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The View

QIC

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Message from Doug

In my first message for 2009 I would have liked to convey more optimism, however, to do so would mean I was being less than frank with my views and analysis of the current situation.

While it is generally accepted that the global economy will get worse before it gets better, I fear that we are also likely to experience another shock to the financial system, or what I am calling the 'third wave' of the financial crisis (the first wave was caused by initial liquidity concerns and the second occurred as illiquidity morphed into insolvency). We will experience a third wave because those institutions that have survived to date, with the assistance of generous global taxpayers, are not in a condition to weather the increase in bad loans normally associated with the onset of a recession.

The willingness of governments, read taxpayers, to bail out these institutions will be tested, and even if rescue packages are forthcoming, confidence in various markets will again be severely tested. In particular, the subsequent heightened risk that a large financial institution (and a major counterparty to many) may fail will cause major disruptions to inter-bank lending, cash and credit markets.

These markets are far from liquid at present and are a significant restraint to economic activity. An additional shock will further delay the ability of the global economy to begin the process of recovery.

While these conditions will put further pressure on equity markets and result in the continuation of poor short-term investment returns, the key risk that needs to be managed is counterparty risk. On that front I remain confident that Troy Rieck and our Capital Markets team have implemented all possible safeguards. The team is a recognised leader in liquidity and counterparty risk management, including the effective use of Credit Support Annexures (CSAs). You can read more about liquidity management in the article 'Liquidity challenges for superannuation funds' on page 3.

Post crisis – what will we be left with?
In such dire and extreme conditions it is easy to lose sight of the end game. In an uncertain environment characterised by significant reductions in individual wealth, low job security and rising bankruptcies, it is not surprising that all of our thoughts are on the here and now. However, in order to emerge from the current crisis as quickly as possible and to make the best of opportunities as they arise, it is important that we keep an eye on the likely longer-term scenarios and outcomes.

For me, the most likely scenario is that during the first two quarters of this year will see a continuing spiral into global recession. The primary cause, over and above the issues associated with the credit squeeze, is the fact that globally, consumers stopped spending in the second half of last year. I believe this decision was, individually, largely voluntary and a precaution against the bad news emanating from financial markets.

However, when all consumers stop spending we have what Keynes called the "paradox of thrift". As spending declines, sales fall, corporate profits dry up, business confidence falls and business investment and industrial production contracts. Employment is highly correlated with industrial production, and therefore employment also contracts. Consumers who were cautious are unhappy that they are in the midst of a recession, but are pleased they have been prudent – collectively their expectations have been self-fulfilling.

The cycle is reversed when the flow of bad news lessens and consumers cautiously re-emerge. I expect and hope that this will occur in the second half of 2009 and, if it does, recovery should be relatively swift. However, many pundits are much more pessimistic and expect a longer and weaker recovery.

The global economy that will eventually emerge will have a much smaller financial sector, fewer structured products and a greater appreciation for risk management. Inevitably we will have more regulation – both good and bad.

As for investment returns, the question that remains is just how much bad news is currently priced in? If we use the US stock market as an example, the S&P500 to date has experienced less than 4% compound annual growth since 1995. With inflation growing at 2.5% per year, equity prices, adjusted for inflation, grew more slowly than real output over the 13 year period. This suggests to me that a lot of bad news is currently priced in.

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With this in mind, it is much easier to consider attractive investment opportunities in the current climate. However, while most asset prices are depressed at the moment, it is important to be prudent, selective and disciplined to ensure the asset can negotiate the current crisis and deliver strong long-term returns.

I hope you enjoy this latest issue of 'The View'. Though not a very cheerful one, our aim is to keep you well informed about conditions and developments in investment markets. Ongoing and open dialogue is even more important during these difficult times. Where we can, we are always willing to help you overcome any challenges that you are facing. As usual, I would appreciate any feedback, questions and challenges you have for me and the QIC team. Please send them directly to me at d.mctaggart@qic.com.

Doug

Doug McTaggart
Chief Executive

Economic and market snapshot

The global economy has deteriorated sharply over recent months and it is likely that during 2009 it will record its weakest outcome since WWII. In response, policy makers have stepped up their efforts to arrest the slide in economic activity. The US and Japanese central banks have already taken their effective cash rates to zero, and although the central banks of Europe and the UK appear more reluctant, we expect that they too will be forced to lower their cash rates to zero by the second half of the year.

