

## 2008 – a tough year on many fronts

We are deeply conscious that the last year has been exceptionally difficult for investors. The impact of the unfolding global financial crisis has been brutal on capital markets, producing exceptionally weak returns for most asset classes. All long-term investors have had to endure sharp declines in the value of their portfolios.

In many ways 2008 was a year when the financial system failed and the complacency of virtually the entire financial sector came home to roost. While our approach to investment management ensured that our portfolios were well diversified with strong levels of liquidity, when we reflect on the year, we too let the benign market conditions provide a false sense of security.

In reaching for incremental return, we underestimated the potential negative impact that some of our portfolio strategies could have in extreme market circumstances. In particular, some of the cash and fixed interest strategies, that ended up very much in the "eye of the storm" of the financial crisis, performed much worse than our risk modeling had forecast. While we continue to expect portfolios will benefit from these strategies over the medium-term, clients in defensive funds are justifiably disappointed by the magnitude of the underperformance, given the stated objectives for the funds.

The financial crisis is unprecedented in its scale and the speed with which it has translated into slowing global economic activity. To draw a mechanical analogy, the supply of oil (akin to the provision of finance) has stopped flowing to the engine (the real economy) causing a rapid deceleration. The challenge for policy makers around the world has been to quickly restore the flow and deal with any problems the shock created. This has called for equally rapid and unprecedented economic policy responses. While there have been missteps along the way, the actions to date have been nothing short of spectacular.

It will take time before these measures work to stabilise conditions. It is difficult to know exactly when these actions will begin to bear fruit, restoring confidence to businesses, decision makers and investors. Markets aim to anticipate these trends. As the flow of new data is "priced in", market views constantly re-adjust. In the shorter-term, the general run of economic indicators will remain uncomfortable for at least the first six months.

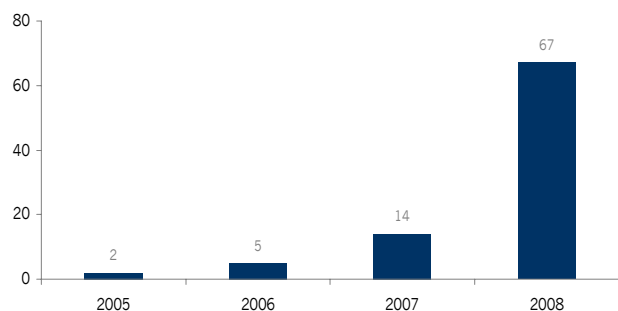
The cross currents created by mixed economic news and policy responses could mean volatility remains elevated as markets continually reassess growth prospects.

Our baseline outlook assumes the global economy shows signs of recovery late in 2009, but more likely 2010, under the influence of massive economic policy stimulus. However, we cannot entirely rule out the possibility that the global financial crisis and associated dislocations in credit markets persist for longer than expected, both lengthening and deepening the duration of the global economic downturn. It is important to test the validity of investment strategies and the sustainability of manager arrangements in the context of this potential scenario.

Equity valuations are currently at considerable discounts to normal levels in most markets. This is understandable when the momentum of profits is downward but current pricing does appear to have taken this negative trend into account. The potential exists for sound returns to be generated from diversified portfolios should the world economy track as expected.

Attention has been re-focussed on market risk. The graph below shows the number of days each year in which the market moved up or down by more than 2%. What was a rare event in 2005 and 2006 became a weekly experience in 2008. The return of volatility encourages more discriminating investor behaviour and provides reduced support for leverage. Further, an environment of higher volatility in investment markets argues for well researched and diversified investment portfolios.

**graph 1:** number of days in which the global equity market index moved +/- 2% or more



source: Bloomberg, MSCI World ex Australia Index. Data as of 31 December 2008

Each year ipac reviews its medium-term (five year) asset class forecasts. Our latest analysis can be summarised as follows:

- Cash return expectations are below our forecast of 12 months ago reflecting the weakening of the global economy and the impact of aggressive monetary policy easing on cash rates.
- Bond forecasts mask a large divergence occurring within the fixed interest market. Yields on government bonds are low. They will eventually rise and this is a restraint on returns. By contrast, yields on corporate bonds are high and are likely to fall when conditions eventually normalise. This adjustment would produce strong positive returns from corporate bonds.
- Returns across a large spectrum of growth assets appear more appealing than a year ago following sharp price declines that have improved valuations. However, investors seeking to capture these returns are likely to need to display continuing patience and some courage.

