

investment markets are not all one way traffic

Every year sees changes in the economic landscape – and with the introduction of a new superannuation system, a new government, a credit crunch in the US and a crisis in a major property group, 2007 was no exception. Last year we also saw volatility return to the market. The combination of a stronger Australian dollar, crude oil at times nearing US\$100 a barrel and high domestic interest rates gave many companies and investors no shortage of earnings headaches. The swings in sentiment experienced in 2007 set it apart from what investors have witnessed since the start of the decade. In equity markets, five of the top 10 one-day percentage gains this decade occurred last year, as did six of the 10 largest one-day losses! These statistics serve as a timely reminder to anyone who thinks that investment markets are all one-way traffic.

Although Australian shares posted double-digit returns in 2007, the gains were concentrated in a small number of stocks - in this case, resource-associated names. Any portfolios that did not have reasonable holdings in names such as Rio Tinto, BHP Billiton, or Fortescue found it difficult to keep pace with the market. However, since the onset of the sub prime issues, commodity price gains have been limited and stock price gains, even within the resource sector, have flattened. This recent performance reminds us that cycles exist in all sectors, and those stocks that led the way in the past may not be the strong performers of the future.

In 2007, the sub prime crisis in the US, and the impact that was felt across the globe, showed us how connected the world is today. For years, individuals and corporates had enjoyed the benefits of attractive lending programs. Economists of the International Monetary Fund, and clearly fans of Dire Straits, described this as an era when many received 'money for nothing and cheques for free.' However, as interest rates began to rise, and mortgaggers defaulted on loans, the availability of credit began to dry up. Local entities who found themselves in difficulties included RAMS Homeloans, Basis Capital, and most recently Centro Properties Group.

The innovation we have seen in financial markets in recent years has facilitated the process of risk transfer. This financial innovation has had positive implications - not only did it enable the likes of Centro to become a major player in the global marketplace, but it also allowed people with low credit ratings to own their own homes. However, with this innovation has come excesses, and with it, associated risks. Risk management systems have not always been able to keep pace with the speed of innovation, which has, at times, led to financial loss for investors. As financial markets evolve, the governance structure of investment programs will become increasingly important, as will the ability to improve the understanding of risks in investment portfolios.

The lesson for investors in 2007 was a familiar one. Responding to fads and fashions, and attempting to time the market can prove extremely painful. Cycles exist in all sectors and economies, but well-run companies in industries with favourable conditions will keep on rewarding investors over the long-term.

Jeff Rogers - Chief Investment Officer

economic environment

A large number of factors need to be taken into account when assessing the outlook for economies and markets. We detail several of the themes below that ipac is monitoring closely to test the robustness of client portfolios.

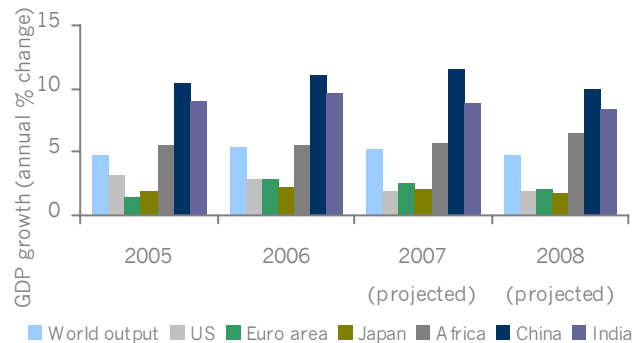
will the US fall into recession?

Growth in the US economy is expected to decelerate this year. The downturn in the US residential property market has not found a bottom and the corresponding influence on homeowners will continue to play out in the market. However, monetary authorities are well aware of the risks, and are likely to reduce interest rates considerably to underpin economic activity, providing this policy response does not create a significant threat to inflation. Of course, the US economy could surprise on the upside later in the year - a weak US Dollar, low interest rates and fiscal stimulus could all contribute to stronger-than-expected growth. A further factor that could impact US growth is the increasing tension in US-China trade relations. The US has accused China of keeping the value of its currency low to boost Chinese imports into the US while making US goods more expensive in China. These protectionist measures are driving competitors out of the market and costing US jobs. In an election year this might elicit a protectionist response from the US.

can the rest of the world decouple from the US?

