keeping perspective in a volatile market

Judging by the number of newspaper headlines painting a picture of doom and gloom, many investors might feel that 2010 was a disappointing year for their investment portfolios. In fact, headlines notwithstanding, diversified investment portfolios recorded positive returns for the year, although the outcome was still somewhat shy of our long term average expectations. Market sentiment shifted direction on several occasions through the year, as ongoing evidence of positive surprises in global corporate profitability was displaced by higher profile episodes of unfavourable macro-economic news, particularly in Europe. The arm wrestle between these countervailing forces ended the year pretty much in deadlock.

This year's headlines are again likely to focus on macro-economic risk as countries and regions continue to work through the imbalances exposed by the financial crisis. The resolution of the sovereign debt crisis in Europe, the medium term outlook for growth in the US, and rising inflation risk in emerging economies are all important unresolved issues which deserve investor attention, especially for their impact on government bond prices and exchange rates. However, it is important to remember that over the medium term it is corporate profits that more profoundly influence our portfolio returns. And here the news remains positive.

There has been a sharp rebound over the past year in the profitability of companies in which we invest. Corporate earnings for the third quarter of 2010 were more than 20 per cent higher than a year earlier, and are approaching a new all-time high. Business profitability, especially in the US, remains exceptionally strong. While some of this profit can be attributed to cost-cutting measures applied by companies over the past few years, an increasingly important contribution has come from overseas sources, particularly from emerging economies. The shift in contributors to global activity has altered the source of revenue for many companies, and with emerging economies expected to soon represent more than a third of global activity, this will become increasingly important for understanding corporate prospects. Indeed, investment in a diversified portfolio of high quality global companies may well be seen as a 'safe' investment in a world of sovereign uncertainty.

Australia remains well positioned in the face of these developments. We have a strong fiscal position, well developed trade linkages with the fast growing economies of Asia, and investment spending is expected to drive economic activity for a number of years. That said, with monetary conditions likely to remain tighter than normal, and the exchange rate higher than average for a considerable period, this environment will be quite testing for a number of segments of the economy (eg, non-resource exporters). The challenge for companies operating in these sectors is to find a way to respond by identifying new markets, boost productivity and thereby re-establish their profitability.

In the year ahead it will continue to be important to distinguish between shifts in investor sentiment which influence the short term pricing of financial assets and the trends in corporate earnings which determine share prices in the medium term. With the global financial crisis still vivid in the memory of investors, these shifts in sentiment are likely to produce some sharp bouts of downward volatility followed by more extended upward trends. However, as time progresses, the influence of the current macro-economic concerns on the share market is likely to wane and the strength of corporate performance will win out.

Jeff Rogers
ipac Chief Investment Officer

headline views from ipac's CIO

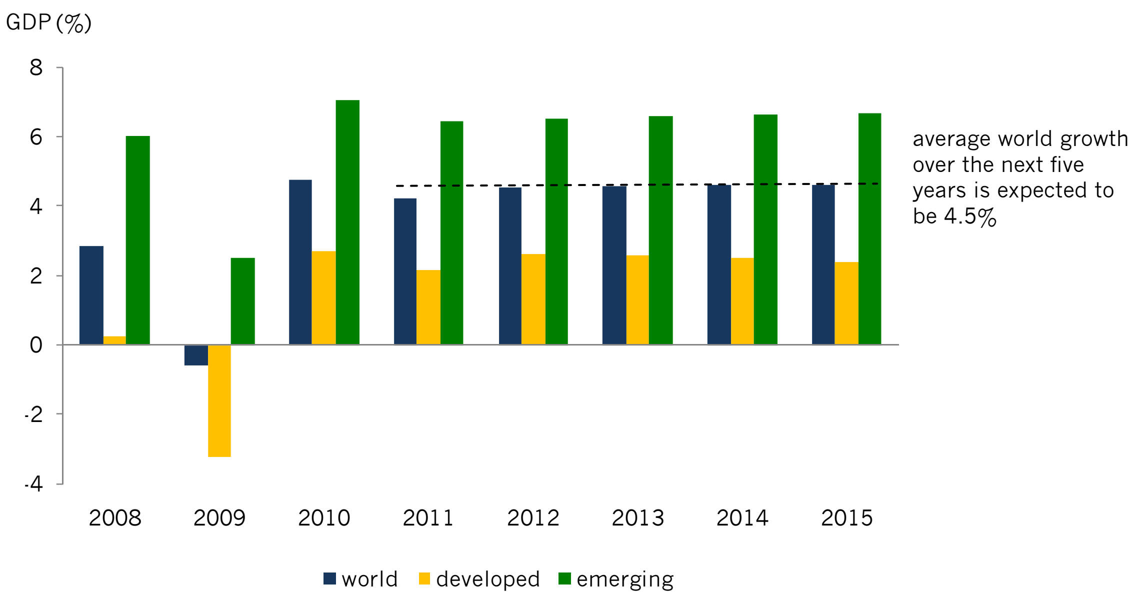
~ ipac portfolios positioned to perform particularly well over the medium term driven by strong corporate profitability
~ clients are invested in high quality global companies benefiting from exposure to fast growing emerging economies
~ it may not be all smooth sailing as old problems, like the debt crisis in Europe or overheating in Asian economies, may re-emerge and create short term volatility
~ a well diversified portfolio anchored on high quality global companies is the best way to navigate the complex investment landscape