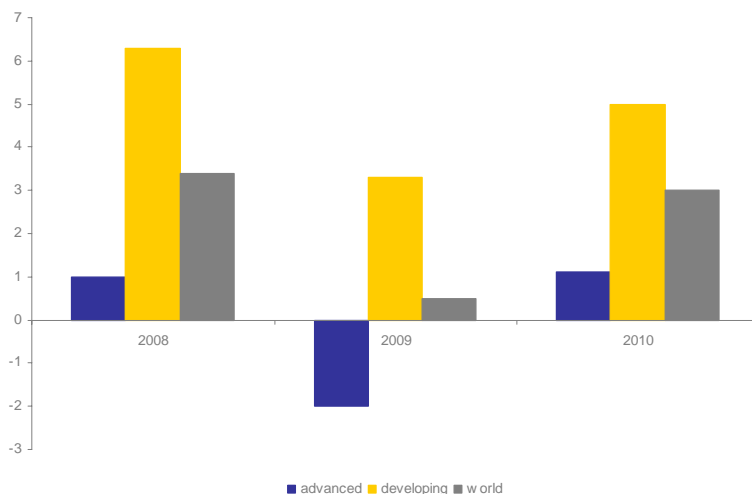
The year ahead presents continuing challenges. However, the repricing of risk is presenting new opportunities for investors over the medium-term. This is an area where our research effort is focussed and where we are looking to add well rewarded opportunities to client portfolios.

**Jeff Rogers**  
ipac Chief Investment Officer

## a challenging economic environment

The financial markets crisis has caused a collapse in business and consumer confidence with many of the world's largest economies in recession. According to the most recent forecast by the International Monetary Fund (IMF), economic growth in advanced and developing economies is expected to slow sharply in 2009, followed by a gradual recovery in 2010, as shown below.

**graph 2:** growth (%) as predicted by the IMF



source: IMF. Data as of January 2009.

ipac's view is for a period of recession in the industrialised economies through 2009 with most economies experiencing an outright contraction in output. Unemployment is expected to rise sharply across the globe this year. Our baseline view is that economic recovery is expected to unfold through 2010 under the influence of massive economic stimulus. But, recovery is likely to be more moderate due to on-going de-leveraging.

One of the key questions is whether deflation could emerge (as was the case in Japan following the bursting of the stock market and property bubbles in the late 1980s) with large reductions in asset prices spilling over into deflation in goods and services markets.

ipac views this possibility as having a low likelihood, as policy makers have made the prevention of this outcome their priority.

Inflation is certainly likely to slow sharply in the short-term under the influence of lower oil prices, but the world's central banks and governments are responding quickly as events unfold. Such responses were absent in Japan. A longer-term issue is whether current massive fiscal and monetary policy stimulus will sow the seeds of renewed inflation when growth eventually does revive. This is not an issue for today, but does point to the wide range of economic outcomes that could unfold longer-term once the current difficulties are addressed.

## assessing the scenarios and risks

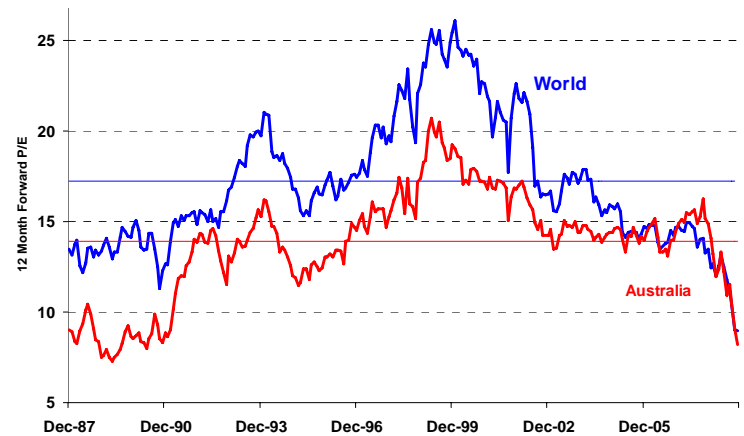
ipac is confident that in the long-term markets can recover. That said, in the medium-term, there are a number of ways in which economic conditions could evolve. This reflects the quite uncertain impact of the upheavals in the global financial system. We highlight two possible scenarios.

