insight

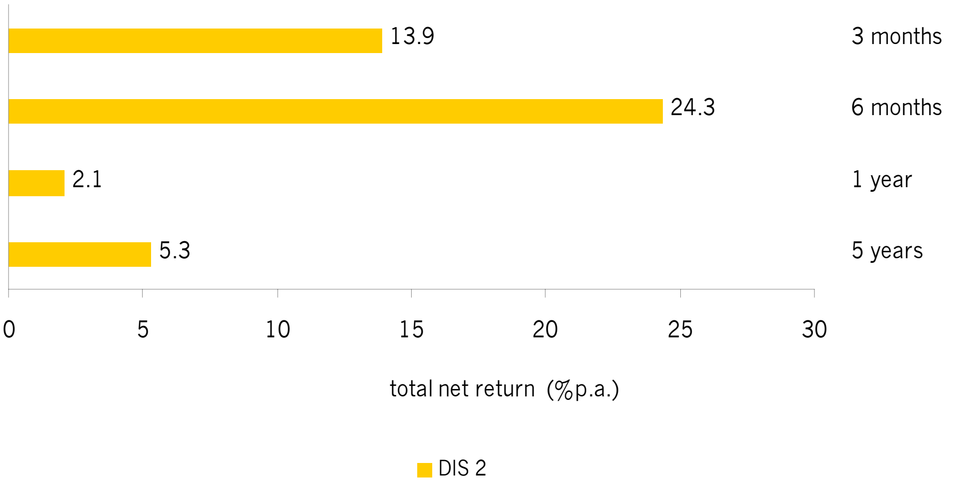
30 October 2009

talking points September Quarter 2009 Diversified Investment Strategies

recovery continues as markets rise and managers add value

To support your engagement with clients, ipac provides talking points each quarter that include stock stories. We highlight how the portfolios are being managed to achieve long-term outcomes for investors.

ipac's portfolios have performed strongly since March



The Diversified Investment Strategies fully participated in the market recovery

source: ipac. Past performance is not indicative of future performance

The Diversified Investment Strategies continued their strong rise in the September quarter, in both absolute and relative terms. All asset classes made a positive contribution. Active management also added significant value. In summary:

~ The quality and liquidity of our portfolios enabled ipac to maintain active positions that have recovered strongly

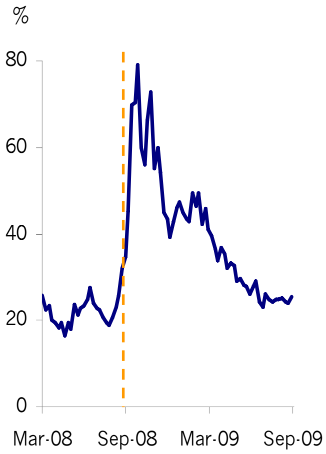
~ Positions in corporate credit (alternative income and global fixed interest) gained from the improved economic environment as credit spreads contracted. The benefit was most evident in Diversified Investment Strategy No 1 that has rebounded significantly (up 9.1% in the September quarter)

~ In Australian shares, a strong market return combined with manager value add helped performance. For the 12 months to 30 September 2009, ipac has added 2.0% on top of the index return of 8.5%.

While short-term returns are encouraging, the impact of the Global Financial Crisis is still evident in medium to longer-term returns.

SEPTEMBER QUARTER 2009 asset class returns					
Australian Shares	International Shares	Global Property	Australian Property	Global Fixed Interest	Aust Fixed Interest
⇑⇑⇑	⇑⇑	⇑⇑⇑	⇑⇑⇑	⇑⇑	⇑

the global economy improves and investment markets surge



Expectations are for improved economic conditions globally in 2010. Australia has led the way, benefiting from our close links to Asia. The developing economies are best placed to drive global growth.

While the signs are positive, there are uncertainties such as how government stimulus is removed and the speed that interest rates are increased to more normal levels. Growth may also be held back by reduced leverage that turbo charged economies and investment markets through the boom times.

Investor risk appetite has returned as shown by the chart opposite that highlights the fall in share market volatility (the CBOE Volatility Index). The dotted line indicates when Lehman Brothers collapsed.

For investment markets, the 'we survived' rally is arguably over. Investment markets are on a more normal footing. So what does normal look like in a post GFC world?

