

Australian Shares

executive summary

ipac seeks to meet client investment needs by building diversified portfolios targeted at specific long-term return outcomes. The reliability of portfolio outcomes is enhanced by accessing return premia from many different sources including equity and credit markets as well as the skill of quality investment managers.

A key challenge is the concentration of the Australian share market. The 10 largest stocks represent 50% of the benchmark

The Australian shares sector is a key asset class in our diversified portfolios. It provides ownership of a share of the profits of corporate Australia and also supports access to the skill of investment managers capable of delivering consistent value add. ipac's Australian share portfolio has outperformed the benchmark by 3.0% (gross) over the 12 months to 31 August 2009 and by 0.5% p.a. over three years.

A key challenge in designing the Australian share portfolio is the concentration of the Australian share market. This market structure can lead to unbalanced portfolios where managers over-emphasise position-taking in large companies even though these stocks are the ones most competitively priced in the market.

The evolution of our Australian shares sector strategy sought to:

Key Issue	Challenge	How Addressed
Address market concentration	<ul style="list-style-type: none"> ~ 10 largest stocks represent 50% of the benchmark ~ Financial sector and Resources (Energy and Materials sectors) represent approximately 70% of the benchmark 	Design mandates to produce a broader spread of active positions across the market
Achieve a smoother path of return	The market can reward many different sources of return for extended periods	Well differentiated investment insights to diversify the sources of return
Capture return more efficiently	Reduce turnover and tax events which diminish after-tax returns	Bespoke mandate design to reduce overlap and focus on each manager's information advantage

ipac believes skilled managers have a greater opportunity to utilise their information advantage in mid to small capitalisation stocks. Working with our investment managers we have tailored mandates to deliver an improved combination of large, mid and small cap stock ideas in our overall sector portfolio.

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The sector is well placed to deliver outperformance more consistently and efficiently

A key driver of ipac's thinking was to build a portfolio that better balanced the use of shorter-term, market-based information with medium-term economic forecasts and the longer-term assessment of company fundamentals. This combination will help deliver a more reliable profile of value add as outperformance will be less reliant on long-term company fundamentals being the dominant factor driving relative market performance.

Portfolio efficiency has been enhanced. We have reduced overlap in holdings in the larger stocks to optimise the impact of these active positions. We have designed manager mandates to reduce portfolio turnover thereby improving after-tax outcomes through decreased transactions costs and less frequent tax events.

The new manager line-up for the Australian shares sector of the Diversified Investment Strategies 1-4 is BGI, Schroders, Lazard and GMO. Integrity, MIR, Wallara, and Maple-Brown Abbott have been replaced.

Jeff Rogers
ipac Chief Investment Officer

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sector overview

overview of the asset class

ipac views Australian shares exposure in the context of a multi-sector diversified fund. In constructing portfolios, we focus on:

- ~ the overall long term return objectives and risk profile for each diversified portfolio
- ~ how to combine asset classes and strategies to most reliably achieve these outcomes
- ~ how to efficiently implement our ideas and access the skills of each underlying investment manager

Australian shares is an important component of a diversified portfolio. ipac has added value over 12 months and three years