Historically, when the US economy sneezed, the rest of the world caught a cold. For the first time, however, China and India are making the largest country-level contributions to global growth, suggesting that the world economy is less dependent on the US as an engine of growth. Strong domestic demand and less reliance on exports to the US mean that any slow-down in growth in emerging economies may be limited. Also, low debt to GDP ratios in many emerging economies will allow them to use fiscal stimulus to help sustain growth. However, the decoupling thesis will be tested if the US economy does indeed fall into recession.

emerging markets will support global growth



Source: IMF, *World Economic Outlook*, October 2007

will the Australian economy continue to grow?

Australia's strong economic ties with China and emerging Asia will provide some cushion against the direct impact of any US weakness. However, inflationary pressures are likely to persist as a result of a tight labour market and the rising cost of raw materials. To combat the threat of inflation, the Reserve Bank of Australia (RBA) is likely to maintain tight monetary conditions, and is only likely to cut rates if the global outlook turns sour. The RBA's ability to sustain growth without allowing inflation expectations to rise above 3% will remain an important theme over the coming year.

how will inflation impact portfolios?

The effects of inflation on investment returns will continue to remain an important factor when managing portfolios. High prices for food, energy and natural resources continue to pose a significant risk to inflation, although a slowdown in global growth should provide some offset to inflationary pressures. Over the past decade, the primary objective of central banks in developed economies has been to ensure price stability, which suggests it is unlikely that global inflation will be permitted to accelerate out of control. For investors, it is important not to ignore the corrosive effect rising prices can have on the value of assets. By searching for assets that have inflation-hedging characteristics (such as infrastructure with long-term cash flows linked to inflation) ipac will continue to protect portfolios against the threat of inflation.

investment market outlook

equity markets will remain volatile...

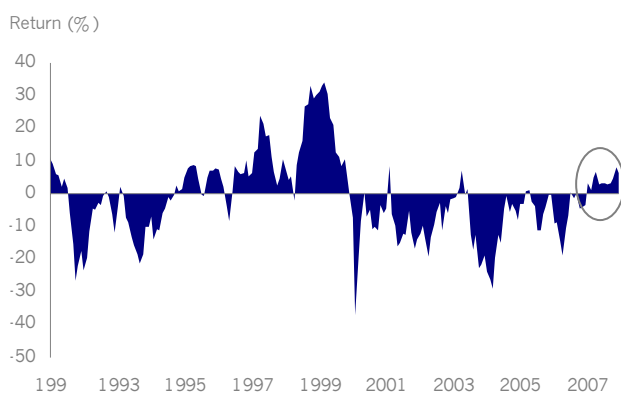
ipac believes that equity markets remain an attractive place to be invested. The world economy is still on a strong footing and the US economy is not falling apart. Needless to say, stock markets are very sensitive to short-term news flow, and with choppy earnings expectations likely, volatility is expected to remain elevated over the coming months. Although 2007 saw a dramatic slow-down in global equity markets, with the international index returning 6.0% on a currency hedged basis, Australian equities returned more than 16%. This leaves Australian equity valuations relatively expensive compared to the rest of the world.

For the past three years small-cap stocks have outperformed large-cap names. However, as a consequence of the credit crunch there has been a general downward repricing of less liquid stocks, and large caps have subsequently outperformed since August. As equity markets are likely to remain volatile, and economic growth is expected to slow in some regions, large-cap stocks may continue to outperform small-caps. ipac's portfolios are well placed to benefit from companies with strong balance sheets and robust, sustainable organic growth in what appears to be a maturing earnings cycle.

In the longer term, we expect to see greater activism among investors. As a consequence, awareness of social and governance-related issues will play a greater role in determining which companies perform well within global equities. Companies that are likely to be most affected by these issues are those requiring a public licence to operate, such as large banks and resource companies. A key differentiator for company performance will be the extent to which company management deals with this development.

are we entering a cycle where large-cap stocks will outperform small-caps?

S&P 500 Index less Russell 2000 Small-Cap Index



...but liquidity may well improve

There is no denying that the credit crunch has had a profound effect on liquidity, particularly with reduced lending by investment banks to finance Merger and Acquisition (M&A) transactions. The equity levels required for acquisitions are now based on a much higher threshold. As M&A activity is likely to remain subdued in the aftermath of the credit crunch, a new focus of attention for the market's much-needed liquidity could be sovereign wealth funds. These funds that have historically invested in fixed interest have now expanded their investment focus. Following the surge in the price of oil and other commodities, sovereign wealth funds in Asia and the Middle East have poured tens of billions of dollars into a range of companies and assets. With global oil markets remaining tight and spare capacity limited, sovereign wealth is expected to grow which suggests continued demand for a wide range of long-term investments. Some sovereign wealth funds, such as the China Investment Corp, have triggered concern in international markets, leading some countries to complain about the alleged threat from acquisitions. However, due to the long-term nature of these investors, sovereign wealth funds could bring stability to the global economy, providing liquidity for the market, and confidence for investors.

