

recent events and global sharemarkets

Global sharemarkets have experienced a sharp fall over the past week. With the experience of the GFC still fresh in everyone's memory, it is understandable that investors have heightened concerns.

This newsnote discusses:

- ~ why sharemarkets have fallen
- ~ the impact on client portfolios
- ~ the outlook for client portfolios

what is influencing share markets?

Sharemarket behaviour over recent years could be described as a tug-of-war between the macro-economic challenges in advanced economies and the robust profitability of businesses around the world. These macro-economic challenges have been in the ascendency over the last few weeks. The sovereign debt crisis in Europe and a softer outlook for economic growth in the United States have been the major sources of investor concern.

In Europe, the focus of the debt crisis has shifted from smaller countries such as Greece, Portugal and Ireland, and spilled over to larger, more economically significant, countries such as Italy. While European leaders have managed to deal with each "crisis" since the fiscal problems in Greece were revealed last year, investors are unconvinced that these policymakers have the political will to permanently stabilise the Euro through enhanced European fiscal co-ordination.

Meanwhile in the US, economic growth has been weaker than generally anticipated and investors fear that policymakers have limited flexibility to restart the engine of growth should it show signs of stalling. Investor confidence has not been helped by aggressive posturing over the raising of the debt ceiling. This led many commentators to lament the lack of political leadership in the US and the inability for the political system to address the need for medium-term fiscal consolidation.

In Australia, consumer confidence has weakened considerably, impacting near-term earnings prospects across a large cross-section of the industrial sector of the Australian sharemarket. At the same time, the combination of weak business sentiment in advanced economies and tighter monetary policy in developing economies has weighed on some commodity prices and negatively impacted the Resource sectors.

In summary, investors are concerned that global growth is slowing and have suddenly become scared that policymakers lack the understanding, willingness or capability to respond.

US credit rating downgrade

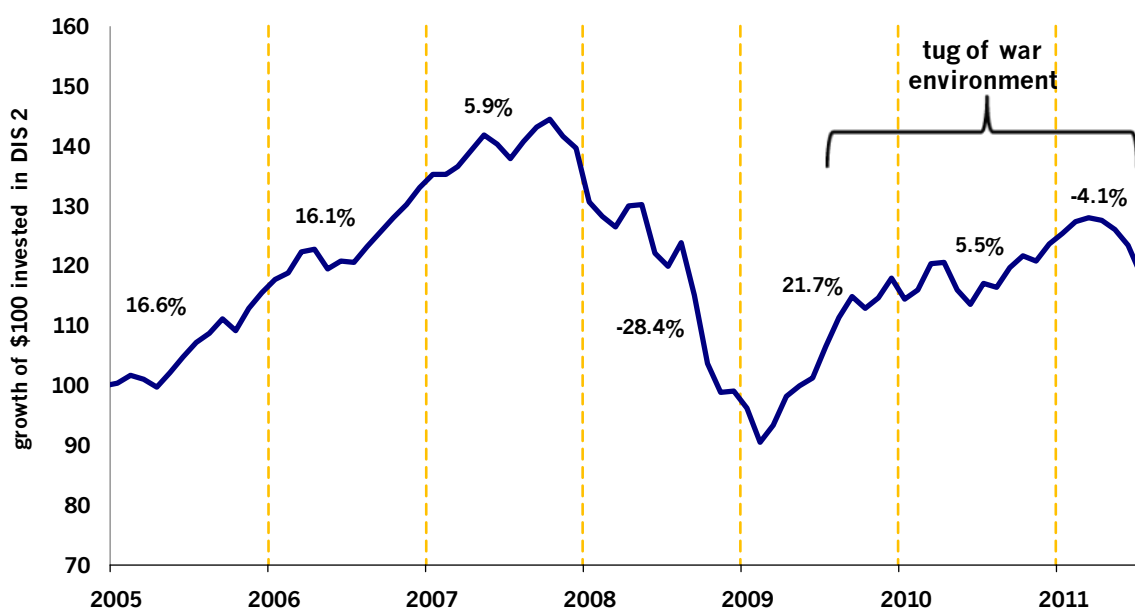
Late last week, Standard & Poor's downgraded the long-term credit rating of the US from AAA to AA+. S&P believes that the fiscal consolidation plans announced by the US are insufficient to stabilise the Government's medium-term debt dynamics.