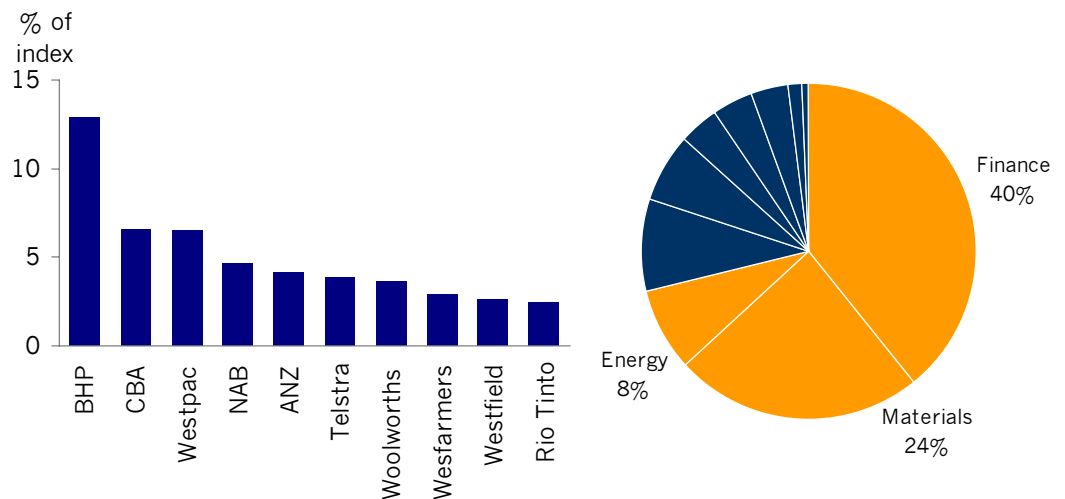
In Australian shares, ipac seeks a portfolio that can consistently outperform the S&P/ASX 300 Accumulation Index. To achieve this aim, we identify investment managers with different investment approaches that together deliver a well diversified set of insights in Australian shares.

We aim for the risk allocation in Australian shares to be well balanced. We also seek to deliver the sector strategy in an efficient way and extract better value from our active managers by only rewarding them for their impact on the overall portfolio.

To achieve the desired sector characteristics we are constantly reviewing the asset class and the benchmark that represents it. One of the key characteristics of the S&P/ASX 300 is its significant level of concentration.

The top 10 stocks represented 50% of the benchmark as at 30 June 2009 (as shown in the chart below). In contrast, the top 10 stocks in the US S&P 500 represent approximately 20% of that benchmark.

Together the Energy, Materials and Finance sectors represent 70 per cent of the benchmark



Source: Bloomberg. S&P/ASX 300 Index. Data as at 30 June 2009.

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The rise of the Materials and Energy sectors in recent years has increased this concentration. Together Materials and Energy (the Resources segment of the market) represent 32% of the benchmark as shown above. Financials remain a significant component of the Australian market (approximately 40%) with the big four banks representing about half of the Financial sector.

Market performance is heavily influenced by the performance of the largest stocks and sectors. For example, when sentiment favours, or is against, the big four banks then this theme will drive the overall market. Similarly, a key driver of the Australian share market is whether Resource stocks are in or out of favour. Relative positioning on the right or wrong side of these key stocks or themes can determine the performance outcome over uncomfortably long periods.

While skilled managers have an information advantage in mid and small cap stocks, their positions in the larger cap stocks can limit the benefit

Skilled managers add value through advantages in accessing and processing information. This information can be sourced from fundamental analysis of companies and from the actions of other market participants. The information advantage can play out over different dimensions, presenting opportunities to improve diversification by effectively combining these insights. Key dimensions of information advantage are time horizon and particularly market capitalisations as stocks lower down the capitalisation scale are less well researched by investors providing opportunities for skilled managers to exploit.

Active managers have different skills that are optimally rewarded in specific segments of the benchmark. We observe that some managers whose alpha delivery is more dependent upon their information advantage in mid and small cap stocks are sometimes unable to take full advantage of these insights as significant positions in the largest stocks can dominate the return outcome.

Furthermore, when constructing a multi-manager portfolio by aggregating the stock positions of the underlying managers, common views in the large stocks can amplify the stock specific risk in these securities. Offsetting views dilute the benefit of the insights of individual managers. As individual managers move in and out of stock positions that offset each other it creates transaction costs and tax impacts for little performance benefit. This inefficiency occurs more frequently in the larger stocks.

ipac's response

Given the features of the Australian share market, ipac has designed a portfolio with the following attributes

ipac has designed mandates that focus active managers on market segments where they have the greatest information advantage

- ~ well differentiated investment insights to diversify the sources of risk and return
- ~ active positions spread more evenly across the capitalisation spectrum of the benchmark rather than skewed toward the largest stocks
- ~ greater emphasis on value add in mid and small cap stocks where skilled managers have an information advantage

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To deliver this outcome individual manager benchmarks have been specified to focus the manager's active positions on those market segments where ipac believes the manager has the greatest information advantage.