With the scope for further support from monetary policy fading, governments around the world have been formulating fiscal stimulus packages to boost economic growth. In the US, it looks likely that President Obama will implement a package of around $US825bn (5.8% of GDP) over the coming two years. A number of other major advanced economies have also announced fiscal packages generally around 1 to 2% of GDP. While these packages will be a positive development for the global economy, our research indicates that they will not prevent a severe global recession. We expect the global economy will grow at around 0.9% in 2009, led by a sharp contraction in the advanced economies. The advanced economies will, on average, contract by around 1.2% in 2009, the first year the advanced economies will have collectively recorded negative growth in the post-war period.

The outlook for Australia has also deteriorated markedly following a sharp slowdown in growth in China and the rest of the Asia region. The collapse in commodity prices and the terms of trade are undermining the outlook for investment and exports, particularly in the mining sector. However, significant monetary and fiscal stimulus is in the pipeline, with the government announcing a $A42bn fiscal package worth around 3.8% of GDP to be spent over the next four years and the Reserve Bank lowering cash rates to 3.25%. Our preliminary analysis indicates that the fiscal package will boost growth by around 1% in 2009 and 0.5% in 2010. Nonetheless, given the current weakness in the global economy, the fiscal stimulus is unlikely to prevent the Australian unemployment rate from rising to around 7% by the end of 2010.

QIC Forecast	Australia			US			Europe		
	Current	*Jun-09*	*Dec-09*	*Current*	*Jun-09*	*Dec-09*	*Current*	*Jun-09*	*Dec-09*
Interest rates	3.25%	2.50%	2.50%	0.00%	0.00%	0.00%	2.00%	0.00%	0.00%
	2008	*2009*	*2010*	*2008*	*2009*	*2010*	*2008*	*2009*	*2010*
Economic growth	2.4%	0.8%	2.0%	1.1%	-1.2%	2.3%	0.9%	-1.8%	1.0%

QIC Real Estate – Toowoomba Shopping Centre purchase

QIC has expanded its property portfolio in south-east Queensland with the strategic acquisition of Gardentown Shopping Centre, its second shopping centre in the Toowoomba region.

The 16,098 square metre retail precinct was purchased from the Aspen Group for a contract price of $30 million, which represents a market yield of 8.8%. Settlement occurred on 19 January 2009.

The acquisition reflected QIC Real Estate's focus on identifying strategic long-term investment opportunities.

The property complements our existing asset in the Toowoomba retail market, Grand Central Shopping Centre, and presents an excellent opportunity to introduce new retailers to the region.

Liquidity challenges for superannuation funds

Troy Rieck, Managing Director, Capital Markets, explores this increasingly important issue of liquidity management.

For many years superannuation funds have benefited from a continuous stream of inflows as a result of Superannuation Guarantee (SG) contributions, and this ready supply of cash has meant that many funds may not have fully considered the risks associated with illiquidity.

Recent market events however have clearly illustrated the effects of paying too little attention to liquidity and risk management. Equity markets have crashed, the Australian dollar has depreciated significantly, credit markets have imploded and hedge funds and commodities haven't provided the promised diversification of risk that funds badly need. These conditions, together with increased member movement and greater allocations to unlisted assets, have meant that some funds are now facing serious liquidity issues.

The liquidity of an asset relates to how quickly and efficiently it can be converted to cash. Liquidity is critical for funds to pay member benefits, fund future commitments and maintain their derivative overlay programs. If a fund does not have enough available cash, it may be forced to sell assets at significantly deflated prices, further eroding performance. The unacceptable alternative would be to unwind the asset allocation of the fund, leaving it exposed to a significantly higher risk of being unable to meet its long-term objectives.

To avoid these scenarios, funds need to understand the potential liquidity needs of their fund and their exposure to a range of risks that may impact on liquidity. In addition, they need to consider how liquid the various assets and strategies are that they invest in. Once this information is known, appropriate strategies can be implemented to manage those risks.

QIC believes that liquidity should be a key consideration in all investment decisions. Further, funds should employ a range of strategies to monitor and mitigate liquidity risk, including detailed contingency and scenario planning, frequent rebalancing strategies and maintaining a suitably large pool of cash assets to meet the fund's short-term liquidity needs.

An efficient way to handle this challenge is to embrace the ability to separately manage the capital allocations and asset class exposures of the fund. In this way, funds can achieve their desired asset allocations while proactively managing their liquidity needs.

It is possible to have your liquidity cake and to eat market performance too.

For more information about how you can protect your fund from the significant risks associated with insufficient liquidity, while also managing your market exposures, contact your QIC Relationship Manager or download the full Red Paper from the Knowledge Centre at www.qic.com. Also have a look at the article on portfolio rebalancing on page 4, which further explores how funds can reduce risk in volatile markets.

