



Chairman's message



Arun Abey provides a perspective on the current investment climate.

In volatile markets, wealth transfers from weak hands to strong hands. Now is a time for strong hands.

Recent turmoil in financial markets has caused concern to many investors. Share markets worldwide have fallen heavily, significantly impacting portfolios, and confidence in the US financial system is weak. It is not every day that major investment banks go broke.

Financial decisions in a downturn can impact our wellbeing for years to come. We can't control markets but we can control how we respond. Here we try to make sense of the turmoil and how to get through to better times.

How did it come to this?

Share markets, jumpy for 12 months, recently fell further and some are now well off their highs. The issues are complex but the cycle is simple:

1. Low interest rates and slack lending policies make home loans freely available. This works fine while house prices rise.
2. US house prices have fallen, up to 15%-20% in some areas.
3. Many borrowers can't repay loans.
4. Portfolios of mortgages held by investment banks and other institutions plunge in value. Some firms that are over-exposed, and have too much debt, go under.
5. Confidence disappears – a classic “credit crunch” ensues.

Casualties have included Bear Stearns, Lehman Brothers, mortgage providers Fannie Mae and Freddie Mac, and American International Group (AIG). Merrill Lynch fast tracked its sale to Bank of America to avoid a similar fate. The US government has acted swiftly, bailing out some and proposing a \$700 billion fund to help others. Their aim is to prevent a Wall Street event from causing a deep recession.

While this is a real possibility, there are also some pluses to note – lower oil prices, lower mortgage interest rates, and globally co-ordinated government action among them. The world economy has been resilient and remains so.

ipac itself has not been impacted by the issues facing the big US financial firms (mostly investment banks, that failed). We have no exposure to these sorts of loans and our assets far outweigh any debt. Most importantly, investments in managed funds are held on your behalf by a custodian. They never form part of our assets and unitholders keep beneficial ownership.

what is ipac doing?

In the past 25 years, we've guided investors through six downturns, each one different. The truth is we know only one sensible way to get through such a difficult period: stay well diversified, ignore "noise" as much as possible and get good advice. Here's some of what we're doing to manage portfolios:

- ~ **staying diversified.** While diversified portfolios have lost ground, because we maintain a wide range of investments even disastrous results like Lehman Brothers and AIG have had a small effect. For example, our balanced portfolios had a 0.20% exposure to AIG in August. For a \$1000 investment, this is \$2.00.
- ~ **managing to long-term asset allocations.** The evidence of history is that knee-jerk reactions like major switches to cash when share markets fall heavily are very costly. Moving to cash will mean losses are locked in. Any potential to re-coup these losses has gone.
- ~ **rebalancing.** We continue to rebalance between different investment types so we routinely buy asset classes that have fallen in value, and sell those that have risen this effectively means that over time we consistently buy cheaper assets and lock in the profit of more expensive ones.
- ~ **reviewing and appointing new fund managers.** Recently we appointed Arrowstreet Capital and Enhanced Investment Technologies to your international shares portfolio. We constantly monitor managers and stress-test their investment processes to ensure these processes remain valid.
- ~ **uncovering opportunities.** Good investments usually emerge from periods like this. Banks that make it through will be better regulated and may end up with fewer competitors. One of the world's best known "value" investors, Warren Buffett, recently pumped around \$5 billion into US investment bank Goldman Sachs, suggesting he thinks it is undervalued. Compelling opportunities are likely to emerge but risks will also need to be closely managed.

Everyday companies haven't stopped performing well just because markets are down. **Woolworths** has strong earnings and growth potential. Their strong full year profit results and revenue growth were better than expected and, despite the current gloom, their long-term earnings and dividend potential is intact.

Coca Cola Amatil is another well-known brand listed on the local share market with solid long-term prospects. It's been a strong performer, a result of selling more drinks at higher prices. People are still drinking.

Commonwealth Bank is a household name and is a well-diversified bank, one of the largest in Australia. It has benefited from its broad retail base and lower exposure to sub-prime mortgages compared to its US counterparts.

