

The View

A quarterly publication from QIC - December 2009

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As equity markets continue to rally strongly and as debt markets return to normal, it seems we are reaching a point where we can relegate the well-used term 'the

global financial crisis', or 'the GFC', to the history books, where it will join the Great Depression, the 1970s oil shocks, the crash of '87, the Asian Financial Crisis and the Tech Bubble, among others.

By now, you may be suffering from GFC overload. While not underestimating the impact of the GFC, it is important that it does not distract from the job at hand, which has always been investing to build real long-term wealth. However, to move forward, it is also important that we look at where the GFC has left us.

Simpler and more transparent financial products, as well as a proportionally smaller global financial sector, are welcome post-GFC developments. However, there are two less desirable after-effects that will need to be very closely monitored – inflation and interest rates.

Since August 2007, the Fed has implemented a range of extraordinary policies in an attempt to reduce the severity of the GFC, which have increased the size of the Fed's balance sheet and the US monetary base.

To date, banks have hoarded the increased funds in excess reserves as deposits with the Fed, which has limited the increase to the money supply. However, as global economic activity improves and as the banks become more confident about the value of their other assets (i.e. ex-toxic assets) and begin to lend these funds out, this excess cash in the economy will lead to a sharp rise in the money supply. The possible consequence is an increase in inflation, unless the cash is removed from the system via tighter central bank monetary policy (i.e. higher interest rates). For more information, read the article on page 2 of this edition of The View, in which Matthew Peter, QIC's Chief Economist, discusses just how much inflation could rise over the next five years.

Dynamic Investment Solutions

At a higher level, the GFC has once again confirmed for me a very fundamental investment belief: markets do get it wrong, and sometimes they get it very wrong.

For QIC, it has also clarified our value proposition to our current and potential clients, which is anticipating and understanding potential events and their impacts on your portfolio and building investment solutions tailored to your needs that deliver in all market conditions. As well as protecting your investments from a range of threats, we aim to position our clients to take advantage of investment opportunities in a timely and disciplined manner.

Some of the ways that we have recently delivered dynamic solutions for our clients include:

- Risk management solutions for liquidity and counterparty risk that were in place well before the GFC.
- A dynamic asset allocation process that has positioned our clients' portfolios to benefit from extreme valuations both before and after the GFC.
- A 16% p.a. return from a fixed interest absolute return fund (the QIC Global Fixed Interest Alpha Fund) during the same financial year as the GFC (13.4% p.a. since its inception in July 2005).
- A record sale price for Central Plaza commercial office complex in Brisbane in December 2007 (now regarded as the top of the market).
- Inflation protection solutions that are customised and cost efficient.
- An after-tax investment (ATI) approach that has delivered real bottom-line benefits, despite investment market conditions (read the article on page 4 for more information about QIC's approach to ATI).

This proven value proposition is reinforced by our 'house of boutiques' business model and encapsulated by our new tagline – Dynamic Investment Solutions. While our previous tagline - Go Further - reflects our overall commitment to exceeding our clients' investment objectives, we feel that Dynamic Investment Solutions more clearly communicates the practical and tangible 'value-add' that we deliver to our clients.

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Message from Doug (continued)

New Head of Funds Management

I am pleased to announce that following an extensive global search that identified some outstanding candidates, QIC has appointed international investment expert Hazel McNeilage to the new position of Head of Funds Management.

Hazel will play an important role in shaping QIC's future direction. Reporting directly to me, she will be responsible for developing and implementing QIC's strategy for investment solutions and asset management services and will drive QIC's investment boutiques to achieve their clients' investment objectives.

Hazel joins QIC from Principal Global Investors in New York, where she was most recently Global Head of Sales, Marketing and Client Service, with

responsibility for serving clients with a total of \$215 billion in assets, including over \$70 billion in assets for third party institutional clients.

With more than 25 year's experience in international investment management, asset consulting and life insurance, Hazel has strong experience in managing a multi-boutique investment structure and a proven track record in growing institutional asset management businesses.

Hazel's appointment completes the new QIC Executive Leadership team, and we are extremely pleased to have attracted a person of Hazel's reputation and expertise. I look forward to introducing Hazel to you soon after she commences her new position with QIC on 4 January 2010.

This is the last edition of The View for 2009. Best wishes for the festive season and we look forward to keeping you informed about all the latest news and views in the New Year. As usual, if you have any feedback, questions or challenges for me or the QIC team, please send them directly to me at d.mctaggart@qic.com.



Doug McTaggart
Chief Executive

Rising inflation – Is your fund prepared?

Following the destabilisation of the financial system and the sudden collapse in economic activity in September 2008, policy-makers around the world have enacted an unprecedented level of monetary and fiscal stimulus in an attempt to 'pump-prime' their economies. In particular, the extraordinary policies implemented by the US Federal Reserve (Fed) have more than doubled the size of its balance sheet and the US monetary base. Normally, the sharp increase in the monetary base would be expected to translate into an even larger increase in the money supply. However, the increase in the money supply has been muted as banks have hoarded funds in excess reserves with the Fed, rather than making these funds available to households, businesses and investors.