what are the overall growth prospects for 2011?

Overall growth forecasts for the global economy in 2011 suggest a continuation of anaemic growth in developed economies and more rapid growth in emerging economies. That said, with the recent monetary and fiscal policy stimulus announced in the US there is scope for some upward revision for developed economy growth, at least in the near term. In contrast to the US, many governments in Europe have started to tighten spending. It will be interesting to track the relative performance of the US and European economies in 2011 as they adopt divergent strategies to deal with the debt overhang in the aftermath of the global financial crisis.

Global growth forecasts by the International Monetary Fund for the next five years average 4.5 per cent (see chart below). This forecast is for higher growth than the average experienced during the 1990s and 2000s which was 3.0 per cent and 3.6 per cent respectively. The increasing contribution to global activity from emerging economies is largely responsible for this, and it is expected that emerging economies will represent more than 50 per cent of global activity within the next few years.

emerging economies are underpinning global growth forecasts



Source: International Monetary Fund, *World Economic Outlook*, October 2010.

With economic activity so dependent on emerging economies, particularly those in Asia, investors are focused on what might go wrong and upset the anticipated growth trajectory. One fear is the potential inflation risk in asset markets resulting from the stimulus packages introduced in response to the financial crisis. Rising food prices globally may also impact on inflation. Investors are paying close attention to attempts to slow down capital flows and cool speculative activity, especially in China. We believe that markets will respond favourably to evidence that authorities can successfully engineer a controlled slowdown.

Our managers have positioned portfolios to take advantage of increased growth in emerging economies. This growth is accessed in two different ways – directly through exposure to companies located in emerging markets, and indirectly through exposure to companies headquartered in developed economies whose business strategies are increasingly focused on emerging markets.

what does this mean for the Australian economy?

Australia's close trade ties to Asia mean that it is well positioned to benefit from the region's growth. The strength of commodity prices is direct evidence of our favourable position while the level of our interest rates and the appreciation of the exchange rate provide indirect evidence of economic strength.

The conditions leading to high commodity prices, risks of above average interest rates and upward pressure on the Australian Dollar are likely to remain in place for some time. This sets up the potential for a three-speed economy with industries linked to the resources sector performing very strongly, the domestic services sector generally benefitting from the increase in national income, while those sectors that export manufactured goods and services or compete with imported goods face significant pressure.

what does this mean for markets?

