

# The View

A quarterly publication from QIC - July 2010

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## Message from Doug



Some of you may recall that last year I predicted a 'third wave' of the financial crisis. The first wave was caused by initial liquidity concerns, with the second occurring as illiquidity morphed into insolvency. I predicted

that we would experience a third wave, because those institutions that survived the first two waves with government assistance would not be in a position to weather the increase in bad loans normally associated with the onset of a recession. The fear of these institutions failing would in turn cause major disruptions to inter-bank lending, cash and credit markets.

While this particular situation has not yet occurred, many are wondering if we are in fact experiencing the beginnings of another global financial crisis, this time driven by fears regarding the European sovereign debt crisis. Global equity markets fell sharply in May following the downgrade of debt in several European countries. While intervention from the European Central Bank (ECB) and bailout packages from The European Union and International Monetary Fund (IMF) have helped to alleviate fears regarding the liquidity of these countries, questions regarding their ability to repay their debts remain, and there are also fears regarding the contagion effects for other economies.

In the last edition of The View, I said the problems with the 'PIIGS' economies (Portugal, Ireland, Italy, Greece and Spain) would be confined to the euro-area because of the political imperative to hold the euro currency together. After spending some time in London recently, I am still of this view. There is an almost universal belief that Greece, and possibly one or two other PIIGS economies, will default (via a

restructuring of its current debt obligations), but this will not, by itself, undermine the euro. Sovereign defaults are much more common than most people realise, and, interestingly, we are currently at a low point in the default cycle (i.e. lower than average defaults are occurring). Going forward, we can expect the number of sovereign defaults to rise, but these will mostly be in inconsequential economies.

The political imperative to hold the euro-zone and the euro together remains, especially in Germany. Even more interestingly, as global concern surrounding the euro grows, it continues to depreciate against almost all other currencies, and German exports become more competitive. That's markets for you!

### Industry changes

In the same issue that I predicted a 'third wave' of the financial crisis, I also predicted that the global economy post-GFC would have a much smaller financial sector, fewer structured products, a greater appreciation for risk management and more regulation. In fact, this is exactly how the Australian superannuation industry is emerging. Industry consolidation is occurring and will continue to occur, particularly as funds seek to improve their cost structures and operational efficiency in the wake of the Ripoll and Cooper reviews. Regulators are demanding much more rigour from super funds around their investment governance processes, and funds are under increasing pressure to move to more simple and easy-to-understand investment products following the downfall of highly leveraged and complex investment products during the GFC. At the same time, funds are also grappling with issues such as longevity, adequacy, sustainability and member education, just to name a few; issues that have all been magnified by the GFC.

So, in times of such industry change, what can you expect to see from QIC? Our focus has always been on working with our clients to help them achieve their investment goals through all market conditions. This requires a very clear understanding of our clients' objectives, while also keeping abreast of all the latest industry and market developments to ensure that our investment solutions continue to perform over time.

As part of this, we are also focused on helping our clients take advantage of opportunities so they can provide even better products, service and performance to their members/investors. A key recommendation of the Cooper Review is that all super funds provide a simple, low-cost default fund that provides better after-fee outcomes for members, particularly for the large proportion of non-engaged members. QIC believes lifecycle funds are well placed to assist trustees in this regard, and our new Lifecycle Strategies team is currently working with clients and key stakeholders to develop solutions that will enable funds to deliver a base level of customised investment advice to all members in a cost-efficient manner to improve their retirement outcomes. You can find out more about the team and some of the outcomes of its work so far on page 2.

I hope you enjoy this latest edition of The View. As usual, if you have any feedback, questions or challenges for me or the QIC team, please send them to me directly at [d.mctaggart@qic.com](mailto:d.mctaggart@qic.com).

**Doug McTaggart**  
Chief Executive

## Introducing the QIC Lifecycle Strategies team

Earlier this year, QIC announced an initiative to develop a new generation of lifecycle investment solutions. This initiative is now well underway, and our Lifecycle Strategies team has just released its first Red Paper, *Dynamic Lifecycle Strategies*. You can find out more about the team below.