As the economy recovers and risk aversion returns to more normal levels, banks will look for more profitable investment opportunities and the money supply will start to increase. Unless the Fed effectively withdraws this excess liquidity from the financial system through appropriate exit strategies, there is a risk that the money supply will grow too strongly. This could place upward pressure on asset and consumer prices and lead to higher rates of inflation.

To assess how much inflation rates could increase, we have used NiGEM, a large-scale macroeconomic model of the global economy, to simulate the Fed's varying degrees of success in draining excess reserves from the banking system.

Specifically, we have tested four scenarios ranging from a 10% increase (from base) in the US money supply to an 80% increase in the money supply. While the chance of the Fed allowing an 80% increase in the money supply to eventuate is minimal, we have included it in our range of scenarios as it indicates the likely outcome if most of the current level of excess reserves were allowed to flow through into the money supply.

The results show that an expansion in the US money supply of between 40% and 80% could lead to a period of inflation of between 8% and 14% (similar to that experienced in the inflationary period of the 1970s). At the less extreme end of the scale, an expansion of the money supply of between 10% and 20% could result in a period of inflation of between 3% and 5%. This is significantly higher than current market pricing.

While it is unlikely that the Fed will make a policy mistake large enough to induce double-digit inflation, the results show that

even a small error in policy settings could produce average annual inflation rates that are significantly higher than would be the case if the Fed is successful in draining excess reserves from the system.

Given the coordinated and global nature of the easing cycle, the need to tighten macroeconomic policy is an issue that will be faced not just by the US, but by central banks and governments around the world. Sharp and unanticipated rises in inflation have the potential to significantly erode investment returns. Therefore, now is an opportune time for investors to prepare for an environment of economic recovery and position their funds for a potentially higher inflation environment by putting appropriate inflation protection measures in place.

For more information about how you can protect your fund from the threat of rising inflation, contact your QIC Relationship Manager or download the full Red Paper from the Knowledge Centre at www.qic.com.



Matthew Peter
Chief Economist

Economic and market snapshot

The recovery in the global economy continues to unfold in line with most commentators' expectations. Ironically, it has been the East Asian region, whose economies are traditionally export-led, that has been at the forefront of the recovery. With domestic demand boosted by huge macroeconomic stimulus packages, an increase in the region's import demand has helped fuel growth in the rest of the world. Chinese import values alone have increased by 25% since the first quarter of the year.

The sharp improvement in financial market conditions, together with fiscal stimulus and the resumption of international trade, have been major factors in the global economic recovery in the second half of 2009. While they will continue to provide support to growth in coming quarters, policy must be normalised once evidence emerges that a self-sustaining recovery is taking place. For example, the US and UK general government budget deficits are currently running at around 12% of GDP over 2009, which is clearly unsustainable

and will push government debt levels in those economies above 100% of GDP by 2013. To stabilise government debt levels at around 100% in these countries, the government deficits will have to improve by around 6% of GDP. As the deficits will still be around 12% of GDP at the end of 2010, this means a very significant improvement in government finances must occur. This presents a significant headwind to growth in the medium term.

Tightening of fiscal policy is also likely to coincide with pressure to tighten monetary policy. Cash rates in the G7 economies are currently at emergency levels of close to zero. In addition, the US Federal Reserve (Fed), Bank of England and the Bank of Japan have been pursuing an alternative form of monetary policy known as quantitative easing. In the case of the US, this has led to a large build in excess reserves held by commercial banks with the Fed. It also heightens the potential of an inflationary spike in the US money supply if the Fed fails to unwind the policy in a timely manner.

The Australian economy has outperformed all other advanced economies during the global financial crisis (GFC) and the outlook continues to improve. Following a modest contraction in late 2008, real GDP growth averaged a robust annualised 2% over the first half of 2009, supported by sizeable fiscal and monetary stimulus. Growth is expected to continue to recover, and we expect a swift return to trend growth over 2010 and 2011. Further fiscal-related infrastructure investment will boost growth in the coming year, while a sharp recovery in business investment, particularly in the resources sector, will fuel growth in 2011 and potentially drive growth above trend by 2012. In response to the improved conditions, the Reserve Bank of Australia (RBA) has raised rates from the emergency level of 3% to 3.5% and is set to continue to raise rates over the coming year. However, it has been careful to temper market expectations of the pace of rate hikes and is likely to pursue a pattern of steady rather than sharp increases in the cash rate.