Global bond markets have continued to deliver good returns helped by the view that inflation is manageable. In Australia, government bond prices have anticipated a tightening cycle. This has led to a flattening of the yield curve with short-term yields rising and longer-term rates falling.

In credit markets, liquidity has increased and the functioning of these markets has improved. Banks are more profitable. There remains suspicion that some toxic assets may still be on balance sheets. Banks continue to be cautious with lending and have taken a hard line on bad debts. The credit sector is expected to outperform government bonds in the near-term although future gains could be less dramatic.

Investment markets are on a more normal footing. Better earnings is the key for share markets to continue their strong rise

Share market valuations are in the normal range following recent large gains. Savage cost cutting at corporates has compensated for lower revenue growth to rebuild earnings. To maintain the upward momentum of earnings requires an improvement in revenue. The signs are positive with some company earnings revised upwards recently to reflect the better economic environment. If earnings rise steadily then there is the potential for solid returns over the medium-term. Of course, share markets will be susceptible to shocks if the economy and companies do not improve as expected.

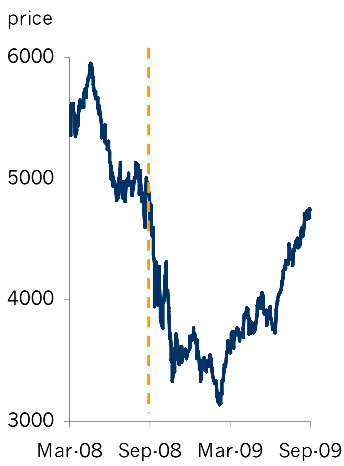
Listed property markets appear to be fairly priced after a significant bounce from distressed levels. Low quality property trusts have driven the rally. A lack of transparency in some property valuations coupled with a more difficult operating environment, such as higher vacancy rates, creates some uncertainty. Listed property trusts have raised significant capital which has quality businesses well placed to take advantage of acquisition opportunities. Some of these opportunities may arise as owners of direct property come under pressure from falling valuations.

shares continue to rebound

Australian shares

The surge in Australian shares continued. The chart opposite shows the rise since March (as measured by the S&P ASX 300 Index) with the price index advancing 20.1% in the September quarter. ipac's managers collectively added value for the quarter and the year.

Cyclical stocks outperformed. **JB HiFi** was an overweight holding that benefited the portfolio.



JB HiFi is a retailer of home entertainment and electrical products sold through its 123 stores. The business has achieved strong growth helped by sales of new products such as the Nintendo Wii and expansion into computers and telecommunications. JB HiFi has strong cash flow and conservative debt levels. The stock was up 29% in the September quarter.

Positions in **Fairfax media** and retail business, **Pacific Brands**, were other overweight holdings that benefited the portfolio in the September quarter. Exposure to more cyclical industrial stocks like **Qantas**, engineering and project management companies, **Downer** and **Transfield**, and construction supplier **CSR** also helped return. Financials was the best performing sector (up 32.4%). Portfolio overweights to **NAB** and **ANZ** benefited from this recovery.

Following the restructure of Australian shares, the portfolio has a better spread of exposures to fundamental, cyclical and market driven insights

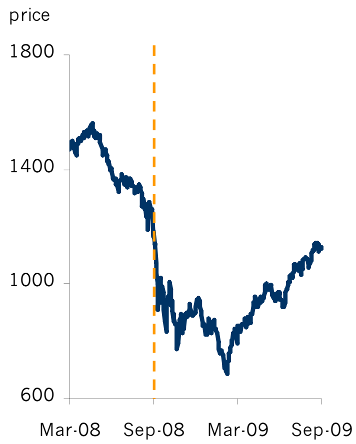
In the quarter, ipac completed its review of the Australian shares sector. This review led to innovative changes that sought a broader spread of active positions to generate consistent outperformance. Clever mandate design has increased exposure to mid and small cap stocks. ipac has also sought to achieve active return more efficiently through reduced transaction costs and less tax events.

The largest overweight positions in the portfolio at 30 September highlight the enhancements made. There are stocks chosen for their fundamental qualities and others that reflect more short to medium-term market signals.

Among the more fundamentally driven overweight positions are **Suncorp-Metway** and **News Corporation**. Suncorp-Metway has been heavily discounted on concerns about the property development portfolio of Metway Bank. Research by ipac's managers suggested the residential nature of this loan book makes the risk overstated. Further, two thirds of the value of the company is in its general insurance business that remains fundamentally sound. NewsCorp is attractively priced as the economy recovers. Low gearing is another advantage of NewsCorp as well as pay television subscriptions that are a reliable source of revenue.