Troy Rieck
Managing Director
Capital Markets

Financial market snapshot

Key Market Indicators (as at 31 January 2009)	*FYTD*	*1 Year*	*3 Year*	*5 Year*	*10 Year*
Australian Shares	-30.4%	-34.3%	-6.6%	6.0%	6.2%
International Shares (Unhedged)	-10.1%	-19.4%	-7.7%	0.3%	-2.2%
International Shares (Hedged)	-36.8%	-39.1%	-12.3%	-1.4%	-1.1%
Australian Bonds	13.6%	15.2%	7.5%	7.1%	6.3%
International Bonds (Unhedged)	51.4%	42.2%	13.1%	8.7%	5.2%
International Bonds (Hedged)	9.4%	9.8%	7.7%	7.6%	7.2%
Direct Property (Australia)	-6.3%	-4.8%	9.7%	10.9%	10.1%
Listed Property (Australia)	-40.2%	-51.7%	-19.8%	-5.5%	1.7%
Inflation (CPI)	-	3.7%	3.3%	3.1%	3.1%

ESG Update – encouraging long-termism

QIC is currently determining how we will best integrate ESG into both our corporate operations and investment decision-making across asset classes.

We believe that now is a good time to promote 'long-termism' in investment management, with the global financial crisis highlighting the failings of some short-term attitudes towards company management, asset ownership and investment management. As a relatively new UNPRI signatory (January 2008), we see that the application of responsible investment, as described by the UNPRI, will assist firms in adopting longer-term views, especially as asset owners, fund managers and brokers adopt a similarly aligned outlook.

While it is not required in our first year as a UNPRI signatory, QIC is currently completing the UNPRI 2009 annual survey. This is because we think it is important to publicly demonstrate our support for the PRI, and that our participation will significantly assist our ESG program.

We also continue to answer client queries about ESG-related issues, and are currently completing a number of ESG surveys that our clients have sent to us. This is a great indication of the increasing importance super funds are giving to the incorporation of ESG considerations in investment decision-making practices.

Portfolio rebalancing – an old concept with significant benefits in volatile markets

Troy Rieck, Managing Director, Capital Markets, explains why.

While the concept of rebalancing is not new, the extreme market volatility we have recently experienced has highlighted its importance, particularly in relation to managing risk and ensuring funds stay on track to achieve their long-term investment objectives.

In the second half of 2008, the extreme volatility in global financial markets meant daily movements of 5% to 8% in sharemarkets and currencies were common. In this environment, a portfolio's asset exposures can drift significantly from the desired position very quickly, increasing the risk of sub-optimal fund performance. Portfolio rebalancing programs help manage this risk.

By regularly rebalancing the portfolio to the desired weights, the investment manager can maintain a high level of control over the portfolio outcomes and keep the portfolio on track to meet the fund's investment objectives.

While rebalancing on a monthly basis is a strategy commonly used by funds, it ignores the fact that member cashflows take place on a daily basis, that markets trade on a daily basis, and that the risks associated with asset allocation exist on a daily basis. This is especially true during highly volatile market conditions.

A frequent rebalancing strategy (i.e. rebalancing on a daily basis) offers funds greater risk control and a superior risk-return tradeoff. Funds that employ an infrequent rebalancing strategy may need to rebalance at a time when liquidity is thin or unavailable, as we saw in September and October 2008. This may result in the inability to trade or may force trades to be undertaken at poor prices, reducing the fund's long-term returns.
A frequent rebalancing strategy means that smaller volumes are traded, and therefore funds are not as reliant on the availability of market liquidity. In addition, if trading cannot be undertaken, the risk associated with the unbalanced positions held is smaller (because position sizes tend to be much smaller when frequent rebalancing is undertaken).

A frequent rebalancing strategy also allows gradual buying as markets fall. This means that purchases are undertaken at lower prices, improving the fund's potential future performance. It also mitigates the risk of having a large underweight position in a volatile asset class just before markets bounce back.

Another important consideration is the rebalancing method. The most effective way to rebalance is through the use of derivative contracts, as transaction costs are significantly lower and funds have more flexibility in managing their total effective exposures. On the downside, using derivatives may introduce counterparty risk; however, this can be managed through the use of multiple, highly rated counterparties and the use of exchange traded derivative where practical.

The benefits of rebalancing can vary from fund to fund; but, we do know that a diversified fund will benefit from the care and attention a frequent rebalancing program brings. To find out more about how rebalancing can help you manage your portfolio risk, contact your QIC Relationship Manager or download the full Red Paper from the Knowledge Centre at www.qic.com.