

A quarterly publication from QIC - August 2008

## In this edition

Gaining investment benefits from rising global food prices

## GFI Alpha Fund

A strong performance in a tough year

## Economic and market snapshot

A quarterly overview

## Message from Brad

In Doug's absence, I'll be introducing this issue of The View.

The turmoil in financial markets over the last year has brought a healthy dose of reality for many.

- Financial and other lending institutions are rapidly reassessing their risk and lending criteria to stem the flow of losses and build a profitable future business.
- Central banks and financial regulators are working out what went wrong, structuring rescue packages and developing strategies for 'next time'.
- After many years of fast growing economies, higher tax revenues and wealthier voters, governments face a new set of challenges including the return of the inflation curse.
- As individuals, double-digit investment returns have been replaced with near double-digit mortgage and lending rates, food and energy prices are hitting our hip pocket harder and asset values (property and shares) are weaker.

All this paints a pretty dismal picture. So where are we going from here?

A swift economic turnaround seems highly unlikely. The fall-out from the credit crisis is set to continue, and this, combined with growing global

inflationary pressure, is likely to put the lid on any fast economic turnaround. Locally it seems unlikely we will see any significant relief from interest rates until next year and asset values will continue to come under pressure.

At QIC, the turmoil in markets has re-affirmed our commitment to the continual innovation of our investment strategies and processes. Our ability to deliver on client performance objectives in a range of economic and market conditions has improved as a result of initiatives including:

- The development of a range of absolute return strategies including the GFI Alpha Fund and Active Currency Trust (both posting strong positive returns during the recent equity market downturn).
- Further diversification into unlisted alternative assets.
- Various cost saving and capital efficiency innovations by our Capital Markets (Omega) team.
- Implementing dynamic asset allocation into multi-sector funds.

In this issue look out for articles on rising food and energy prices and how the GFI Alpha Fund performed in a tough year for fixed interest managers.

Our strong culture of challenging the status quo and finding better ways to exceed your investment objectives through investment innovation continues to gain momentum. We are looking to bring our work on environmental, social and governance (ESG) to you in the near future.

Finally, I would like to welcome Matthew Peter as QIC's Chief Economist. Matthew brings a particular expertise in understanding the economic impacts of contemporary global events and we look forward to working with him to identify emerging themes and opportunities in the global investment industry.

As you can imagine Doug doesn't make life easy for our Chief Economist and we wish Matthew all the best in his inevitable jousts with Doug.

Thank you for the feedback you gave Doug on the last issue of 'The View' and please send any feedback on this issue to me at [b.holzberger@qic.com](mailto:b.holzberger@qic.com).



*Brad*

**Brad Holzberger**  
Chief Executive  
Asset Management

## Gaining investment benefits from rising global food prices

It has been well documented that we are paying more and more for our food items at the checkout. The rise in food prices is a global economic issue – boosted by global inflation and continued strong demand for commodities.

While this recent surge in food prices is hurting us in the hip pocket, it also presents investment opportunities that QIC is capitalising on.

Commodity prices continue to boom, despite the recent financial market turmoil and slowdown in advanced economies.

While much attention has focussed on energy, metal and bulk resource prices, other commodities have hit record highs in recent months. Food prices have risen more than 80% since 2005, led by a 130% rise in wheat prices and a 190% increase in corn and rice prices.

Managing Director, Strategy, Adriaan Ryder explains there are a number of factors driving food price increases.

“There is continued strong global demand for commodity staples including wheat, corn and rice, particularly in developing countries.

“Surging oil prices have seen an increase in demand for biofuel production, leading to higher prices for crops such as corn.

“When you combine these factors with drought-impacted harvests and rising inflation it explains the sharp increases in food prices,” he said.

The greatest impact of higher food prices has been felt by low-income, food-deficit countries with the World Bank estimating that 100 million people will be forced into absolute poverty – or surviving on under \$1 a day.

Adriaan commented that the outlook for food prices over the medium-term is for prices to remain above their longer-term average.

“Demand is expected to remain high with continued government support of biofuel production,” he said.

“Prices for wheat, corn and rice are expected to remain high relative to their historic average over the next decade, albeit somewhat below the recent peak.”

So how do rising global food prices create investment opportunities? Adriaan Ryder explains.

“There is a growing interest in commodities as a separate asset class and the benefits that exposure to commodities creates in an investment portfolio.

“Commodities provide diversification benefits as historically they have a low correlation to other asset classes and a high correlation to inflation.

“Historically at the early stages of a recession or economic downturn when both shares and bonds have been negative, returns on commodities have been positive,” he said.

Using an innovative approach, QIC gains exposures to commodities through commodity futures.