One possibility is that a global recession is more protracted, recovery takes significantly longer and corporate profitability will be very heavily constrained for a longer period. Dislocations in credit markets could persist for longer than expected, both lengthening and deepening the duration of the global economic downturn and producing a high incidence of corporate defaults.

Indeed, this outcome would be quite likely without the current stimulus packages. However, a considerable effort is being made by regulators and governments around the world to stabilise financial markets and to support economic growth. Consequently, a more probable scenario is that the global economy will show signs of recovery during 2010. Investor confidence will begin to slowly re-emerge, investors will return to equity markets and volatility will subside. More resilient financial companies and banks will survive the current crisis and emerge stronger than before. With less competition, these surviving companies are likely to be more profitable, offering potential value to investors to help offset the collapse of some of their weaker competitors.

Markets are currently priced for considerable disappointment on economic recovery prospects (scenario one). Equity valuations appear at considerable discounts to normal levels, as shown in the graph in the next column.

**graph 3:** world and Australian equities – 12 month forward P/E ratios



source: Morgan Stanley

## how ipac's portfolios are positioned for recovery

### credit markets should remain tight with good opportunities in the medium-term

Under the influence of a strong investor appetite for the relative safety of government bonds, interest rates have fallen sharply across the yield curve in all countries, particularly for US Treasuries. Government bond markets may continue to be supported in the near-term as the flow of economic data remains weak, capital markets stay dislocated, investor risk aversion continues to be high and uncertainty exists around the timing of a wide-spread recovery. However, government bonds appear priced for disappointment based on ipac's medium-term growth and inflation forecasts. Even so, it remains sensible to have some exposure to government bonds for liquidity and diversification reasons.

In contrast, the dislocation in global credit markets has led credit spreads (yields above the risk free rate offered by government bonds) to historic levels as a consequence of the illiquidity in these markets.

Corporate bonds are priced for high levels of default and the persistence of difficult business conditions, as reflected by the high yields, which are consistent with the more bearish scenario. This offers the potential for outsized gains in credit markets over the medium-term given ipac's view that the level of defaults priced into spreads has been overstated for high quality securities.

Good quality corporate bonds are trading at depressed capital values providing some very attractive yields. For example, the price of Commonwealth Bank Tier 2 bank capital callable in 2010 has fallen markedly from its starting price of \$100. The price on 20 January 2009 was \$85.80 with an effective yield to call of 16%. In the absence of default by the issuing institution, the value of the bond will return to \$100 when called. This represents a significant price appreciation from current levels, in addition to the regular coupon payments investors will receive.

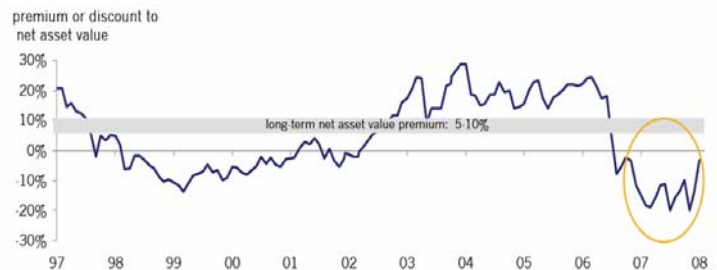
### listed property offers potential for above average returns

Returns from listed property markets have been severely dented over the past year. Investor confidence weakened on concerns over the shut down of debt markets to finance property investments and the dilution of equity interests as pooled vehicles issued cheap equity. In addition, confidence was negatively impacted by weakening fundamentals as property demand reduced and pressure on rental income rose.

