

A quarterly publication from QIC - May 2008

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Message from Doug

Welcome to the first edition of 'The View', our new client newsletter. Each quarter we will keep you up to date with:

- our views on the latest market developments
- my thoughts on the economy
- how QIC is 'going further' for our clients
- our latest thinking on investment issues.

The financial year has been dominated by the 'credit crisis' and the resultant volatility in equity markets. Essentially markets have been reacting to the growing likelihood of a US recession as a result of the 'credit crisis'. The crisis finds its roots in excessive lending practices in the US housing market and subsequent defaults. The flow on effect has seen the world move from an environment of easy credit to extreme caution in lending practices, stifling potential economic growth.

Volatile market conditions such as these always test the strength of our investment systems and processes. I am pleased to report that all our investment teams have managed the volatility in markets very well. In fact, in many cases our portfolio managers have opportunistically backed their conviction by strengthening portfolio positions.

While QIC's Economist will provide you with regular economic updates, in 'The View' I cannot resist sharing with you some of my thoughts on economic matters. What I have found intriguing in recent times is the belief that world commodity prices are set to maintain their meteoric rise. I question the consensus view that the growing demand for commodity-intensive product out of China and India is the primary reason for the rise in commodity prices.

There is no doubt that the rapid pace of economic growth in China and India is creating a growing middle class that is becoming a significant consumer group in its own right. This group is having an influence on the demand for commodities. But, while global growth is good, it is not great. It certainly isn't as strong as it was in the 1950s and 1960s when Japan and Germany were re-industrialising. So demand is growing, but not strong enough in my view to generate the very high commodity prices we currently see.

Also often forgotten is the supply side of the price equation. Currently the global stock of many commodities is at a record low. This is significantly contributing to record high prices. But with high prices comes motivation to get more supply onto the market. This is coming, albeit more slowly than in the past. Evidence of this can be found in the record levels of exploration and development expenditure underway. When the new supply hits the market there will be a

significant dampening effect on current commodity prices with associated flow on effects to the Australian dollar.

I am continually challenging QIC's economists and portfolio managers about their views and analysis. Creating a culture where people are free to express their opinions and are encouraged to challenge others is central to our investment philosophy. At QIC we would also like to challenge your thinking in a constructive way to help you go further for your clients/members and encourage you to interact with and challenge us as well. A regular feature of 'The View' will be articles outlining some innovative ideas for you to consider.

In this issue we look at protecting your fund from inflation and a more comprehensive approach to capturing client investment objectives by using a 'Client Scorecard'.

I hope you enjoy the first issue of 'The View' and I would appreciate any feedback, questions and challenges you have for the QIC Team.



Doug McTaggart
Chief Executive

Email your questions and feedback direct to me at d.mctaggart@qic.com

Economic and market snapshot

The global economy continues to be hampered by ongoing turbulence in financial markets. Equity markets have slumped since late 2007 on concerns about write-downs at major financial institutions and the deteriorating economic outlook, while credit markets remain under strain. Although markets have improved modestly since mid-March, the dislocations in credit markets have widespread repercussions. Global activity is expected to slow markedly to a below-trend pace in 2008, weighed down by a mild recession in the US and weaker growth in other advanced economies. Central banks in the US, UK and Canada have

all lowered interest rates in response to the deteriorating outlook.

Despite the turmoil in global credit markets, the Australian economy grew strongly in 2007, driven by rapid growth in consumer spending. Capacity pressures continued to build, lifting inflation to an uncomfortable level. The Reserve Bank of Australia (RBA) responded by raising rates 25bp in February and March in order to slow demand. Furthermore, major banks raised rates by an additional 30-40bp due to higher wholesale funding costs. Clear signs are emerging that these tighter financial conditions, combined

with a weakening global economy, are slowing domestic demand. Business and consumer confidence has softened in early 2008, while retail sales and housing credit has slowed. Growth in the Australian economy is expected to ease to a below-trend pace in 2008, but remain supported by a further rise in the terms of trade, additional tax cuts and a tight labour market. While inflation is expected to remain elevated in the near-term, moderating demand is expected to gradually dampen inflationary pressures, allowing the RBA to leave rates unchanged for the remainder of the year.

QIC Forecast	Australia			US			Europe		
	Current	Jun-08	Dec-08	Current	Jun-08	Dec-08	Current	Jun-08	Dec-08
Interest rates	7.25%	7.25%	7.25%	2.00%	2.00%	2.00%	4.00%	4.00%	3.50%
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Economic growth	3.9%	2.8%	2.7%	2.2%	1.1%	2.0%	2.6%	1.4%	1.5%

Taking a flexible approach to inflation protection

Sharp rises or spikes in inflation have the potential to significantly erode investment returns. With the potential dark "inflation" clouds on the horizon, QIC has developed an innovative and flexible approach to protecting investments from inflation.

