed property (%)	Australian cash (%)	Inflation (%)
1989	17.4	14.4	26.2	18.8	2.4	18.4	7.8
1990	-17.5	19.1	-15.1	13.5	8.7	16.2	6.9
1991	34.2	24.8	20.0	18.1	20.1	11.2	1.5
1992	-2.3	10.4	4.6	9.6	7.0	6.9	0.3
1993	45.4	16.3	24.2	14.3	30.1	5.4	2.0
1994	-8.7	-4.7	-8.0	-3.02	-5.57	5.3	2.6
1995	20.2	18.6	26.1	19.9	12.7	8.1	5.1
1996	14.6	11.9	6.2	10.7	14.5	7.6	1.5
1997	12.2	12.2	41.6	10.7	20.3	5.6	-0.25
1998	11.6	9.5	32.3	10.8	18.0	5.1	1.6
1999	16.1	-1.2	17.2	0.3	-5.0	5.0	1.8
2000	4.8	12.1	2.2	10.4	17.9	6.3	5.8
2001	10.5	5.5	-10.1	7.1	15.0	5.2	3.1
2002	-8.6	8.8	-27.4	11.5	11.9	5.2	3.0
2003	15.0	3.1	-0.8	6.6	8.8	4.9	2.4
2004	27.9	7.0	9.9	8.9	32.2	5.6	2.6
2005	22.5	5.8	16.8	6.6	12.7	5.7	2.8
2006	24.5	3.1	11.5	4.4	34.1	6.0	3.3
2007	16.2	3.5	-2.6	6.6	-8.4	6.7	3.0
2008	-38.9	14.9	24.9	9.2	-55.3	7.6	5.2

source: Bloomberg, Mercers, Iress. Australian shares: S&P/ASX 300 Accumulation Index merged (ASX All Ordinaries Accum Index to March 2000); Australian fixed interest: UBSA Composite Bond Index (All Maturities); Cash: UBSA Bank Bill Index (90 Day Bank Bill used for 1987); International fixed interest: Barclays Capital Global Aggregate Hedged in \$A (JPM Global Government Bond (Hedged) ex-Aust prior to September 2002); International shares: MSCI World ex Australia in \$A (unhedged); Australian listed property: S&P/ASX 300 AREIT Index in \$A merged (ASX Property Accum Index to March 2000). Data as of 31 December 2008.

allow enough time

It's what happens over a long period of time that matters. The shape of the following chart tells the story. It shows global share market returns since the 1970s by calendar year. On the right of the vertical line are the years the global share market rose. On the left are the years it fell. Since the 1970s, the market has produced positive returns far more often than not. While it has fallen more than 20 per cent in a calendar year on three occasions, it has risen more than 20 per cent nine times over the same period. Overall, the good times far outweigh the bad.

don't miss out on the rebound

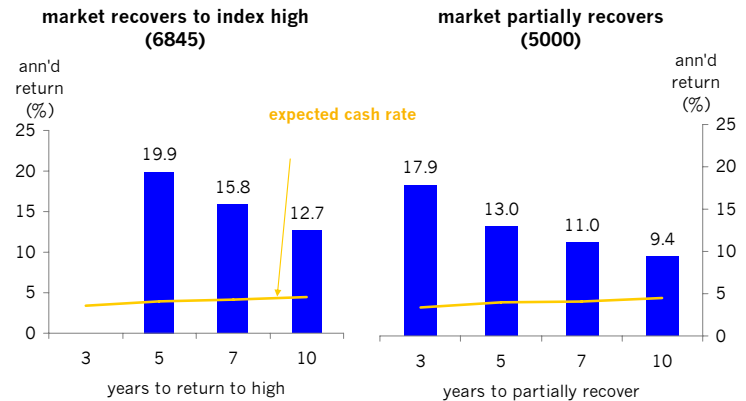


source: FactSet, MSCI and AllianceBernstein. Returns are in US Dollars. *Calculated for those companies in MSCI World Index on 1 January 2008 that remained on 31 December 2008. Data as at 31 December 2008.

When we look at 2008 we can see that not only was it an abnormal year, it was also an extreme event. The thing about extreme events is they do not occur very often and the odds of recurrence in the near-term are low.

For the remainder of 2009, share markets are likely to remain volatile. However, we are confident that they are well placed to recover. When they do, the return for investors will be healthy. The chart opposite and to the left shows the returns investors could expect to achieve from Australian shares if the market returns to its high of 6845 which it hit in November 2007. If the market takes five years to recover to its high, investors would generate a return of 19.9 per cent per annum assuming a dividend yield of 6 per cent. If it takes the Australian share market as much as 10 years to recover to its high, this still equates to an average annual return of 12.7 per cent.

The chart to the right takes a more conservative view of recovery and assumes the market only recovers to the 5000 level. If it takes the market five years to recover to this level, investors would receive an average annual return of 13.0 per cent. Again this return assumes a 6 per cent contribution from dividends. If it takes as long as 10 years, investors will still receive more than they would if they were to invest in cash today.



source: Bloomberg. S&P/ASX 300 Price Index (excluding dividends). Index high is at 1 November 2007. Index today is at 24 March 2009 (3563.8). Assumes dividend yield of 6%. Expected cash rate shows the Australian government bond yield curve at 24 March 2009.

share markets tend to reach their trough around the middle of a recession

While there is no way of knowing when a rally might occur, waiting for the bottom of the market, or waiting for positive economic news before investing, means you may miss the rebound when it inevitably occurs. Share markets tend to reach their trough around the middle of a recession.

Just as markets started to decline well before we saw evidence of a decline in the real economy, they usually recover well before the economy does. While it is difficult to predict how long a market downturn will last, one thing is certain, only those who are invested in shares will fully benefit from the eventual rebound.

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