### What is the Lifecycle Strategies team's focus?

QIC Lifecycle Strategies was formed earlier this year and is focused on designing and constructing dynamic lifecycle investment strategies, using the most advanced techniques, to improve the retirement incomes of super fund members.

Lifecycle strategies aim to adjust the risk faced by a member as he or she approaches retirement. Such strategies are not typically offered by superannuation funds in Australia, and this is an exciting opportunity for QIC to develop an innovative solution for superannuation funds.

You can find out more about the benefits of lifecycle funds and some early outcomes of the team's work in the article *Dynamic Lifecycle Strategies* on page 3.

### Who's who in the team?



in 2010, Michael was a member of the QSuper Investment Committee and

**Michael E. Drew** is Managing Director of QIC Lifecycle Strategies and Professor of Finance at the Griffith Business School, Griffith University.

Prior to joining QIC

previously held the position of General Manager, Investment Services, QSuper.

Michael's research has studied and developed new approaches to the design of the default option in superannuation funds, as well as devising winning strategies for lifecycle and target date funds. He has published more than 50 articles in academic journals, including the *Journal of Portfolio Management*.

In June 2009, Michael was invited to appear before a joint hearing of the US Department of Labor and the Securities Exchange Commission in Washington, DC, where he presented testimony on target date funds.

Michael received a PhD from the University of Queensland in 2000, and is Senior Fellow of the Financial Services Association of Australasia (Finsia).



**Evan Reedman** is Director of QIC Lifecycle Strategies. He is responsible for the day-to-day management of the team, the implementation and operation of lifecycle

portfolios and client relationships. Evan has over twenty years' professional experience in finance, most recently as Head of Portfolio Construction at JANA Investment Advisers.

**Adam Walk** is Head of Lifecycle Research. He is responsible for the team's research, design and investment risk management activities. Adam has over ten years' professional experience in finance and

risk management, most recently in QIC Strategy as an investment researcher, concurrent with doctoral research.

### What services will the team offer?

Ultimately, the team is working towards offering a range of lifecycle products and services that meet the different needs of super funds and their members. Such services could include:

#### *Lifecycle advisory service*

- An 'open architecture' solution that provides customised arrangements for the provision of ongoing advice regarding the client's default option (i.e. tailored glidepath design for various member groups).
- In addition, the potential to include a range of QIC's existing capabilities (e.g. downside risk management, efficient portfolio rebalancing, dynamic asset allocation).

#### *Lifecycle portfolio management*

- An 'implemented' solution that will include a range of lifecycle strategies provided as a customised QIC offering, which utilise the QIC Boutiques to help deliver required outcomes for members.

We are very pleased to have the Lifecycle Strategies team on board, and we will continue to keep you up to date with the team's progress over the coming months.

## Financial market snapshot

Key Market Indicators (as at 30 June 2010)	FYTD	1 Year	3 Year	5 Year	10 Year
Australian Shares	13.1%	13.1%	-7.9%	4.5%	7.0%
International Shares (Unhedged)	6.8%	6.8%	-11.0%	-1.9%	-4.4%
International Shares (Hedged)	15.1%	15.1%	-10.5%	0.8%	-0.4%
Australian Bonds	7.9%	7.9%	7.7%	6.1%	6.4%
International Bonds (Unhedged)	-1.0%	-1.0%	7.4%	2.8%	2.4%
International Bonds (Hedged)	9.3%	9.3%	9.5%	7.0%	7.9%
Direct Property (Australia)	5.6%	5.6%	-0.7%	6.3%	8.3%
Listed Property (Australia)	20.4%	20.4%	-23.8%	-8.0%	2.9%
Inflation (CPI)	-	2.9%	3.2%	3.0%	3.2%

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## Dynamic lifecycle strategies

Since 2007, investors and super fund members alike have experienced some of the most turbulent economic conditions in recent history. This, together with issues such as changing social dynamics, longevity risk and adequacy, has led to an industry-wide reassessment of the superannuation system in Australia.

In particular, the global financial crisis has highlighted the shortcomings of traditional default option design, which provides a 'one size fits all' solution for members regardless of their individual circumstances.

Recently, lifecycle funds have been touted as a possible solution to address this issue. While Australia has had little experience with lifecycle strategies to date, we believe that when carefully implemented by funds, these strategies have the potential to provide better retirement outcomes for the average super fund member.

