



Investment market update 3 March 2009

(Prepared by Mark Sainsbury, Chief Investment Officer, FSS Trustee Corporation)

The global economic situation remains depressed. For much of last year, the key problem was the “sub-prime” crisis in the US banking and credit system. Now, the main concern is the extent of the economic fallout. The US, Europe and Japan are in recession and the Australian economy appears to be headed along the same path.

The global policy response

The global policy response was, and continues to be, a necessary reaction to the global financial crisis. To date, the policy response has focused on:

A rapid reduction in interest rates. Rates are near zero in the US and Japan and at a record low in the UK. Rates have also fallen sharply in other countries including Australia. From a peak of 7.25% in March 2008, the Reserve Bank cash rate now stands at 3.25%.

Fiscal stimulus including spending increases and tax cuts. The US has announced a massive mix of tax cuts and extra spending, with many other countries announcing similar packages. These packages are aimed at supporting consumer spending and building for the future through new infrastructure.

Unprecedented measures to stabilise the financial system. These measures vary from country to country and include loans to financial institutions, providing funds for credit markets, buying private sector securities, injecting capital into banks, insuring banks against additional losses on bad debts and providing guarantees over bank borrowing.

Will the policies work?

While recessionary conditions are widespread, it is likely that the situation today would be far worse without the measures outlined above. There have been some small signs of improvement, particularly in the US, but economic recovery appears some way off. Any recovery must be supported by much stronger signals including:

- a smaller gap between interbank lending rates and official interest rates
- a rise in bank retail deposits
- improvement in consumer confidence
- a slowing in the pace of US house price declines
- an easing in bank lending standards
- an improvement in credit growth.

More action is needed via fiscal stimulus and measures to get banks lending again. Economic news could get worse before it improves, which may result in a volatile ride for investors over the short term. But there are signs that the policy response is helping and this provides some confidence that growth may start to stabilise later this year and into 2010.

However, if forecasters have deep concerns about the economy, then profitability forecasts for the next 2-3 years may be slow and it may be difficult to support good valuations of assets. Either way, it is far too early to suggest that we've seen the bottom of the cycle.

How does this affect Australia?

Naturally, events offshore affect Australia. Our economy has slowed and profit expectations for 2009 have been lowered, pushing the share market much lower. The Reserve Bank of Australia acted quickly and aggressively by cutting interest rates to their lowest level for many years.

Lower interest rates are designed to boost both the economy and company profits. With RBA cash rates at their lowest level since December 2001, businesses and mortgage holders should benefit through lower





interest payments which should, in turn, help the economy. Furthermore, petrol prices are down and tax cuts are on the way. This should be good news for companies that depend on consumer spending. On top of this, the Federal Government has announced its own extensive stimulus measures.

With bad news grabbing the headlines, the positives are often forgotten. Australia still has many drivers of growth. Population growth is at its highest level for many years, interest rates have fallen to multiple decade lows, tax cuts have been programmed, and stimulus packages will encourage some economic activity. More cuts to interest rates around the world, additional government spending packages and recovery in credit markets could be catalysts for further improvement.

How has First State Super responded?

Negative returns are, unfortunately, a natural part of the investment cycle. While a fund can take some defensive actions to protect against negative returns, it is unlikely that any action would 'save' the investment numbers when the market falls are extremely large, as they have been over the last 18 months. What's more, the falls have been across most asset classes, including parts of the fixed interest market. The only areas that have been something of a 'saviour' for fund returns have been government bonds and cash.

Unless a fund is very liquid (holding a lot of cash) the move to a defensive position can mean forced asset sales at less than satisfactory prices. First State Super is not in this position and has been defensive for some time. This may help the Fund take advantage of opportunities that may arise as part of the recovery.

First State Super has responded to the challenges by keeping its portfolios reasonably liquid, which gives the portfolios some degree of protection and assists the portfolios to respond to opportunities as they arise.

Members should also be aware of their risk tolerances in this environment. Moving to low risk investments like cash and fixed income has been a feature of a limited number of member accounts, but during the early stages of an economic recovery fixed income may not be a strong asset class.

Part of the reason Australian fixed income has been the best performed asset class over the past twelve months is because interest rates have been falling. Fixed income portfolios benefit from capital gains when interest rates fall.

However, the reverse can happen as well – if interest rates begin to rise from their current low levels, then fixed income can generate capital losses. The first sign of any economic recovery may deliver disappointing investment results to those members who thought that they were defensively invested.

The Trustee will try to position the portfolio to guard against this factor, but members who have made the specific choice to invest in fixed income portfolios also need to be on guard about this effect.