We expect that better targeted inflation protection measures will become an increasingly important aspect of investment portfolio management.

QIC Managing Director of Active Management Susan Buckley says that recent research questions previously held views on hedging against inflation:

"Many investors have previously believed that equities represent a hedge against inflation, yet recent research goes against this thinking," she said.

"Traditional assets such as bonds, equities and property are actually not correlated with inflation spikes over short to medium term periods. Inflation swaps and commodities provide the best hedge against inflation spikes".

"To date investors have used cluster bombs to hit a target (constructing an inflation hedge) and QIC can use laser guided weapons."

The traditional approach for hedging inflation risk is to use inflation linked bonds to generate an income stream linked to inflation outcomes.

Yet there are some significant factors that impact on the effectiveness of Australian inflation linked bonds, as Susan Buckley explains:

"The effectiveness of inflation-linked bonds is impacted by three key factors," she said.

"First, they are difficult to access. Second, using physical assets limits your exposure to the extent that the inflation linked bonds have been issued. For example, currently there are no Australian inflation linked bonds with maturities beyond 2020.

"The final drawback in using physical securities is that they require a 100% capital allocation to achieve the desired exposure. So the only way to increase exposure is through increasing your capital allocation".

Rather than using physical assets, QIC has implemented a strategy to use synthetic securities to provide a more flexible and tailored approach to mitigate the impact on inflation on investment portfolios.

"We can generate better investment outcomes for clients through the use of derivatives called 'inflation swaps,'" Susan said.

"These customised securities provide greater flexibility and capital efficiency.

"In other words, we can generate the same hedging exposure as physical assets but without the same level of capital allocation. This frees up cash to invest in other alpha or beta opportunities," she said.

For further information on this initiative please contact your QIC Relationship Manager or download the Red Paper from the Knowledge Centre at www.qic.com.



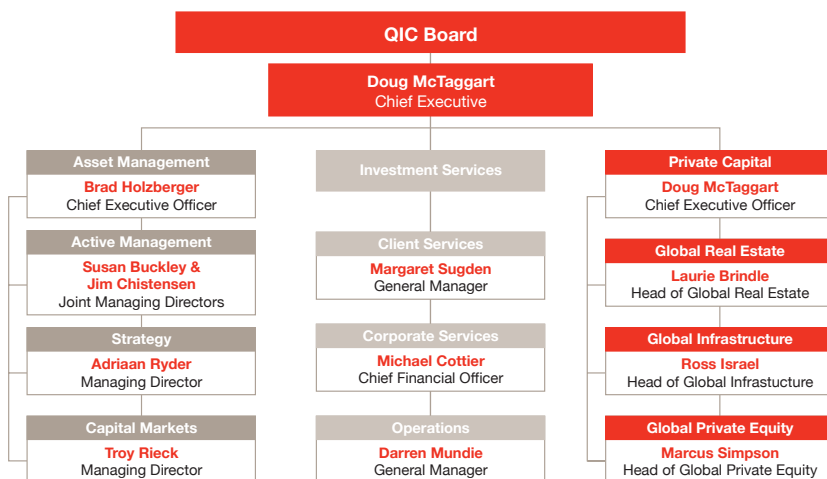
Susan Buckley
QIC Managing Director
of Active Management

New structure drives better investment decisions at QIC

One of the cornerstones of QIC's success is a culture where people are encouraged to express their views and challenge others too. The significant amount of information and idea sharing and collaboration occurring between various asset classes (e.g Australian Equities and Global Fixed Interest sharing their company research from both a debt and equity perspective) led us to review our corporate structure.

The major structural changes to be made as a result of the review are:

- To have three business lines; QIC Asset Management, QIC Investment Services and QIC Private Capital
- The previously separate investment strategy team will now be integrated with all asset-based investment teams and implemented teams in QIC Asset Management
- Within QIC Asset Management, the Global Equities, Global Fixed Interest and Absolute Return Strategies teams are now integrated into the QIC Active Management Division.



How do clients benefit from the new structure?

- Better investment decisions via even more information sharing and better co-ordination
- Even greater continuity of investment services through better management of key person risk and clear career progression paths
- Greater focus of key investment staff on investing and client objectives through a more robust non-investments support structure: QIC Investment Services.

For more detail on QIC's new corporate structure please contact your QIC Relationship Manager.

Getting serious on ESG

In January 2008 QIC signed the United Nations Principles for Responsible Investing (PRI). This commitment will see QIC incorporate environmental, social and corporate governance (ESG) issues in the development of investment strategies.