### Lessons from the GFC

With most super fund members in defined contribution plans, the recent effects of the global financial crisis (GFC) have illustrated the dangers of taking a static approach to asset allocation.

In particular, the GFC has reinforced that diversification doesn't necessarily protect members in poor market conditions, and its ability to shield investors from financial turbulence varies over time.

But perhaps the biggest single lesson for investors is that while stocks might be the best investment in the long term, there are investors who have short-term investment horizons (e.g. those nearing retirement). This has highlighted the need for long-overdue consideration (in Australia at least) of the

entire investment lifecycle, both in the lead-up to and post retirement (i.e. both the accumulation and decumulation phases).

### A new approach to lifecycle investing

The prevailing approach to lifecycle investing sees the long-term asset allocation or 'glide path' of the investment fund change from high equity weights in the early years of the investor's working life to lower equity weights as the retirement or target date approaches.

While this simple 'set and forget' approach sounds attractive in theory, in practice the GFC was not at all kind to lifecycle investors in the US, the most developed market when it comes to this form of investing. But this is not a valid reason to reject or ignore the concept of lifecycle investing, particularly as the GFC tested all forms of investing. Rather, the lessons from the GFC provide the rationale for improving lifecycle investment approaches which, to date, have been relatively simplistic.

In recently published research<sup>1</sup>, retirement income experts Anup Basu and Michael Drew (2009), the latter of whom has recently joined QIC as Managing Director, Lifecycle Strategies, questioned the simplistic 'set and forget' approach to lifecycle investing. They contend that it is the account balance upon which the risk is taken that is the important factor (i.e. the 'fund size effect'), not just the age at which the risk is taken. Research<sup>2</sup> by the same authors, in conjunction with British expert Alastair Byrne, has also shown that *dynamic* lifecycle strategies that incorporate both account balance and age exhibit superior performance to current investment practices.

While our research is at a relatively early stage, we believe that a successful approach that overcomes some of the problems associated with existing lifecycle strategies will involve the following principles:

- A concentration on the real objectives of the ultimate investor
- An asset allocation focus
- Dynamic strategies
- A long-term, whole-of-life approach
- Optionality (i.e. changing the distribution of returns with the intelligent use of derivatives to mitigate the myriad of shocks members face over their lifetime).

### Improving retirement outcomes for super fund members

A premise of the Cooper Review is that a large percentage of super fund members are either disengaged from or poorly placed to manage their retirement savings and that default arrangements should be designed with this in mind.

Lifecycle strategies, as we conceive them, are well placed to assist trustees in this regard by providing a low-cost, conceptually simple and diversified superannuation product for the bulk of members they represent.

While these strategies will not remove the option for members to manage their own retirement savings if they wish, they will provide the vast majority of members that don't with a better investment vehicle for both the accumulation and decumulation stages of their retirement savings.

For more information about QIC's research on dynamic lifecycle strategies, download the full Red Paper from the Knowledge Centre at [www.qic.com](http://www.qic.com) or contact the QIC Lifecycle Strategies team.

<sup>1</sup> Basu, A. and Drew, M.E. (2009) Portfolio Size Effect in Retirement Accounts: What Does It Imply for Lifecycle Asset Allocation Funds, *Journal of Portfolio Management*, 35:3, 61-72.

<sup>2</sup> Basu, A.K., Byrne, A. and Drew, M.E. (2011) Dynamic Lifecycle Strategies for Target Date Retirement Funds, *Journal of Portfolio Management*, forthcoming.

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## QIC Global Real Estate receives highest accolade at the SCN Marketing Awards

In May, QIC Global Real Estate (QIC GRE) collected two major awards at the Shopping Centre News Marketing Awards, including the coveted 'Overall Winner' award for Robina Town Centre.

Shopping Centre News is an industry-specific publication that hosts the annual awards ceremony, which this year attracted more than 140 entries. In addition to the prestigious 'Overall Winner' award, QIC GRE also took first place in the Big Guns,

Development/Redevelopment category for its 'Get into it Robina Town Centre' campaign.

