



Investment market update May 2009

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

On 21 April, Reserve Bank Governor Glenn Stevens formally confirmed that Australia is in a recession, adding that there is "no precedent for avoiding one of this size". The US, Europe and Japan are also in recession. This update considers recent developments in light of the global policy response to the economic situation.

Lower interest rates reflect slower growth and subdued inflation

Since the start of the downturn over 12 months ago, interest rates around the world have fallen significantly. In Australia, the Reserve Bank has reduced cash rates from a peak of 7.25% in March 2008 to their current level of 3.00%.

While the International Monetary Fund expects subdued inflation in Australia of only 1.6% this year and 1.3% in 2010, figures for the March quarter show that inflation remains stubbornly high, with a 1.1% increase lifting the annual growth rate to 3.9%. Higher than expected inflation and growth estimates could discourage financial institutions from passing on further rate cuts and could also limit their ability to lend.

And in the US...

The US economy remains reasonably fragile. While the worst may be over in terms of the potential collapse of the banking system, there are still too many issues such as increasing unemployment and its impact on consumer credit and loans to say that all the problem areas have been identified. Moreover, the general market belief that China will lead the recovery may be a little premature. Time will tell, but for the time being, it appears that sentiment may have overtaken reality.

Slow recovery towards end of year, says Governor Stevens

On 19 May, Reserve Bank Governor Glenn Stevens made some interesting comments at the Chamber of Commerce Canada-Australia Breakfast: "Both economies (Australia and Canada) have slipped into recession as international forces have taken hold, albeit through differing chains of causation. But...there are good grounds to think that both countries should be in a relatively good position and well placed to take part in a renewed international expansion. It is too soon to say this is beginning yet, though developments over recent months are certainly consistent with the view that a recovery will get under way towards the end of the year. That said, most observers think that the early part of any new global expansion will be characterised by pretty slow growth."

But have we seen the bottom?

Australian and international share markets have bounced back over the past month. While markets appear keen to resume positive trading, the underlying economic conditions do not point to a sustained recovery just yet. In the US, the unemployment rate rose from 8.1% in February to 8.9% in April.

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 bumpy ride for investors over the short term. But there are signs that the policy response is helping and growth could start to stabilise later this year and into 2010.

However, if forecasters have reservations about the economy, then profitability forecasts for the next two to three years could slow and it may be difficult to support higher asset valuations. Either way, it is far too early to suggest that we've seen the bottom of the cycle.





Does fixed interest offer protection?

In theory, at least, fixed interest is a less risky asset class than shares or property and should offer a greater degree of protection. But during the early stages of an economic recovery, fixed income may not be a strong asset class.

Part of the reason Australian fixed interest investments have performed well over the past twelve months is that interest rates have been falling. Fixed interest investments benefit from capital gains when interest rates fall.

However, the reverse can also happen. If interest rates begin to rise from their current low levels, then fixed interest investments will incur capital losses. The first sign of any economic recovery – which could push up interest rates – may well deliver disappointing investment results to those members who thought 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 interest portfolios should be aware of this possibility.

How has First State Super responded?

First State Super has responded to the challenges by keeping its portfolios very **liquid**, which means holding reasonably high levels of cash. This gives our investments some degree of protection and allows us to respond to investment opportunities as they arise.

Low and 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, but with the increased fiscal deficits, government bonds once again become marginally attractive investments.

Unless a fund is 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 could arise as part of the recovery.

Mark Sainsbury
Chief Investment Officer

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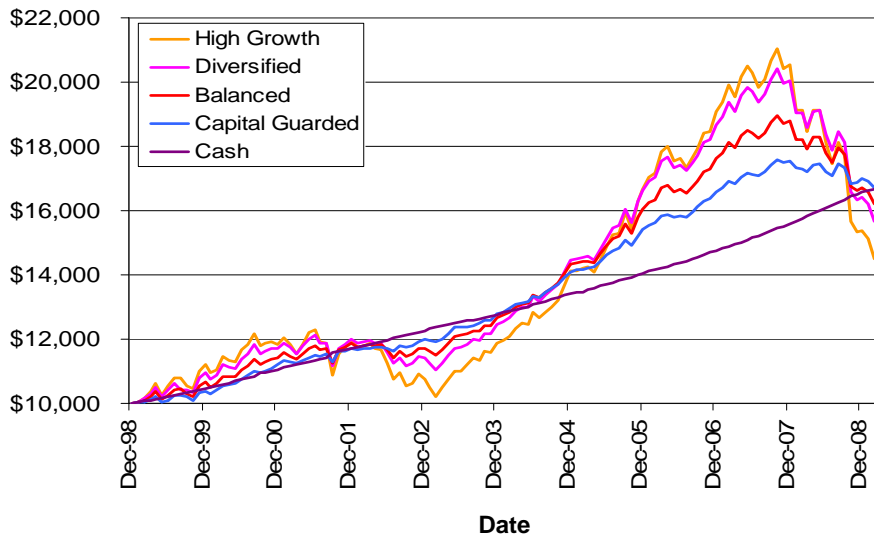


Fund update - including questions (and answers) commonly asked by members

(This section is for current members of First State Super only)

Growth of \$10,000 invested in the First State Super pre-mixed and cash investment options December 1998 to March 2009

Investment value



The chart shows the movement in the value of \$10,000 invested on 31 December 1998 in the First State Super pre-mixed and Cash investment options. The returns used in the graph 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.