“Research has shown that a long-term risk premium can be accessed in commodities via the futures market,” Adriaan said.

“Commodity futures allow producers of commodities to obtain a known future price for the value of their outputs.

“This futures price is usually below the expected market price at harvest time due to the risk being taken on by the owner of the commodity future.

“This creates the opportunity for a profit to be made by selling the commodity at a market value which is higher than the futures price.

“The current strong food prices increase the chance of generating investment returns through commodity futures,” he said.

For further information on this initiative please contact your QIC Relationship Manager or download the full Red Paper from the Knowledge Centre at [www.qic.com](http://www.qic.com).



**Adriaan Ryder**  
Managing Director  
Strategy

## Financial Market Snapshot

Key Market Indicators (as at 30 June 08)	1 Year	3 Year	5 Year	10 Year
Australian Shares	-13.4%	11.4%	16.2%	11.2%
International Shares (Unhedged)	-21.5%	0.5%	3.9%	-0.7%
International Shares (Hedged)	-13.8%	7.8%	12.0%	4.1%
Australian Bonds	4.4%	3.9%	4.4%	5.5%
International Bonds (Unhedged)	2.7%	-1.7%	-1.0%	1.8%
International Bonds (Hedged)	8.6%	5.0%	6.1%	6.9%
Direct Property (Australia)	10.0%	15.1%	13.8%	11.4%
Listed Property (Australia)	-36.3%	-1.8%	5.5%	8.4%
Inflation (CPI)	4.5%	3.5%	3.1%	3.1%

## Economic and market snapshot

A year after the US sub-prime crisis erupted last August, significant uncertainty remains about the extent of the fall-out on the global economy.

Financial markets remain fragile, with writedowns from global banks approaching \$500 billion, around half the International Monetary Fund estimate of potential aggregate losses. At the same time, rising food and energy prices have lifted global inflation, complicating the policy trade-off between growth and price stability facing central banks. Against this backdrop, major global equity markets have tumbled with the MSCI World Index falling approximately 13% since late May and around 20% since its peak in October 2007. Financial market conditions are likely to remain

difficult until the extent and distribution of mortgage-related losses become clear, systemically important financial institutions strengthen their balance sheets and the risk of a more severe deleveraging process dissipates. All these conditions require a stabilisation in the US housing market, which is not expected until the oversupply is eliminated in 2009.

Global economic activity is expected to slow further, from around 5% in 2007 to about 4% in 2008. Growth is expected to be particularly weak in the advanced economies as downturns in the housing market dampen consumer spending in the US and UK. Activity in the Euro area and Japan is expected to slow significantly from the firm pace experienced in early 2008. Growth in emerging markets is expected to slow,

but remain solid, with China slowing from almost 12% in 2007 to around 10% in 2008.

The Australian economy continues to be buffeted by opposing forces. Tighter financial conditions and higher petrol prices are working to restrain household demand, while further gains in the terms of trade are supporting national income. On balance, activity is expected to moderate to a below-trend pace in 2008 and 2009, while inflation should ease in 2009 after remaining elevated in the near-term. This should allow the Reserve Bank of Australia to begin gradually easing rates in the next few months, with three cuts expected by mid 2009.

QIC Forecast	Australia			US			Europe		
	Current	Dec-08	Jun-09	Current	Dec-08	Jun-09	Current	Dec-08	Jun-09
Interest rates	7.25%	7.00%	6.50%	2.00%	2.00%	2.50%	4.25%	4.25%	4.00%
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Economic growth	4.3%	2.6%	2.8%	2.0%	1.5%	1.5%	2.7%	1.6%	1.4%

## GFI Alpha Fund Shines in a Tough Year for Fixed Income Managers

*Susan Buckley, Managing Director, Active Management explains why.*

The credit crisis and the subsequent volatility in global credit markets has seen fixed interest managers having to negotiate a difficult market environment. As we are seeing in the media, managers that fail to appreciate the risks within their portfolio along with the benefits of diversification have struggled.

The Global Fixed Interest (GFI) team has a long track record of adding significant value for clients. However, the volatile year has highlighted some of the differences between traditional physical-based fixed interest portfolios and more innovative approaches.

The GFI Alpha Fund delivered a total return of 11.5% in 2007-2008 and has averaged 12.7%pa over the last three years. The key to this strong performance is that GFI can apply its research and scorecard process across global markets with fewer investment restrictions that can limit portfolio flexibility. The structure of the fund means we can be more nimble, which is particularly valuable in volatile market conditions.