global listed property still provides opportunity

As a result of the fallout from the sub prime residential mortgage market collapse, Real Estate Investment Trusts (REITs) looking to refinance in the coming year will likely face tighter covenants and increased financing costs. Both of these factors are likely to constrain real estate values, and returns from REITs are expected to be volatile in the coming year as investors digest these developments. Despite its recent relative poor performance, international property remains an important part of a diversified portfolio, providing a differentiated source of return. In addition, the fall in prices in REITs has created good buying opportunities, particularly in the US. Important lessons have been learnt from the global credit crunch, and there will be a renewed focus on the transparency of ownership structures. In the wake of Centro's debt-related problems, it will become increasingly important that property fund managers ensure there is clear transparency of governance and ownership structures for the pools of assets they are managing.

credit spreads are offering better reward for risk

As a result of the credit crisis, and the re-pricing of risk, 2007 saw spreads widen in fixed interest markets. While this was bad news for investors, on a forward-looking basis there is a positive twist as credit now offers better reward for risk. Given the downward slope of the yield curve, there is less value in long-dated bonds. If this environment persists, a strategy to take advantage of it is to diversify into alternative income/enhanced cash. While value has re-emerged, it will be important that investors understand the risk they are taking as market volatility is expected to remain high.

emerging portfolio themes

ipac has identified two other developments that may influence portfolio design in 2008 and the years ahead – the search for greater diversity and implications of market concentration.

the search for greater diversity

Correlations among growth asset classes have increased over the last few years. As markets evolve, it will become important to examine how effective traditional balanced portfolios are at providing diversification. The high double digit annual returns of equity markets of the last few years are not expected to continue, which makes it important to diversify portfolios away from their traditionally heavy reliance on equity markets. Strategies that are independent of market direction will become more important in portfolios, as will new asset classes and investment strategies that have until now not been included in traditional balanced funds. ipac will continue to explore opportunities to develop investment strategies that take advantage of innovation in capital markets and enable the goals of investors to be met more efficiently in a broad range of market conditions.

implications of index concentration

Australian equity and property markets are becoming increasingly concentrated. The top 10 stocks in the Australian equity market account for over 40% of the S&P/ASX 300 Index, while the top 4 trusts account for over 60% of the S&P/ASX 300 Listed Property Trust Index. The increased concentration of these markets raises concern over the effectiveness of many standard mandate designs. Not only does concentration reduce diversification within portfolios, but it is becoming increasingly difficult for active managers to appropriately reflect their views and deliver consistent added value. ipac is exploring ways to design mandates for managers that enable them to better express their value-adding ideas and thereby produce solid incremental returns for clients in multi-manager portfolios.

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top 10 stocks make up 43% of Australian equity market

company	share of index (%)
BHP Billiton	10.7
Commonwealth Bank of Australia	6.1
National Australia Bank	4.8
ANZ	4.1
Westpac	4.0
Woolworths	3.4
Rio Tinto	2.9
Westfield	2.7
Telstra	2.4
QBE Insurance Group	2.3
Total	43.3

Source: S&P/ASX 300 Accumulation Index, January 2008.

top 4 trusts make up 62% of Australian property market

company	share of index (%)
Westfield Group	35.1
Stockland	11.7
GPT Group	8.4
Goodman Group	7.4
Total	62.6

Source: S&P/ASX 300 Listed Property Trust Index, January 2008.

conclusion

the path will remain unpredictable

Investors should be aware that the world economy is slowing, and as a consequence of some unique features of the global credit crunch, the speed of recovery is uncertain. There are significant short-term risks and depending on how these play out, the markets could move quickly up or down. As a long-term investor it is important not to respond to the 'noise' in the headlines as the path will be unpredictable. Over the longer-term the fundamentals do win out, and based on ipac's long-term forecasts, equity markets are priced to deliver returns in line with historical averages.

The credit shock has highlighted a number of linkages in financial markets that investors had not previously appreciated. In this environment, active management and the value of quality research is important to manage risk and to identify opportunities with strong fundamentals. The best and most reliable way to achieve investment objectives is to invest in a quality globally diversified portfolio in a range of asset classes. Quality companies, sensibly priced will keep on delivering solid portfolio outcomes.