First State Super's single asset class investment options* (with the exception of the Cash option) have not been included in this chart because they were not launched until October 2006. The Cash option was called Cash Plus until October 2006, when the name was changed to Cash to reflect a small adjustment to the asset allocation. Previously, the asset allocation for the Cash Plus investment strategy was 100% cash and short term income producing assets, including 15% investment in one or two year bonds. This was changed to 100% cash and short-term income producing assets with a duration of up to one year.

* the full range of single asset class investment options are Australian Equities, International Equities, Property, Australian Fixed Interest, International Fixed Interest and Cash.

Members at our seminars are asking the following types of questions about the graph

1. Given that the First State Super Cash and Capital Guarded investment strategies are currently doing better than, say, Diversified, should I switch to Cash or Capital Guarded?

Generally, over the longer term, the High Growth, Diversified and Balanced investment options offer higher average returns than the Cash and Capital Guarded options, although the returns tend to be more volatile and even negative in some years. The higher returns and higher volatility reflect the higher proportion of **growth** assets such as shares and property that the High Growth, Diversified and Balanced options hold. The Cash and Capital Guarded options, on the other hand, hold mainly defensive (income) assets such as cash and fixed interest investments. Over the longer term, growth assets such as shares and property tend to outperform defensive assets such as cash and fixed interest.

However, over the short term, the returns from growth assets can fluctuate quite significantly, as we have seen over the past 18 months. As a result, cash and fixed interest investments are currently performing better than share and property investments and members are asking whether they should switch to Cash or Capital Guarded.





The answer to this question depends on your personal circumstances and tolerance of risk:

If you have a lot of time until retirement, you may feel that you can ride out the current turbulence in investment markets and remain in an investment option that has a higher proportion of growth investments. But you also need to understand that growth investments can be very volatile in the short term and your account balance may go up and down quite often.

There is something called *dollar cost averaging* that can work in your favour when investment returns – and therefore, unit prices – fall. The value of your investment in First State Super is represented by a number of units. When earnings are positive, the unit price goes up, and when earnings are negative, the unit price goes down. These unit prices are adjusted every day, depending on what happens in the investment markets.

When the unit price falls, you can buy more units for the same dollar investment. For example, if the unit price falls from \$2.00 to \$1.50, then an investment of \$100 will buy you 67 units rather than 50 units. Adding money to your super account when the unit price is lower allows you to buy more units which will potentially have greater value when markets recover.

If you have some time until retirement. Even if you are in your fifties, you may have twenty years or more until retirement. Typically, this is ample time for investment markets to recover so you may feel comfortable remaining in an investment strategy with higher exposure to growth investments. But, just like your 30-year-old colleagues, you also need to understand that if your superannuation is invested in growth investments, then there is a very good chance that your account balance will fluctuate. Of course, the longer you have till retirement, the more time markets have to recover and the more time you have to top up your account. Conversely, the closer you get to retirement, the more cautious you should be with your investment choice because any sudden market fall could leave you without enough time for recovery.

You have retired or you are going to retire in the very near future. This is a difficult time for members who have retired and members contemplating retirement. In the current environment, your superannuation account balance may be constantly fluctuating when what you really want is some degree of certainty about the amount of money you will have in retirement.

So in some respects, you have competing financial objectives. On the one hand, you want certainty about how much money you will have for retirement (which means more conservative investments) but on the other hand, you want to know that your nest egg will grow enough to provide a reliable income stream for many years (which means more aggressive investments).

Once again, the decision ultimately depends on how comfortable you are seeing your account balance frequently going up and down.

Each member's personal circumstances and financial objectives are different, so we recommend that you seek financial advice. Members of First State Super have access to personalised financial advice through FSS Financial Planning*.

2. I am already invested in a First State Super investment strategy such as Cash, Capital Guarded, Australian Fixed Interest or International Fixed Interest. Should I stay there?

The answer depends on:

- When you expect to withdraw your superannuation
- If you intend to withdraw your money soon, then you probably want greater certainty about how much money will be in your account when you do access it
- If you have more time before you withdraw your super, you could be more concerned investing too conservatively and missing any upswing in the investment markets
- How comfortable you feel with regular fluctuations in your account balance.

Whatever your answers to these questions, every member's personal circumstances and financial objectives are different, so we recommend you seek financial advice. Members of First State Super have access to personalised financial advice through FSS Financial Planning*.





FIRST STATE SUPER

FSS Trustee Corporation
ABN 11 118 202 672 AFSL 293340

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