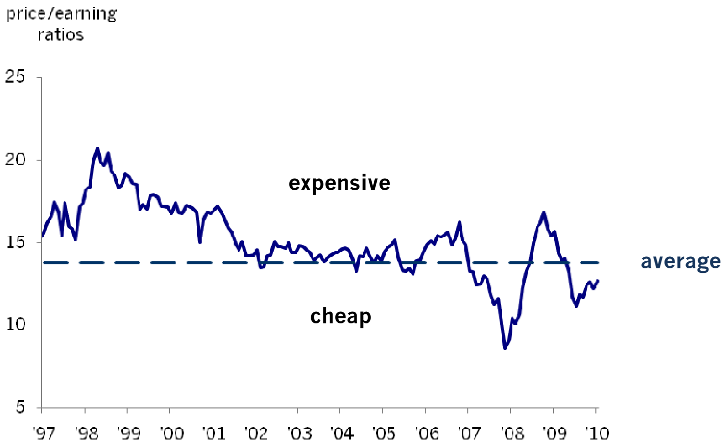
While there are strong growth prospects and genuine opportunities to capture returns, growth stands side by side with the negative tide of deleveraging in developed economies. Continued news of deleveraging may, at times, dominate headlines, overshadowing the strength of the corporate sector and the positive microeconomic growth story. Therefore, thriving in this environment is going to require perspective.

equities

The outlook for equities remains constructive. Many of the companies in which we invest have strengthened their balance sheets, repaired their profitability and are continuing to access growth opportunities in emerging economies. Given their strong cash flow, they are in a good position to reward shareholders with increased dividends as well as by making new strategic investment decisions. Given investor concern about macro conditions it is still possible to buy these companies at attractive valuations as shown in the chart below.

Investment in high quality global companies makes an excellent bedrock for a long term portfolio given their ability to move their sources of production to control costs and target sales to high growth economies. These companies include global businesses such as Nestle, Apple, Google, Nokia and Samsung as well as leading Australian companies like BHP, Brambles, and Rio Tinto.

share valuations still look attractive



Source: Bloomberg. 12 month forward price/earning ratios. MSCI Australian Index. Data as of 31 December 2010.

listed property

Over the past year, there has been a rebound in price levels, particularly in the global listed property sector. This is in part due to a stabilisation in economic conditions and an improvement in the capacity to finance the purchase of high quality property assets. We are taking advantage of the rebound in prices in this asset class by reducing exposure and allocating funds to alternative growth strategies that offer significantly higher prospective returns. In contrast, Australian listed property has been somewhat of a laggard so there is scope for improved returns for this asset class in the period ahead.

debt markets

In the second half of 2010 government bond rates fell to very low levels, especially in the US, and ipac took the opportunity to reduce exposure to interest rate risk in the portfolios. However at the end of 2010 these rates began moving upwards in response to improved US growth prospects. In the shorter term, we don't think that inflation will be a major concern in the US and Europe. If the rising trend in rates were to continue, we would look to re-establish a larger interest rate exposure to take advantage of the higher returns those yields would imply. In Australia, a combination of a higher exchange rate and potentially higher cash rates should ensure that inflation is contained near the top end of the 2-3 per cent inflation band set by the Reserve Bank of Australia. This would tend to limit any material sell-off of bond yields domestically.

how are portfolios expected to perform over the coming year?

When we consider which investments are best suited for the portfolios, we make medium term forecasts that are driven by the fundamental prospects for cash flows and the price we have to pay today to access those cash flows. Based on our assessment, the forecast returns from our portfolios are quite attractive. We often ask ourselves whether other market participants disagree with our assessment, and as far as we can determine, there is no major disagreement with our baseline assumptions. While memories of the financial crisis remain vivid in the minds of investors, many investors are waiting for more certainty before they commit. By the time the required evidence arrives, prices will be higher and prospective returns somewhat reduced.

At ipac, we have made a number of changes to portfolios over the past year to ensure that they remain on track to meet client investment objectives. We have increased manager diversification in global emerging markets and alternative growth sector portfolios. We have also restructured the fixed interest segment of the active diversified portfolios into two new sectors (multi strategy fixed interest and government bonds) to more effectively manage interest rate exposure in the portfolios.

While we expect that over the short term markets will continue to be dominated by news from macro events, we do believe that favourable fundamentals will eventually end up reflected in market prices. As a consequence, client portfolios are expected to perform particularly well over the next few years, delivering returns in excess of long term expectations.

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