By incorporating these features we have responded to the issues associated with the concentration in the market. In doing so, we have sought to capture value add more efficiently. The table below details the appointed managers and highlights their differentiated approaches.

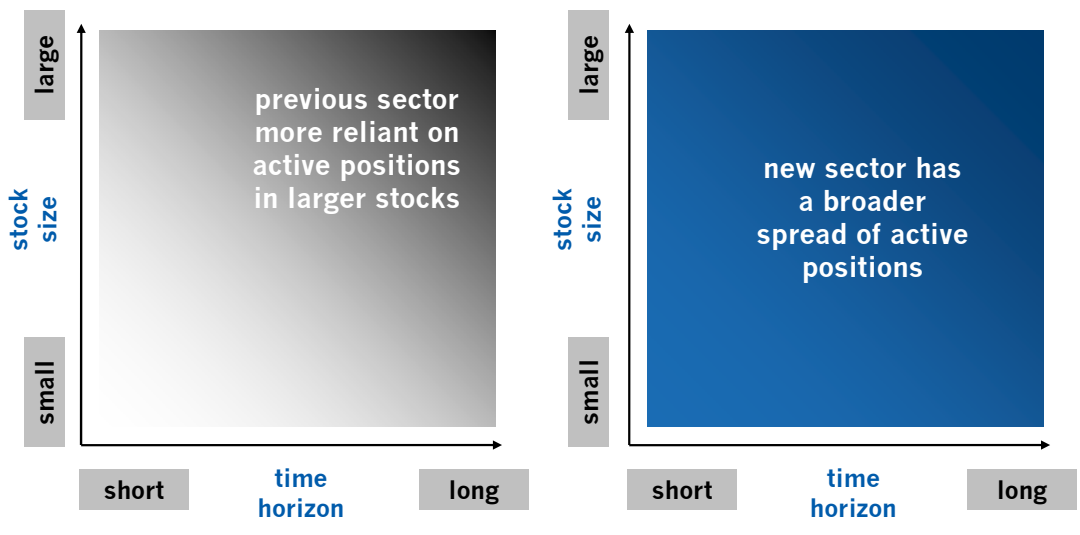
The sector combines shorter-term market sentiment driven insights with longer-term fundamental opportunities

Australian Share Managers	Description	Current Allocation%
Lazard Asset Management Pacific (Lazard)	Fundamental, relative value focus. Long-term time horizon	18
Barclays Global Investors (BGI)	Quantitative, multi-factor approach. Medium-term time horizon	40
GMO	Quantitative, market signals orientation. Short-term time horizon	24
Schroder Investment Management (Schroder)	Fundamental, combining quality growth and relative valuation. Long-term time horizon	18

The process diversification in the sector draws upon shorter-term, market sentiment driven information as well as longer-term fundamentals. This combination will help deliver a more reliable return profile.

Overall there has been a modest shift in active risk away from larger stocks. The result is a better combination of active risk across large, mid and small cap stocks. The chart below illustrates the broader spread of active positions.

Active risk is spread more broadly across the benchmark covering large, mid and small cap stocks



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The mandates managed by GMO and Lazard have been designed by ipac. They are unique. Both managers will focus their risk taking in the mid and small cap segments of the market where their stock selection skills are well suited. Their mandates lead them to maintain exposure to the largest 12-15 stocks at close to benchmark weight.

ipac has increased efficiency by reducing the number of managers that can take active positions in the largest stocks

BGI and Schroder can take positions across the entire market, including the largest stocks. By limiting the number of managers that take active positions in the largest stocks, ipac will increase portfolio efficiency by reducing turnover and tax events in the large capitalisation shares.

Stock specific risk in the largest companies is reduced while also ensuring the value-add potential of positions in these larger stocks is not diluted by manager overlap. Where there is overlap then the different time frame for the investment idea to pay off will make the sell decisions more differentiated.

ipac's Australian shares sector strategy is well placed to continue to deliver a return premium above the benchmark while improving both the consistency and efficiency of this outperformance.

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