We did not sign the PRI just to be seen to be 'green'. The commitment to responsible investing reinforces QIC's view that environmental, social and governance issues directly affect clients' investment returns.

QIC has always been strong on governance, and the PRI reinforces our commitment to not just look at 'the numbers', but to further investigate the long-term sustainability of assets and companies from an environmental and social perspective. We believe the impact of issues such as climate change will have significant influence on investment returns. While it will have a negative impact on some industries it will also create new investment opportunities.

The challenge for a recently formed QIC working party is to determine how we best implement the PRI across QIC's range of businesses and investment processes. We'll keep you posted on our progress in future issues of 'The View'.



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Investment Scorecard – a key factor in good fund governance

Together with many consultants and academics, we believe that good (or great) fund governance can provide a strong platform for the delivery of superior risk-adjusted performance. While the role of setting investment objectives to create a strong governance regime is well recognised, QIC has taken this a step further with our multi-sector clients through the development of our Investment Scorecard process.

Drawbacks of the traditional approach

The traditional approach to setting objectives is often fairly imprecise, standardised and generally targeted at matching long-term peer or CPI+ returns. At the same time, funds often have implicit objectives, such as downside risk, that are never clearly expressed or quantified, but are, in fact, important issues for trustees and their members.

QIC's Investment Scorecard approach

An Investment Scorecard provides the trustee, in consultation with QIC, with the opportunity to specify multiple, prioritised and sometimes conflicting goals for the Fund. While each fund will consider different types of objectives depending on their operating environment, aspects such as the level of fees, tax, liquidity and downside risks during market instability are some of the additional areas that might be considered during the Scorecard process.

Once a draft Investment Scorecard is completed, the multi-sector manager or consultant is able to provide clients

with a number of proposed investment portfolios, which might trade-off the probabilities of meeting various priorities. In this way, both proposed objectives and investment portfolios can be varied to find a suitable portfolio that is most likely to meet important objectives.

Practical benefits and potential challenges

QIC Asset Management Chief Executive Officer Brad Holzberger says the Scorecard process is very constructive for trustee Boards.

"The framework allows the range of views and priorities on the Scorecard elements to be constructively debated and agreed by trustees. What you are left with is a clear set of prioritised objectives that address the issues important to the trustees and fund members".

A common dilemma faced by trustees during the process is the trade-off between fees and diversification. The Investment Scorecard modelling often highlights that an exposure to unlisted assets such as private equity, infrastructure and direct property provides significant diversification benefits, particularly during equity market downturns.

The flip-side of investing in unlisted assets, however, is that generally they come with higher fees than listed investments. The process helps trustees come to a robust decision about the level of investments in these types of assets with all relevant facts and implications at hand.

"One of the most important challenges with this approach is that it will more clearly highlight that some objectives may not be achievable in certain conditions", he said.

"For example, there may be times when expected returns from assets are so weak that the ability to generate a CPI+4% return over the next one or three years is very challenging, regardless of investment policy. This may particularly be the case after a period of strong returns from markets or during a recessionary period". "Whilst the recognition of the potential failure of an objective is unpleasant for fund staff, consultants, trustees and members, being more aware of future potential returns must surely demonstrate a higher commitment to fiduciary responsibilities than blindly accepting long term past returns as a guide to the future. A fund is then in a better position to make a more informed decision".

To QIC, this is one of the most important challenges that the adoption of a forward looking Investment Scorecard approach has raised, but we've found the benefits to far outweigh the challenges.

For further information on this initiative please contact your QIC Relationship Manager or download the Red Paper from the Knowledge Centre at www.qic.com.

Financial Market Snapshot

Key Market Indicators (as at Mar 08)	FYTD	1 Year	3 Year	5 Year	10 Year
Australian Shares	-11.8%	-7.0%	13.9%	18.0%	11.2%
International Shares (Unhedged)	-15.7%	-14.6%	3.5%	6.5%	1.2%
International Shares (Hedged)	-13.5%	-7.9%	9.2%	15.5%	4.3%
Australian Bonds	4.0%	4.3%	4.9%	4.7%	5.6%
International Bonds (Unhedged)	11.7%	4.8%	1.1%	-0.9%	3.5%
International Bonds (Hedged)	9.5%	9.0%	6.7%	6.8%	7.2%
Direct Property (Australia)	11.2%	18.6%	16.5%	14.8%	11.8%
Listed Property (Australia)	-24.7%	-22.8%	5.4%	9.8%	9.8%
Inflation (CPI)	-	3.0%	3.0%	2.8%	2.9%