The implications and lessons for investors

- **Increased regulation of the financial sector.** The damage caused by the financial crisis may lead to a rise in regulatory oversight of the financial sector globally.
- **More government involvement.** This is already apparent with various governments taking stakes in financial institutions. A big increase in public infrastructure spending is also on the way in China, the US and Australia.
- **'Back to basics' investing.** Investors have lost confidence in new products like bundled mortgage securities underpinned by poor quality loans, and hedge funds claiming to deliver positive returns in all market conditions. We may well see a shift back to more traditional investments like shares, government bonds, cash and direct property/infrastructure.
- **Slower growth in the financial sector.** Greater investor scepticism and more regulation are likely to slow the rate of growth in the financial sector after many years of above average growth.





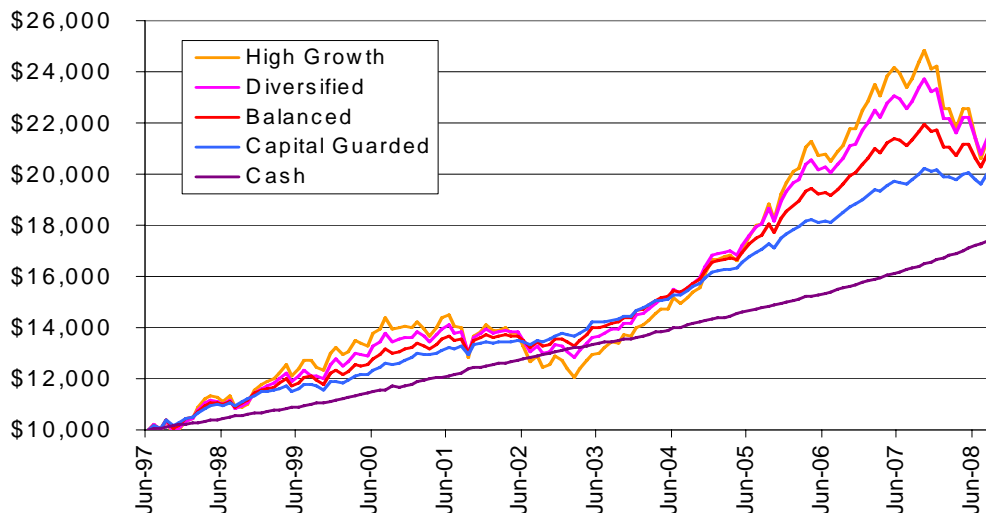
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- **A faster shift in economic power to Asia.** The global financial crisis is likely to accelerate the shift in relative economic power from the G7 countries (which have suffered a loss of global credibility and are likely to be hampered by excessive debt) to Asia.
- **Be aware of the dangers of gearing.** Gearing (debt) is fine when all is going well but can magnify losses if markets move unfavourably. It can also produce big losses if lenders lose their confidence and refuse to roll over maturing debt or when a margin call occurs.
- **The importance of diversification and government bonds.** While listed property and hedge funds have been seen as alternatives to lower-yielding government bonds, they have run into trouble over the last year. Conversely, government bonds have performed well.
- **Think long term and understand your risk profile.** The wild movements in markets over the last year highlight the difficulty for most investors in timing short-term moves and remind us that the best approach is to focus on a long-term strategy. These events also remind us that every investment has **risk**, and you need to understand the impact that certain risk levels can have on your returns and your account balance. As a member of First State Super, you have access to 10 investment options with different risk-return combinations from very conservative cash and fixed interest options through to more aggressive Australian and international share options. We also offer a range of pre-mixed options that hold different amounts of *all* the asset classes. The 10-year performance of the pre-mixed options is shown in the graph below.
- **Get financial advice.** If you want to discuss the most appropriate investment strategy for your personal circumstances, you can talk to an experienced financial adviser from FSS Financial Planning* by calling 1800 665 756.

*First State Super is not responsible for any advice given to you by FSS Financial Planning. Q Invest, trading as FSS Financial Planning, provides financial planning services under its own Australian Financial Services Licence. While the Trustee of First State Super is not responsible for, nor involved in, the provision of financial planning services, the Trustee has retained FSS Financial Planning to provide financial advice to First State Super members relating to their First State Super account.

Growth of \$10,000 in First State Super's pre-mixed strategies from June 1997 to June 2008



The member returns used in the graph above were calculated after tax and investment management expenses but before administration fees. Past performance is not a reliable indicator of future performance and future performance is not guaranteed.

Important note: This communication contains general information only and does not take into account your specific objectives, financial situation or needs. FSS Trustee Corporation recommends that, before you make any financial decision about your First State Super account, including whether to invest in a First State Super product, you seek professional advice from a suitably qualified adviser. The information in this communication is current as at March 2009. This document was prepared by FSS Trustee Corporation ABN 11 118 202 672, AFSL 293340, the trustee of First State Superannuation Scheme ABN 53 226 460 365.