

# positioning for recovery



**'Green shoots' of economic growth and better conditions in markets lifted investor confidence last year. And ipac's multi-manager portfolios, with revised asset allocations and new managers in key sectors, are well placed to participate in opportunities that arise in 2010.**

## capturing recovery

Legendary US investor Warren Buffett wrote in 2007 in his well-known Annual Letter to the shareholders of Berkshire Hathaway ([www.berkshirehathaway.com](http://www.berkshirehathaway.com)): "It's only when the tide goes out that you learn who's been swimming naked".

Buffett, reportedly the world's second richest person after Microsoft founder Bill Gates, was referring to the role of giant US finance houses in inflating a housing bubble by lending money to people who could not afford to repay their loans.

Yet his comments could easily have referred to the well-publicised investment wipeouts of recent years – from the Madoff Ponzi scheme on Wall Street through to the more mundane but equally painful failures of groups like Opes Prime, the plantation timber groups Great Southern and Timbercorp, investment bank Babcock & Brown and the debt-stricken childcare consolidator ABC Learning.

Like an aircraft that flies well but hides an undetected hairline fracture of the fuselage, it is sometimes only when pressure is applied to a portfolio that we find out whether it's built to last. A robust investment portfolio will not usually avoid a fall in markets but, through diversification and a focus on quality, should protect against significant permanent loss of capital and be there to participate in recovery.

The period from March 2009 brought a strong rebound in the ipac diversified multi-manager portfolios, broadly in line with the recovery in global investment markets. It may be some time before valuations are back to previous levels, but they are on the way.

## outlook for 2010

What comes next in markets is hard to predict. We've reached a point of inflection between rising share markets on the one hand, and uncertainty about the strength in recovery in the economy and corporate earnings on the other. So far most of the good news has been of the 'less bad' variety – now we need some good news.

On the one hand, a rise of more than 30 per cent in the Australian share market in calendar 2009 sounds like (and is) a lot. On the other, markets are still well short of previous highs and, by traditional measures such as the price/earnings ratio, around levels considered roughly 'normal', ie likely to deliver 'normal' mid-term returns of something like 6 per cent to 10 per cent.

Share prices can't continue to rise without companies making bigger profits, yet there are reasonable prospects for profits to rise in 2010. What's not known is the extent to which consumer spending and business investment will step in when government stimulus – a major contributor to global growth – starts to slow.

What we do know is that the Australian economy has effectively 'dodged a bullet' and is well positioned with one of the regions that looks set for continued growth – China and South-East Asia. These

economies continue to buy our metals, minerals and natural resources, such as gas, to fuel their resource-intensive industries. This puts Australia in a pretty good position. The ipac diversified portfolios continue to have exposure to this trend through holdings in resource groups like BHP Billiton, Rio Tinto, Newcrest Mining and energy groups such as Woodside and Origin Energy.

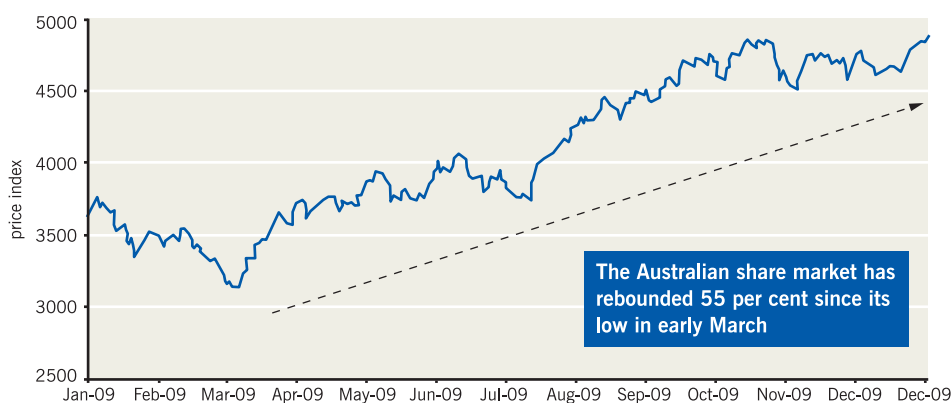
## active portfolio management

Throughout 2009 your portfolio managers made some important changes in key sectors to position the portfolios for good performance. The most significant of these was a restructure of the Australian shares portfolio that takes into account shifts in this market.