During 2008, global real estate securities traded at a significant discount to their underlying property values. More recently, as chart four illustrates, declining property values have reduced this discount and currently property values are reasonably well balanced. A combination of solid fundamentals (low supply) with lower valuations gives the listed property market a reasonably good outlook over the medium to long-term.

ipac's property securities managers expect that pricing of global real estate securities will improve when the credit markets start functioning efficiently again and long-term credit spreads normalise. Furthermore, our portfolio holds high quality companies that should recover and we believe that our securities managers will both capitalise on opportunities that may arise from the current distress and participate in future value creating opportunities.

graph 4: global listed property still trading at a discount



source: LaSalle Investment Management (Securities) EPRA. Global REITs are comprised of REITs in US, Canada, Netherlands, France, Australia, Japan and the UK (from Jan 2007) and re-weighted monthly by EPRA/NAREIT Index USD market cap. Data as of 31 December 2008.

### Australian shares are well placed for a medium-term re-rating

ipac forecasts a solid return for Australian shares over the medium-term. The driver of higher expected returns is the forecast expansion of the price-to-earnings (P/E) multiple. Following recent large market declines the trailing P/E is at low levels. On a forward-looking basis, the P/E for the Australian share market (shown in graph three) is in single digits pricing in a considerable contraction in earnings.

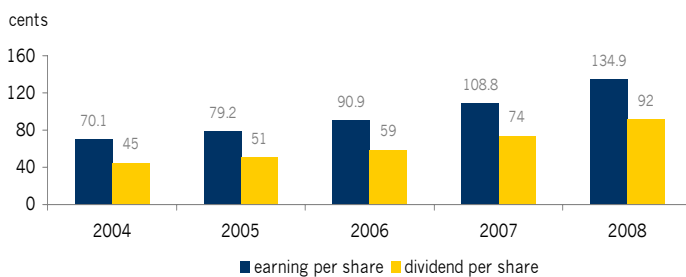
As the table below shows, even if it takes the Australian share market as much as 10 years to recover to its high of November 2007, this still equates to average annual capital growth of 7.5%. Including dividends, the return would be well into double digits, and a much healthier figure than the cash rate, currently at 4.25%, which is likely to remain low for quite some time.

index high	6845.4
index today	3331.1
years to return to high	annualised return (%)
3	27.1
5	15.5
7	10.8
10	7.5

source: Bloomberg. S&P/ASX 300 Index. Index high is at 1 November 2007. Index today is at 23 January 2009.

Within Australian shares the vast bulk of client money is invested in companies with strong fundamental qualities. Woolworths is one example of the holdings in client portfolios. The chart below shows how the company's earnings and dividends per share have increased each year since 2004. Although Woolworths' share price fell 25% in 2008, we believe the global financial crisis has had minimal impact on the long-term earnings and dividend-paying potential of the company.

**graph 5:** earnings and dividends per share - Woolworths



source: [www.woolworthslimited.com.au](http://www.woolworthslimited.com.au) 2008 Annual Report

## international equities are well valued

With equity prices globally down around 50% (and up to 90% in some markets), valuations appear at considerable discounts to normal levels in most markets. As indicated in the chart below the US (and world) equity markets appear priced for considerable earnings disappointments, trading in single digit P/Es.

**graph 6:** world and US 12 month forward P/E ratios



source: Morgan Stanley

Many companies, whose share prices have been impacted by fears of an economic slowdown, remain fundamentally sound. This includes financial companies that are well placed to benefit from consolidation. For

example, JP Morgan Chase is a holding in our international equities portfolio. This business is likely to emerge a stronger player with less competition and more pricing power following its take-over of Bear Stearns and the purchase of Washington Mutual. The table below highlights the increased retail banking footprint of JP Morgan Chase following the acquisition of Washington Mutual. In time, we expect ipac's international equities portfolio to benefit from exposure to quality companies like JP Morgan Chase where current prices do not reflect the long-term growth potential of the business.

JP Morgan Chase Retail Banking	end 2007	end 2008	change
net revenue (US\$ billions)	2.5	4.5	↑ 78%
net income (US\$ millions)	521	1000	↑ 85%
no of checking accounts (millions)	10.8	24.5	↑ 126%
total deposits (US\$ billions)	208.4	339.8	↑ 63%
number of branches	3152	5474	↑ 73%

source: JP Morgan Chase.