QIC Forecast	Australia			US			Europe		
	Current	Jun-10	Dec-10	Current	Jun-10	Dec-10	Current	Jun-10	Dec-10
Interest rates	3.50%	4.00%	4.50%	0-0.25%	0.50%	1.00%	1.00%	1.00%	1.00%
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Economic growth	2.4%	0.8%	3.2%	0.4%	-2.3%	2.9%	0.6%	-4.1%	1.0%

Financial market snapshot

Key Market Indicators (as at 31 October 2009)	FYTD	1 Year	3 Year	5 Year	10 Year
Australian Shares	19.0%	21.4%	-0.5%	8.8%	9.2%
International Shares (Unhedged)	3.3%	-11.3%	-10.9%	-1.4%	-3.1%
International Shares (Hedged)	13.1%	14.7%	-7.1%	2.9%	0.5%
Australian Bonds	1.6%	4.8%	6.3%	5.7%	6.3%
International Bonds (Unhedged)	-5.0%	-16.2%	3.0%	1.8%	2.6%
International Bonds (Hedged)	2.8%	8.6%	7.8%	7.2%	7.7%
Direct Property (Australia)	0.5%	-14.8%	2.1%	7.1%	8.5%
Listed Property (Australia)	18.7%	-7.3%	-21.1%	-6.6%	3.7%
Inflation (CPI)	-	1.3%	2.7%	3.0%	3.2%

After-tax investing: Finding the best fit for your fund

Imagine if you could increase your fund's returns by up to 1% every year without increasing your investment risk, or if your investment manager offered you a fee rebate of 1% each year.

Dreaming you say? Well, maybe not! Through after-tax investing (ATI), you can significantly increase your fund's returns through lower tax liabilities (or higher tax refunds). Your members won't mind where the benefits come from, as long as their net returns are higher and their balances grow more rapidly as a result.

QIC's experience is that ATI strategies can generate additional return streams ranging from 3 basis points (bps) per year (for fixed income) to around 100 bps or 1% per year (for Australian equities strategies). Additional benefits can also be generated by employing ATI at a multi-sector overlay level, which can result in performance pick ups of between 11 to 45 bps per year. No wonder the current Cooper Review into superannuation fund governance is questioning why so many investment managers continue to focus on pre-tax investment outcomes, and why so many investors let them.

So, with sizeable benefits like these, and with the prospect of future government intervention to make an after-tax focus mandatory for superannuation funds, why haven't we seen more investment managers evolve their practices to manage and measure after-tax outcomes? The answer is that ATI is much simpler in theory than it is in practice. While our industry has a broad appreciation of the benefits of ATI, there is an ongoing debate about how (and in what form) ATI can be delivered as a practical, meaningful, cost-effective and value-adding investment solution.

Designing an ATI solution

It is important to know that there is no 'one size fits all' ATI solution for funds. Rather, to obtain a 'best fit' solution, funds need to understand three things:

1. What kind of value does your fund expect ATI to deliver? This will determine your fund's budget for an ATI solution (to ensure the benefits outweigh the costs).
2. How would you like your investment managers to measure after-tax returns? The key to this will be agreeing on an appropriate benchmark with your managers.
3. Among the ATI options available, which is the best fit for your fund?

While it can be tempting to turn to simple ATI solutions, you should be wary of oversimplifying your fund's ATI approach. The right ATI solution doesn't necessarily have to be complex or all-encompassing, but it should be 'best fit' in the context of your fund's broad investment targets, size, operational structure, risk appetite, budget and other strategic factors to deliver better investment outcomes for your members.

There are a range of ATI approaches that can be applied both within and across asset classes, depending on your fund's specific requirements. Therefore, it is important that your fund's investment managers and advisers can help you understand the differences between emerging ATI approaches, rather than just suggesting one standard approach. An investment manager with experience in a wide range of ATI approaches is more likely to be able to help your fund find the right solution for its members.

Implementing an ATI solution

Turning your fund's theoretical commitment to ATI into a clear design, and then implementing this design, has its own challenges, particularly if your investment manager and other key service providers (e.g. your custodian) are still firmly entrenched in the pre-tax world. Therefore, it is important that you discuss with them what skills and experience they have in ATI.

It is also important that your investment manager understands the difference between minimising tax and maximising after-tax outcomes. The latter, which is QIC's focus, takes a much more holistic view. This view is more closely aligned with what fund members really want, which is not necessarily lower tax, but better overall after-tax investment outcomes.

With experience in designing and successfully implementing a full-scale ATI solution, QIC can provide practical insight into how ATI works and help you determine your fund's ATI approach. As well as a proven ability to extract ATI benefits from traditional areas such as Australian equities, QIC's ATI solutions extend into emerging areas such as currency hedging instruments and synthetic exposures.

For more information about ATI, please contact your QIC Relationship Manager or download the full Red Paper from the Knowledge Centre at www.qic.com.



Raewyn Williams
Head of After-Tax Investing



Recycled paper used



An environmentally responsible product

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