## restructure of Australian shares portfolio

The Australian share market has become significantly more concentrated with the 10 largest stocks together making up 50 per cent of the market benchmark. While these 10 stocks are important to portfolios, ipac has identified that active managers have an 'information advantage' (ie more opportunity to gain deeper insight than the market) in mid-sized and smaller capitalisation (or smaller size) stocks.

## the Australian share market has rebounded strongly



source: Bloomberg. S&P/ASX 300 Price Index (31st Dec 08 to 30 Dec 09)

ipac restructured the Australian shares allocation of the diversified portfolios including Pathways and the Strategic Investment Service to exploit this opportunity, reduce overlap in the holdings of individual managers, and ensure managers are paid only for their impact on the overall portfolio.

Two previous managers were retained and two new managers appointed. Table 1 summarises the current line-up, your financial adviser can provide further information.

Holdings in the portfolios reflect this new structure.

For example, two of the largest overweight positions\* are Suncorp Metway and News Corporation. The investment managers believe these are priced attractively compared to their fundamental strength.

Suncorp shares were 'on sale' due to concerns about the property development portfolio of Metway Bank. Research by ipac's managers suggests the residential loan nature of this book makes the risk overstated, while two-thirds of the business is in general insurance which remains sound.

NewsCorp is expected to benefit from a recovering economy, with its low gearing and reliable revenue from Pay TV subscriptions, and is also well priced. NewsCorp shares closed 2009 on a strong note, contributing to overall returns.

Smaller stocks that have been picked up by managers focusing on market signals include JB HiFi, which gained 29 per cent in the September quarter. The electronics retailer has 123 stores and has grown sales through products like the Nintendo Wii and expansion into computers and telecommunications. If you went into a JB HiFi store in the lead-up to Christmas, the broad appeal of its retail electronics formula would have been obvious.

The Australian shares review is just one of a wide range of changes implemented throughout 2009.

Table 2 summarises other activity in the past nine months.

\* position as at 30 September 2009

ipac continues to closely monitor the fund manager line-up for the diversified portfolios, paying attention to areas such as business strength, investment processes and the retention of key staff in the investment teams in 2010.

The portfolios focused on quality assets with recovery potential, remained liquid at all times through the Global Financial Crisis and, with the changes implemented through 2009, are well positioned to benefit investors.

**table 1 - current line up of Australian shares allocation of diversified portfolios**

|                     | Lazard   | BlackRock (formerly BGI)  | GMO   | Schroders  |
|---------------------|--|---|---|--|
| <b>process</b>      | Fundamental manager, with an emphasis on relative value between different shares | Alpha tilts (quantitative manager taking small active positions vs index) | Quantitative manager using market signals, such as momentum | Fundamental manager, combining quality growth with relative value strategies |
| <b>time horizon</b> | Long term  | Mid term  | Short term  | Long term  |
| <b>focus</b>        | Mid-small cap  | Broad market  | Mid-small cap   | Broad market   |

**table 2 - summary of other changes implemented in 2009**

| strategy or sector                              | what's changed and why  | when           |
|---|---|----------------|
| Strategic asset allocations adjusted            | Increased allocations to alternative investments to add to diversification and smooth returns. Small allocations to emerging markets and global smaller companies for Pathways 30/ Inflation Plus 2, Pathways 70/Inflation Plus 4 and Pathways Value. | Apr – Oct 2009 |
| Australian Listed Property sector restructured  | Adopted blended high-active/passive approach for this concentrated market. New managers Vanguard and Perennial appointed.   | May 2009       |
| Alternative Growth investments added            | Further investments added progressively, including listed infrastructure, to increase diversification and provide new source of return.   | Ongoing        |
| Alternative Defensive investments added         | Exposure to credit and other strategies progressively included with specialist manager Oak Hill appointed.  | Ongoing        |
| Australian Fixed Interest and Cash restructured | Macquarie Funds Group appointed to take advantage of current opportunities and structural changes in this asset class.  | Jul 2009       |
| Australian shares restructured                  | Significant enhancements (described above) to achieve active return more consistently.  | Sep 2009       |
| Global smaller companies restructured           | Addition of two new managers, Dimensional and Pyramis, to provide extra sources of return and manage risk.  | Oct 2009       |

for more information contact an ipac financial adviser on 1800 626 881 or visit [www.ipac.com.au](http://www.ipac.com.au)



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