From an investment perspective, the downgrade has virtually no impact on the quality of our bond portfolios and the way in which they are managed. The ratings change does not reflect a reduction in the capacity of the US to pay bond holders. The S&P downgrade reflects a negative assessment of the capacity of the political process in the US to address medium-term issues. **It is a comment on the investment outlook for US bonds rather than their underlying creditworthiness.**

impact on client portfolios

The tug-of-war in the sharemarket is creating sharp and uneven swings in portfolio values that are discomfoting for investors. While sharemarkets have risen at a measured pace in response to the good corporate news, they have been much swifter to respond in the opposite direction on signs of macro-economic stress.

The chart below shows the changing value of an investment in the Diversified Investment Strategy No 2 (DIS 2) valued at \$100 on 1 January 2005. Following the return of 11.6% in the financial year to 30 June 2011, the value of the portfolio has fallen approximately 6.3% in the first five weeks of the new financial year (to the end of Friday 5 August). The impact of the tug-of-war on portfolio performance over the past two years is evident in the chart.



source: ipac. calendar year returns shown are net of fees. data to 5 August 2011. Return doesn't include applicable rebates.

outlook for client portfolios

It is important to appreciate that sometimes action in the financial markets can become unhinged from economic fundamentals. ipac believes this is one of those times.

The share prices of high quality Australian companies such as Woolworths, BHP and CBA have fallen in value but these blue chip businesses are as strong as they were a few months ago. **It is the sentiment towards the business not the quality of the business that has changed.** The same is happening globally with Apple, Wal-Mart and Nestle amongst a host of companies that continue to perform well. At present, share price movements of these high quality businesses do not reflect changes in their prospects.

The global economy remains on track to expand by more than 4% this year. So it is not surprising that underlying corporate profitability remains very strong with earnings continuing to beat analyst forecasts. In addition, the listed companies in which we invest have very healthy balance sheets and many are looking for opportunities to use their strong positions to invest for the future. Following the share price declines, valuation measures indicate that sharemarkets are priced to deliver very attractive medium-term returns, even if global economic growth is at a moderate level.

In the shorter-term, investors are assessing the credibility of the actions of fiscal and monetary authorities as they bring forward plans with the aim to alleviate fear and create the foundations for future economic success.

In this climate, central banks are operating to ensure the plentiful supply of liquidity to markets and maintaining policies that support the orderly functioning of markets. Australia's central bank is maintaining a steady hand in what it acknowledges to be a more challenging climate. The recent weakening in commodity prices, especially the oil price, serves to reduce inflationary pressures and allows central banks to consider more accommodative policies.

While we did make timely shifts in allocation to global smaller companies and foreign currencies exposure earlier in the year, ipac's diversified portfolios are not insulated from short-term volatility. However, the market upheaval presents a number of opportunities to further improve medium-term portfolio outcomes.

Our equity managers are finding excellent opportunities to invest in high-quality companies at marked-down prices. At the same time, we are looking at the opportunities presented by recent share price weakness and bond market appreciation to enhance portfolio prospects.

We are confident portfolios are well-placed to deliver returns meaningfully above-average over the next few years.

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ipac asset management limited Level 31 Grosvenor Place 225 George Street Sydney NSW 2000 Australia
Sydney Office Locked Bag 15 Grosvenor Place NSW 1220. DX 10328 Sydney Stock Exchange.
Telephone 02 9373 7000. Facsimile 02 9373 7111. Adviser Services 1800 812 950. Investor Services 1800 624 542.