Similar to the Australian equities portfolio, the international equities portfolio is dominated by companies with strong medium-term fundamentals. McDonalds is one of the holdings. McDonalds operates and franchises fast food restaurants worldwide. Net profit in 2008 was \$US 4.3 billion compared to \$US 2.3 billion in 2007. The company plans to open 1000 new restaurants this year. The share price in the US gained 4% in 2008, while the broader market fell. McDonalds has benefited from investors rotating to companies with more certain earnings. The low debt to equity ratio and high quality management has also attracted investors.

In both international and Australian shares, the recent price falls have created opportunities for active managers which should be beneficial for performance going forward.

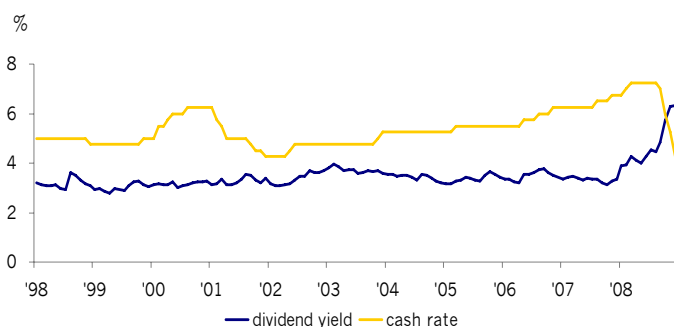
## cash is not the answer

During volatile times, investors are often tempted to exit the equity market and move their money into cash. However, this short-term relief may come at a high price over the long-term. By selling their equity holdings and settling for a low, guaranteed return, investors lock in a loss that is currently largely on paper. As a result, after tax and inflation are taken into account, investors may not be able to achieve their long-term investment objectives.

Even though share prices have fallen, many good quality companies are paying meaningful dividends. The chart below shows that in Australia, falling share prices have pushed trailing dividend yields on the All Ordinaries Index to more than 6%, and higher if franking credits are considered. At the same time, the cash return is now 4.25%, and likely to go lower. Even if some companies reduce their dividends, shares potentially provide a better income return and the potential for capital growth.

Unless investors need cash in the short-term for a specific purpose, it makes sense to remain invested in equities. Share based portfolios provide a superior way to fund long-term consumption needs.

**graph 7:** dividend yields vs cash rate



source: Bloomberg. Data as of 31 December 2008.

## what is ipac doing in this environment?

We are confident that client portfolios will recover in time. We outline below the key activities ipac is undertaking to manage client's money effectively.

### monitoring of our portfolios

We continually monitor our portfolios to ensure they remain well constructed and diversified to meet longer-term objectives. ipac's portfolios have multi-layer diversification which is diversification across asset classes, within asset classes, across fund managers and across investment styles. Our aim is to contain, as far as possible, the effects of volatility and take advantage of market opportunities as they arise. We have reviewed the position of each portfolio to ensure we are well placed for recovery.

### monitoring of our managers

We constantly monitor the activities of our managers including corporate and people changes. Our analysts are in close contact with all our managers and they continue to stress test their processes. We are well placed to benefit from a favourable shift in sentiment. Our constant monitoring also provides comfort that our managers remain focused on improving portfolio outcomes.

### rebalancing

ipac regularly rebalances portfolios to keep to strategic asset allocation targets. This disciplined process involves buying into asset classes that have underperformed in the short-term and selling those that have been unusually strong. In this way, portfolios are neither underexposed nor overexposed to one particular asset class due to market fluctuations. This discipline also applies to allocations between individual fund managers. At the same time, we are ensuring we have adequate liquidity to meet re-balancing needs and to be prepared for new opportunities as they arise.

### taking advantage of new opportunities

Market dislocation has created some opportunities, which ipac and its managers are monitoring closely. In the absence of any other sources of liquidity, investors looking to raise funds are being forced to sell investments at deep discounts. As a result, high quality assets are being sold at prices well below their fundamental value. our managers spend many hours seeking out these opportunities to ensure that they can purchase quality assets with the aim of adding significant value to the performance of our portfolios when markets normalise.

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