While traditional funds rely on their ability to manage physical securities, the GFI Alpha Fund utilises the latest available instruments and innovative processes in actively managing global interest rate and credit derivative strategies. Underlying these active strategies are the physical investments that are placed in cash, providing a significant return buffer in the current environment.

For clients that wish to maintain fixed interest market exposure (other than a cash plus approach) we can combine the GFI Alpha Fund with a synthetically created fixed interest exposure that will resemble a traditional benchmark structure.

This approach highlights one of the many benefits of separating alpha and beta, and is a strategy that can be utilised by most funds regardless of size or structure.



**Susan Buckley**  
Managing Director  
Active Management

## In Brief....

### **New economist to drive innovation**

QIC has appointed Matthew Peter as Chief Economist to oversee strategic investment research and macro-economic analysis. Matthew joined QIC in July this year from Tactical Global Management (TGM) – a specialist global tactical asset allocation and global-macro manager.

As Chief Economist, Matthew has a central role in continuing to promote innovation in QIC's investment strategy and processes. He has extensive experience in identifying long-term themes in global markets and investigating the impacts of global events (such as global debt imbalances, war and terrorism) on investments and macro-economics.

### **Implemented Aussie Share Fund hits number one**

The QIC Implemented Australian Equities Fund has rated number one across all periods in the Chant West Survey released for the end of May 2008. The multi-manager fund outperformed its 17 major competitors including Russells, MLC, Mercer, AMP and Jana in what's been a challenging period for equity markets.

Greg Liddell, Director Implemented Equities credits the strong performance to:

- A major manager review and re-structure conducted in June 2006 by portfolio manager Stuart Birkett and the team.
- The use of swaps to take advantage of extreme sector valuations and to mitigate particular sector risks – an innovative and successful strategy that is unique to QIC's Implemented Equities team.

### **Growth Fund gets latest 'bells and whistles'**

The QIC Growth Fund, which is a pooled investment trust providing investors with an exposure to a diversified range of asset classes, has undergone some improvements. With the aim of reducing the portfolio's risk while maintaining long-term expected returns the changes made include:

- The Fund becoming more diversified through the introduction of new asset classes and investment strategies including private equity, infrastructure, commodities, managed funds and absolute return strategies.
- The asset allocation of the Fund will now be managed dynamically within new ranges. This will reduce the risk of poor returns from asset classes at extreme valuation levels and provide a more stable return stream to investors.

### **What goes up when equities go down?**

In addition to the GFI Alpha Fund (see fixed interest article on page 3), the QIC Active Currency Trust has also delivered strong positive absolute returns during the recent equity market downturn. Returns from active currency managers, although volatile, have the advantage of not being correlated to equity market returns, making them a good diversifier for funds. In the last financial year the QIC Active Currency Trust returned 12.8% and over the past three years has averaged 8.7%pa.

### **Risk controlled emerging markets solution**

While investing in emerging markets equities can provide exposure to some of the strongest growth sectors in

the world, superannuation funds have traditionally faced governance, risk and cost issues in this area. In response to these concerns the QIC Implemented Equities team has developed an investment solution (QIC Emerging Markets Equity Fund) that reduces the governance concerns of investing in emerging markets, whilst utilising QIC's scale to access these markets in a cost-efficient manner.

### **ESG Update**

QIC became a UNPRI signatory in January, 2008. A major project is underway to determine how QIC will move towards integrating ESG into both its corporate operations and investment decision-making across asset classes. According to Kate Grant, QIC's Corporate ESG Manager, QIC's approach to ESG integration is a pragmatic one. "We are moving with purpose to integrate ESG into our operations with our focus firmly on the benefit of delivering higher, long-term value to our clients." The implementation program will begin over the next few months.



Recycled paper used



An environmentally responsible product

#### **Important information**

QIC ABN 95 942 373 762 is a statutory government owned corporation regulated by State Government legislation pertaining to government owned corporations. The Corporations Act 2001 does not apply to QIC and, therefore, QIC does not hold an Australian financial services licence and the financial product disclosure provisions in the Corporations Act 2001 do not apply to QIC. However, the Corporations Act 2001 does apply to QIC's wholly-owned subsidiaries. Where required, QIC's subsidiaries have obtained an Australian financial services licence. QIC and its subsidiaries and associated entities, and their directors, employees and representatives ("the QIC Parties") do not warrant the accuracy or completeness of the information contained in this document ("the Information"). To the extent permitted by law, the QIC Parties disclaim all responsibility and liability for any loss or damage of any nature whatsoever which may be suffered by any person directly or indirectly through relying on the Information, whether that loss or damage is caused by any fault or negligence of the QIC Parties or otherwise. The Information is not intended to constitute advice and persons should seek professional advice before relying on the Information.