Robina Town Centre, a super regional shopping centre located in the heart of the Gold Coast, was acquired by QIC GRE in 1999. In 2009, QIC GRE successfully completed a major stage of its redevelopment of the Centre, which is now widely acknowledged as one of Australia's best shopping centres.

The next phase of the expansion program is currently underway and will deliver a new two-level Myer department store, additional speciality retail stores and increased parking. When this development is completed later this year, it will further position Robina Town Centre as the most progressive and dominant super regional retail centre on the Gold Coast.

## Economic and market snapshot

Recent movements in global financial markets have been dominated by renewed concerns about sovereign default risk among peripheral European governments. In response, European Union (EU) members and the International Monetary Fund (IMF) were forced to arrange a €750 billion loan package to support fiscal consolidation of member nations in an attempt to restore financial market confidence in the region. Events in Europe have led many commentators to draw parallels between the current sovereign debt crisis and the global financial crisis (GFC) of 2008-09, and speculate whether a second GFC has arisen.

Our view is that the current sovereign debt crisis will not spark GFC Mark II. Although the formulation of policy in the EU is cumbersome, the eventual policy responses are of sufficient size that the peripheral European governments will not have to access debt markets for sovereign financing for around two years. Consequently, the immediate threat to liquidity, which would have been the catalyst for contagion to the European banking system, appears to have been dealt with.

However, recourse to bail-out packages cannot persist indefinitely, and beyond 2011 the peripheral European economies will again be exposed to market forces. Greece is clearly the country at most risk and, in response to the crisis, Greek authorities have announced a substantial

fiscal austerity plan. While the fiscal program is essential to stabilise Greek public finances and restore investor confidence in Greek sovereign debt, it will sharply curtail Greek economic activity. We expect real gross domestic product (GDP) in Greece to fall 3.7 per cent in 2010, 2.5 per cent in 2011 and 0.9 per cent in 2012, and for the unemployment rate to rise from around 10 per cent currently to about 15 per cent in 2011 and 2012. Sustained rates of unemployment at such high levels, combined with ongoing fiscal austerity, will severely test the tolerance of Greek households and the political will of Greek governments. Consequently, the risk of a restructure of Greek sovereign debt is high.

On its own, debt restructuring of small economies such as Greece should not bring down the EU. For example, the entire government debt of Greece is only around 3 per cent of euro-area GDP. A more critical risk to the ongoing stability of the EU is the lack of a cohesive approach to fiscal policy within the region. Clearly defined procedures with appropriate incentives and penalties need to be implemented by the EU to reduce uncertainty associated with breaches of fiscal discipline.

In Australia, policy-makers have been taking centre stage. The Reserve Bank of Australia (RBA) raised the cash rate by 25 basis points at both its April and May meetings

to 4.5 per cent, citing recent increases in coal and iron ore prices as the catalyst behind the move. Further rate hikes are expected, although with mortgage rates now at the RBA's declared average level, future hikes are expected to be gradual.

In addition, the Federal government released the Henry Tax Review and its response to the Review's recommendations. The key government policy initiatives include the introduction of a tax on the abnormal profits of mining companies (Resource Super Profits Tax or RSPT), a reduction in the corporate tax rate from 30 per cent to 28 per cent, and an increase in the compulsory employer superannuation contribution from 9 per cent to 12 per cent. Markets reacted negatively to the RSPT, with the share prices of Australia's two largest miners, BHP Billiton and Rio Tinto, falling 8 and 9 per cent respectively after the announcement.

While the RSPT is clearly a negative for valuations of profitable mining companies, the near-term impact of the tax on the economy is unclear and depends on the final structure of the package negotiated between the government and mining companies. However, in the long run, the RSPT is a theoretically superior tax to the existing regime of state-based royalties because it does not distort investment decisions of mining companies.

QIC Forecast	Australia			US			Europe		
	Current	Sep-10	Mar-11	Current	Sep-10	Mar-11	Current	Sep-10	Mar-11
Interest rates	4.50%	4.75%	5.00%	0-0.25%	0-0.25%	1.00%	1.00%	1.00%	1.00%
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Economic growth	1.3%	3.3%	3.8%	-2.4%	3.1%	2.6%	-4.0%	1.0%	1.8%



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