JB HiFi and **David Jones** are stocks with shorter-term price momentum. Retailers are well placed in an improving economic environment. JB HiFi is at the discounted end of the retail spectrum. David Jones continues to perform well in the department store segment.

international shares



ipac's international shares managers collectively outperformed for the September quarter. Sector performance for the year is marginally behind the benchmark. Investors benefited from a rising market as shown by the upturn in the MSCI World ex-Australia Index in the chart opposite.

The hedged index was up 15.1% for the quarter. A surging Australian Dollar, supported by strong metal prices and higher interest rates, impacted on the unhedged return (up 7.1% for the quarter).

Value oriented investment processes in ipac's portfolio performed well as the market rewarded companies that were considered cheap.

The consumer discretionary sector was fruitful for some managers. **Electrolux AB** was an overweight holding. The stock was up 48% in local currency terms in the September quarter. Electrolux is an appliance company selling products such as cookers, cook tops, ovens, refrigerators, freezers, dishwashers, washing machines, tumble dryers, room air conditioners and vacuum cleaners. Electrolux estimate that they sell two products every second of every day of the year.

The international shares sector benefiting from exposure to different types of companies in the September quarter

ipac's international share portfolio provides exposure to many different types of companies. They vary in size and are spread across many industries. Some are names investors know, such as Electrolux, while others are successful businesses that are not as well known such as **Seagate Technology**. The portfolio had an overweight holding in Seagate. The stock was up 45% in the September quarter.

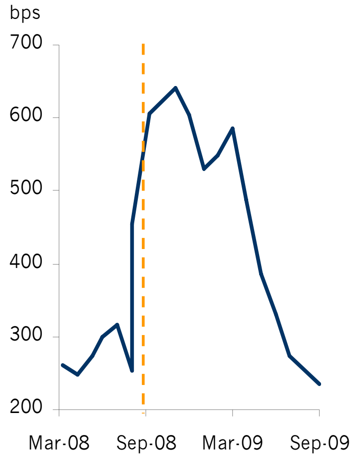
Seagate has provided digital storage solutions for 30 years. Their main products are hard drives for personal computers and recording technology for consumer electronics. Advanced gaming consoles, digital video recorders, portable media players and automotive GPS systems are some of the consumer applications of Seagate products.

Another overweight holding for the portfolio was in **Prudential Financial inc**. This stock was up 34% as the Financial sector continued to rise from the ashes. Prudential Financial Inc, demutualised in 2001 and had approximately $USD580 billion in assets under management at 30 June 2009. The business, founded in 1875, offers a variety of products and services, including life insurance, annuities, retirement-related services, mutual funds, investment management, and real estate services.

exposure to corporate credit pays off in bond markets

Credit spreads are back to the levels that existed before the Lehman Brothers collapse. The chart opposite shows the fall in US investment grade credit spreads.

These spreads are higher than they were at the peak of the boom (approximately 235 basis points now compared to a low of 93 when economic conditions were perceived to be most benign). This provides scope for further contraction although whether credit spreads fall to the very low levels of the boom times is debateable.



The sector's strong outperformance for the September quarter was due to the overweight position in corporate bonds. While ipac retains a bias to corporate bonds, over the quarter the positions in investment grade credit and mortgage backed securities were reduced as credit markets rallied.

enhancing portfolios

Significant changes to portfolios in 2009 has them well positioned for the next phase

Significant enhancements were made to portfolios through 2009. These changes demonstrate the value of outsourcing investment management to a specialist who is constantly reviewing and capturing asset class and portfolio management opportunities.

We remain fully exposed to core markets and continue to participate in the recovery. Active management based on sound research will be important to identify investment opportunities best placed for the next period. Share markets may be more discerning between higher and lower quality businesses going forward. We maintain close scrutiny of managers to ensure they retain their alpha edge and business strength.

We continue to seek opportunities to further enhance diversification. We want to increase the return drivers in portfolios through exposure to new areas such as alternative assets. A current area of research is insurance risk such as life and catastrophe insurance. These types of investments have a different return pattern to mainstream investment markets providing diversification benefits.

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