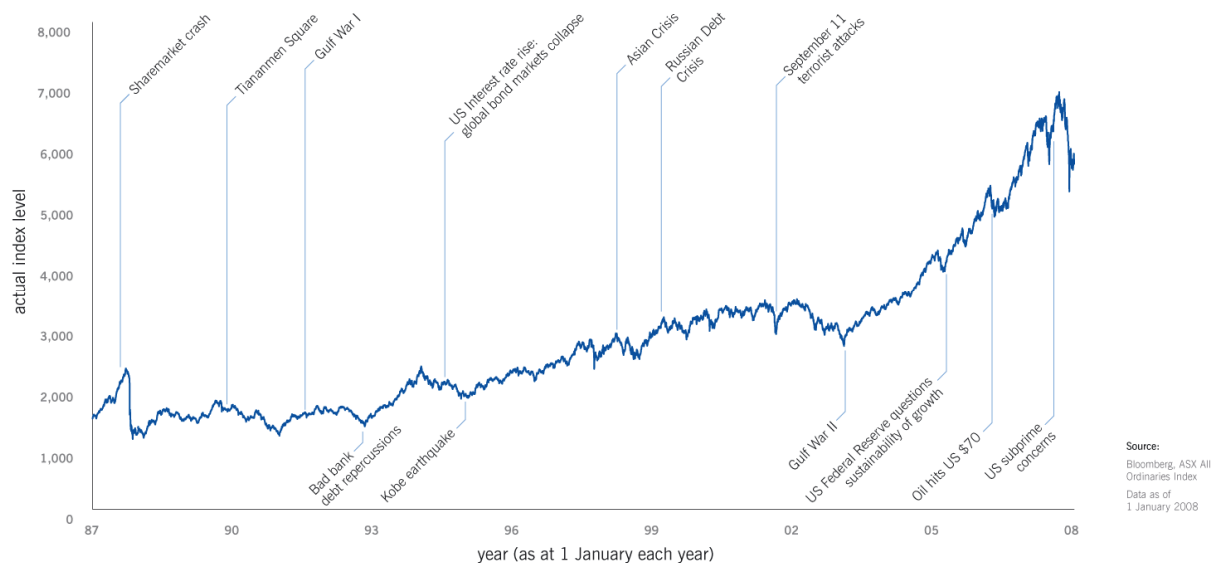
There will be winners from the current turmoil in global financial markets. **Lloyds TSB**, is a large and stable UK bank with a diversified business model and broad retail base. They have purchased HBOS (Halifax Bank of Scotland) who was impacted by the current crisis. Lloyds were previously prevented from similar acquisitions. Lloyds will eventually profit from increased market share and improved efficiencies. Similarly **Citigroup** has bought the banking operations of US financial services company, Wachovia. Buying the 4th largest bank in America makes Citigroup one of the three dominant forces in US banking. These three banks – Bank of America, JPMorgan Chase and Citigroup, can use their strong positions to improve business performance.

what does history tell us?

Most forecasts of market direction are worth less than the paper they're written on. But there are typical market behaviours during and after most downturns:

- ~ **it's different (and the same).** Every downturn is different but financial institutions have failed before. The system normally emerges stronger but never foolproof.
- ~ **markets typically do recover.** When markets have fallen sharply – the 1987 crash, Dot Com Bubble, 1970s oil crisis and so on – they have typically recovered. Sometimes recovery is surprisingly quick, other times it takes years. Only those who are invested participate in the return.

performance of Australian share market, 1987 – 2008

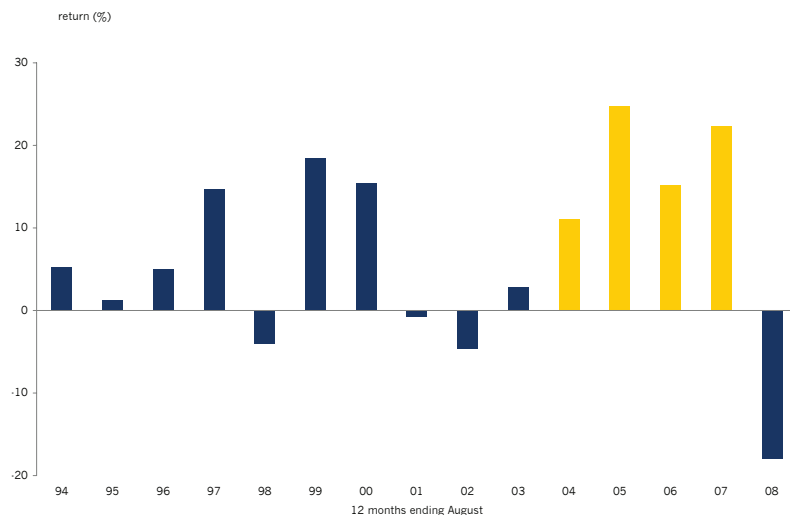


long-term investors ride the ups and downs

- ~ **recovery may come without warning.** No-one holds up a big sign saying “market recovery”, so parking too much in cash may mean missing a rebound. Markets often recover from a downturn six to nine months before the economy.
- ~ **markets are cheaper post-fall.** At times like this, good stocks are thrown out with bad. Currently share prices in many markets are below long-term averages. A combination of fair economic conditions and lower prices sets up diversified portfolios to deliver reasonable returns in the coming years.

what can you do?

~ **keep perspective.** While the last year has been tough, even including this poor recent performance, the past five years have still been good in many markets. The table below shows that shares have a very good track record of recovery in the year following a downturn.



source: Bloomberg – S&P/ASX 300 Index

- ~ **try not to be affected by daily news.** We don't attempt to downplay the very real challenges facing markets in the period ahead, but reacting to daily news may be a bigger threat to long-term success than a fall in the market.
- ~ **remember why you did, what you did.** At some point in the past with the help of a financial adviser you established a portfolio to assist in supporting the life you want to live. Unless you've changed your goals, think very carefully – and consult your adviser – before changing your portfolio.
- ~ **be careful how you use cash.** Cash is fine for the short-term. But as a long-term investment, it's likely it will not support the lifestyle you'd otherwise enjoy. Switching to cash in a downturn may simply close the door to an eventual recovery.
- ~ **get good advice.** If advice is important in good markets, in tough times it's essential. Work with your adviser so you make the right choices.

Finally, the current turmoil will most likely pass. We don't know when (no-one does for sure) but our research and experience suggests it will happen.

You may be interested in reading more from my colleague, Paul Clitheroe, who has posted his latest insights on www.ipac.com.au or reading reports from some of our fund managers.

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